RESTATEMENT OF THE LAW THIRD

THE AMERICAN LAW INSTITUTE

RESTATEMENT OF THE LAW

PROPERTY

Mortgages

As Adopted and Promulgated

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INTRODUCTION

This Restatement deals with transactions in which real property is employed as security for some obligation. In these transactions there are typically two documents. One represents the obligation itself, and is usually a promissory note, bond, or contract. The other is a conveyance or retention of an interest in real property to secure the obligation. It is most commonly called a mortgage, but in some locales and circumstances it may be termed a deed of trust, security deed, contract for deed, installment contract, or even an absolute deed. In general this Restatement treats all such security devices alike, and refers to them as mortgages.

The American Law Institute has never previously adopted a Restatement of the law of real property security. This seems surprising in light of the obvious importance of this body of law. Several factors may explain it. One is the heavy statutory control of the law in most jurisdictions. Another is the degree of variation in court-made legal rules from one state to another, particularly with respect to such mortgage substitutes as installment land contracts and absolute deeds.

This lack of uniformity may have been only a minor inconvenience in an earlier era; today it is a serious obstacle to the nation's economic well-being. The reason is the vast expansion in the flow of funds across state lines for real estate financing purposes. The mortgage market, which 30 years ago was almost entirely local in nature except for the Federal National Mortgage Association's trading in FHA and VA loans, has become truly national in scope. Mortgage loans, and securities and debt instruments collateralized by mortgage loans, are constantly traded across state lines in vast volumes. In addition, it has become common for lenders that originate mortgage loans to transfer their servicing rights to other entities, often in other jurisdictions.

All of this is a result of a conscious national policy to facilitate the flow of credit to the areas and borrowers where it is needed. In general this policy has been a remarkable success. But there can be no doubt that legal differences from state to state act as a serious impediment to the carrying out of these business arrangements.

A major goal of this Restatement, then, is to assist in unifying the law of real property security by identifying and articulating legal rules that will meet the legitimate needs of the lending industry while at the same time providing reasonable protection for borrowers.

INTRODUCTION

Lenders in the United States have made use of a variety of real estate security devices. The oldest, of course, is the mortgage, a legacy of medieval England, and its virtual twin, the deed of trust. Other devices include the absolute deed as security, the contract for deed, and the "negative pledge." Lenders developed these instruments because they felt dissatisfied with the mortgage, either because its foreclosure procedure was considered unduly cumbersome or because the substantive protection provided to borrowers was considered excessive. The result has been a plethora of devices and a corresponding profusion of legal uncertainty in most jurisdictions. The picture is not a tidy or an efficient one.

This Restatement proceeds on the premise that only one real property security device is necessary. It is here referred to simply as a mortgage, since that term has history on its side. If the rules governing the mortgage are efficient, flexible, and equitable to both borrower and lender, there should be no need for the invention or perpetuation of other devices, and this Restatement in effect encourages their eradication by the courts and legislatures. The goal is a unified body of law that will govern real property security instruments, irrespective of the name given them by their signatories.

Protection for borrowers. The courts have developed two fundamental rights for mortgage borrowers that are preserved in this Restatement. The first is the mortgagor's equity of redemption, which arose in the English equity courts during the 16th century. It is in essence the right of a borrower, although tardy in payment, to redeem his or her land by paying the debt prior to some fixed date established by the court—literally, the date of "foreclosure" of the right of redemption. This right continues to exist in every American jurisdiction. Where nonjudicial foreclosure is employed in the United States, the date is typically established by a statute providing a fixed number of days from the service or recording of a "notice of default" by the mortgagee. But whether set by court order or by statute, the principle of the equitable right of redemption is generally considered an element of fundamental fairness to borrowers, and is fully recognized and endorsed by this Restatement.

A corollary of equal importance is the prohibition on the "clogging" of the equitable right of redemption by a mortgage clause or contemporaneous agreement. The borrower's right to continue to hold an interest in the real property until it is foreclosed, and to redeem until foreclosure occurs, cannot be waived or impaired when the loan is made. That principle, too, is preserved in the Restatement.

A second basic right of borrowers, developed in the American courts and nearly universally recognized today, is the right to any surplus generated by a foreclosure sale. In England foreclosure was originally "strict," with the lender simply retaining title to the land if the borrower did not redeem prior to foreclosure. But in the United States nearly all states today employ a process of foreclosure by auction sale. In theory, at least, the sale serves two functions simultaneously: It establishes a current value for the real estate, and it acts as a marketing device, liquidating the security and transferring title to some new owner.

There is much to criticize in presently employed procedures for foreclosure by sale. One can well argue that, while attempting to combine the two functions mentioned above, foreclosure by sale manages to perform neither task very well, and serves both borrowers and lenders inadequately. However, the foreclosure process is defined by statute in nearly all American jurisdictions, and hence is beyond the direct reach of a Restatement. Still, the fundamental right of the mortgagor and other junior interest holders to surplus—that is, to have the property's value established, and to receive payment of that value insofar as it exceeds the debt plus accrued interest, foreclosure expenses and costs—is and must be recognized.

Moreover, the right to surplus, like the equity of redemption itself, is regarded in the Restatement as nonwaivable in the mortgage or contemporaneous documents. While this principle is widely recognized today with respect to formal mortgages, it is by no means universally agreed to apply to certain mortgage substitutes, such as the installment land contract. Since the Restatement, as mentioned above, regards all real property security devices as mortgages, its effect is to ensure all debtors (including purchasers under installment contracts) a right to return of the surplus value of their property.

It is frankly recognized that these two principles, the right of redemption and the right to surplus, are restrictions on the parties' freedom of contract. They have been justified for hundreds of years by the view that borrowers are often necessitous and incautious, and that they will frequently agree to exceedingly improvident arrangements in order to secure the funds they need. This is, of course, a generalization to which countless individual exceptions might be found, but it contains an important element of truth.

One might, for example, propose a regime under which individual borrowers (or consumers, or "protected parties," or the like) have the benefit of these principles, while corporate borrowers (or businesses, or commercial borrowers, or "non-protected parties," or the like) do not. While there may be some contexts in which such a distinction has great value, the Restatement's view is that the twin rights to foreclosure and to surplus should be protected for all borrowers against waiver at the inception of the mortgage transaction. There can be little or no social utility in a legal rule that permits lenders to cut off borrowers' rights precipitously, or to gamble that the property may have surplus value in excess of the debt and all expenses and to snap it up if it exists. Real property security should be just that—security—and not an opportunity for the lender to realize a windfall profit as a result of the borrower's default. Of course, this protection of individual borrowers comes at a cost to borrowers generally. Precluding lenders from garnering the windfall of the borrower's equity is inevitably reflected in higher borrower costs for all mortgage loans. Still, the protection is amply justified because it serves to restrain the often oppressive bargaining power lenders exercise over borrowers.

On the other hand, these principles of borrower protection should not unnecessarily inhibit the creativity of borrowers and lenders in developing new and socially useful forms of financing transactions. For example, the Restatement draws a sharp distinction between devices such as the option to purchase when employed as a default remedy, and similar devices when used outside the default context to provide an investment return to the lender. When sophisticated parties create novel and untried loan arrangements in order to allocate the economic benefits of a transaction by careful negotiation and full agreement, the law should be most reluctant to stand in their way unless a clear violation of public policy would otherwise ensue.

The Restatement's subject matter. A good deal of the Restatement is concerned with the enforceability of mortgages. Hence it must be recognized at the outset that numerous doctrines not uniquely or directly related to mortgage law may render a mortgage unenforceable. Examples of these doctrines include the Statute of Frauds, the operation of the recording acts, the principles of fraudulent transfers, the Bankruptcy Code, and the rules governing validity of transfers by such artificial entities as corporations, trusts, and partnerships. Except as specifically noted, the Restatement does not concern itself with these doctrines, and its commentary and Illustrations assume that the mortgage in question satisfies their demands.

On the other hand, there are numerous legal doctrines so closely related to mortgage enforcement that treating them to some extent in this Restatement was unavoidable. They include such equitable concepts as restitution and subrogation. See §§ 5.1–5.3, 7.6. In addition, since mortgages exist only to secure other obligations, it has been necessary to deal in some measure with the law of negotiable instruments and the general principles governing enforceability of promissory notes and other contracts. See, e.g., §§ 1.2–1.5, 5.4–5.5, 6.1–6.4, and 8.2.

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Since mortgages are conveyances of interests in land they must meet the requirements of conveyancing law. Thus in a mortgage the parties must be identified, the real property must be described adequately, words of conveyance must be used, and there must be a delivery and acceptance. Since these demands are not unique to mortgages, they are not specifically mentioned in the Restatement, but are assumed to apply throughout.

In many jurisdictions, numerous aspects of mortgage law beyond the foreclosure process are governed by statute. Such statutes commonly cover mortgage formalities, foreclosure procedures, surplus distribution, deficiency judgments, future advances, limitations periods, and other matters. Where statutory schemes of this sort exist, they will, of course, prevail over any conflicting provisions of this Restatement. Restatements are not often cited directly in the legislative process, but it is nonetheless hoped that this work will assist legislators in refining and improving existing statutes. For this reason the Restatement frequently includes comments addressed to statutory issues.

A final word on terminology may be helpful. The Restatement constantly employs the words "mortgagor" and "mortgagee." These terms refer to the original parties to a mortgage transaction, of course, but they also comprehend the successors in interest of those parties. It would have been cumbersome to speak so frequently of "the mortgagee and/or its successors in interest" or the like. Hence the reader must understand that the words "mortgagee" and "mortgagor" include successors whenever the context so requires, and that successors are treated like their predecessors in interest except when the doctrines of Chapter 5, which deal specifically with transfers of interest, require a different result.

FOREWORD

The real-estate mortgage is a basic legal device of a social order predicated on private ordering through ownership of property and formation of contracts. Real estate is a fundamental form of property and has been since the beginning of sedentary civilization. The real-estate mortgage is a primary mechanism for extending credit, both for purchase and development of real property and for financing other ventures. It therefore is and long bas been a fundamental institution of the common-law system.

The mortgage law of today, being of ancient derivation, is encrusted with technical anachronisms. Many of these complexities are the result of the law's oscillations in trying to maintain the basic balance required in this field: on the one hand, seeking to assure firm security for the creditor who advanced money; on the other hand, restraining creditors from exacting exploitive concessions from needy borrowers. As pointed out in the Introduction, this is the balance involved in providing adequate remedies for the mortgagee but still protecting the mortgagor's equity of redemption.

The matter of credit based on real property mortgages is also socially and politically sensitive. This sensitivity is reflected in the pervasive legislative interventions. These interventions have also oscillated in trying to maintain a proper balance between the conflicting objectives of mortgage law. Indeed, some technical complexities can be traced through cycles of interaction among judicial precedent, conveyancer ingenuity, and legislative response. Modern legislation in the form of codification has sought once again coherent reconciliation. However, legislative reform has not been uniform or constant, so that there is continuing need for clarifying judicial resolutions of various issues. Hence, the need for this first effort by the Institute to restate the law of mortgages.

As perusal of the text will demonstrate, the Reporters, Professors Nelson and Whitman, are fully conversant with these issues of policy, economics, history, and legal technicality. They have brought their scholarly mastery to bear on the hasic substantive concepts, remedies and defenses, and rights of third parties, as well as on other types of transactions that are recurrently relevant as a practical matter. Among the latter are those when the mortgaged property is destroyed or damaged and questions arise concerning rights to insurance proceeds; when the property is taken, in whole or in part, by eminent domain; and when the primary value of the property results not from occupancy by the mortgagor but from rents payahle by tenants. Thus, the Reporters have framed the scope of their undertaking in terms of practical contemporary issues and not merely of classic legal concepts.

The product of the endeavor is skillful formulation of common-law rules informed by appropriate deference to prevailing legislative mandates and thoughtful social and economic analyses. We express our gratitude to the Reporters for their mastorful and efficient performance. We also recognize and express appreciation hoth to the Advisers and to the Members Consultative Group, wbo provided continuous critical review and innumerahle helpful suggestions.

GEOFFREY C. HAZARD, JR.
Director
The American Law Institute

January 23, 1997

CHAPTER 1

CREATION OF MORTGAGES

Introductory Note: This Chapter deals with the formalities of mortgage creation and function. Its principal goals are to eliminate unnecessary barriers to the creation of valid mortgages and to clarify certain of mortgage law's minimum requirements.

Sections 1.1 through 1.3 are intended to establish that no personal obligation is necessary to the validity of a mortgage, that consideration is not required for a mortgage itself (although the absence of consideration may render the underlying obligation unenforceable), that gift mortgages are valid, and that preexisting obligations may be secured by mortgages. Additionally, the obligation secured by a mortgage need not be that of the mortgagor, but may be owed by another person.

Sections 1.4 and 1.5 state certain elements that are essential to mortgage validity: The mortgage must secure an obligation that can be reduced to monetary value, and the mortgage itself must identify the person by whom it is initially held.

Section 1.6, while not dealing directly with mortgage creation issues, bears heavily as a practical matter on the making of many mortgage loans. It expresses a duty on the part of a mortgagee to provide information about the obligation's balance and status to those who have an interest in the real estate. Providing this information is necessary to facilitate payment of the obligation, as well as the consummation of real estate sales and subordinate loans in which an existing mortgage will remain on the realty.

§ 1.1 The Mortgage Concept; No Personal Liability Required

A mortgage is a conveyance or retention of an interest in real property as security for performance of an

obligation. A mortgage is enforceable whether or not any person is personally liable for that performance.

Cross-References:

Section 1.2, No Consideration Required; § 1.4, Obligation Must Be Measurable in Monetary Terms; § 3.2, The Absolute Deed Intended as Security; § 3.3, The Conditional Sale Intended as Security; § 3.4, A Contract for Deed Creates a Mortgage; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage.

Comment:

The function of a mortgage is to employ an interest in real estate as security for the performance of some obligation. The principles of this Restatement apply irrespective of the precise form of the mortgage. It may, for example, be styled a deed of trust or a deed to secure debt. The historical form of mortgage in England, and in some American jurisdictions, was a conveyance by deed containing a defeasance clause that provided a right of reentry in the mortgagor upon full performance of the obligation the mortgage secured. Such a mortgage form continues to be permissible under this Restatement, but it is not the only or preferred form. In many jurisdictions today it is customary to employ a form that gives the mortgagee a lien or security interest. This, too, is "an interest in real property" as that phrase is used in this section, and is entirely acceptable to create a mortgage. Under appropriate conditions an absolute deed or conditional sale may be regarded as a mortgage under §§ 3.2–3.3. Under this Restatement, whether the document purports to transfer legal title or merely to create a lien or security interest has no significant consequences; all forms of mortgages are treated alike.

In most cases the mortgage takes the form of a conveyance executed by the owner of the real estate to the secured party. Sometimes, however, the owner simultaneously conveys a possessory interest in the real estate to a purchaser and retains a security interest in it as collateral for payment of the purchase price. This is generally the case with a contract for deed, which is treated as a mortgage under § 3.4.

Unless it secures an obligation, a mortgage is a nullity. Most often the obligation is the payment of money under the terms of a promissory note or other debt instrument, although many other forms of obligation may also be secured; see § 1.4. Commonly the mortgagor or some other person is personally liable for performance of the obligation in question. If this is the case, then in the absence of some statutory restriction the mortgagee may proceed either by foreclosure of the mortgage or by means of a personal action against the party liable; see § 8.2. However, it is not unusual for the parties to the mortgage to agree that there shall be no personal liability for the performance, or that personal liability is to be limited. This is often termed a "nonrecourse" or "limited recourse" mortgage. If personal liability is entirely excluded by the parties' agreement, the effect is to restrict the mortgagee's remedy for nonperformance to foreclosure of the mortgage. Such a restriction or exclusion of personal liability does not impair the enforceability of the mortgage by means of foreclosure, but it does limit or bar the mortgagee's access to both a personal judgment prior to foreclosure and a deficiency judgment following foreclosure.

Terms that limit or eliminate the mortgagor's personal liability may be found in either the note or the mortgage. No special formula need be employed, and any words reasonably expressing an intent to limit or eliminate the mortgagor's liability will have the effect of doing so. However, unless the note itself sets out the limitation of liability, if it is negotiable in form it may be enforceable personally against the maker in the hands of a Holder in Due Course, notwithstanding the contrary language of the mortgage; see U.C.C. § 3-305(b) (1995).

While personal liability is not essential to the validity of a mortgage, the existence of such liability may be relevant in determining whether a document that is not a formal mortgage, such as an absolute deed coupled with a contract to repurchase, should be treated as a mortgage as between its parties; see § 3.3.

Illustrations:

1. Mortgagor borrows $100,000 from Mortgagee and executes a promissory note for that amount and a mortgage on Blackacre to secure the debt. The note states "borrower shall not be personally liable for this debt or for the covenants in the mortgage securing it." Subsequently Mortgagor defaults in payment of the note. The quoted language is enforceable. Mortgagee may foreclose the mortgage but may not obtain a personal judgment against Mortgagor, either prior to foreclosure or for a deficiency after foreclosure.

2. The facts are the same as Illustration 1, except that the mortgage and note state "Mortgagee shall look solely to the real property for full satisfaction of this debt." The result is the same as in Illustration 1.

3. The facts are the same as Illustration 1, except that the note and mortgage in question contain covenants by which Mortgagor promises to pay taxes and perform maintenance on the property. Mortgagor fails to perform these duties. The result is

the same as in Illustration 1. Mortgagee may not obtain a personal judgment against Mortgagor on a theory of breach of contract.

4. The facts are the same as Illustration 1, except that the mortgage described is junior in priority to another mortgage. The prior mortgage is subsequently foreclosed, eliminating Mortgagee's mortgage. The result is the same as in Illustration 1. The fact that Mortgagee's security has been destroyed does not warrant a different result.

5. The facts are the same as Illustration 1, except that the note states "Mortgagor's personal liability, including both principal and interest, shall be limited to $40,000, and Mortgagee agrees to look solely to the real property for satisfaction of the remainder of this debt." Mortgagor in fact pays $60,000 toward the principal balance owing on the debt and then defaults. The result is the same as in Illustration 1.

6. A is the developer of a residential subdivision in City B. Under a municipal ordinance, City B requires A to provide an undertaking, with security, that the streets in the subdivision will be paved to City B's specifications. A gives City B such an undertaking, and secures it with a mortgage on Blackacre, land which is unrelated to the subdivision. The undertaking does not impose personal liability upon A. If A does not complete the streets as required, City B may foreclose the mortgage, notwithstanding the fact that A has no personal liability.

REPORTERS' NOTE

This section recognizes that limitations on the mortgagor's personal liability are often useful and desirable from the parties' viewpoint, and that there is no sound policy basis for discouraging such limitations.

For example, when a limited partnership holds real property subject to a mortgage, the limited partners normally desire to allocate the basis in the property among themselves in proportion to their shares of the partnership's profits. If they can do so, they can thereby increase their bases in their partnership interests and thus the losses they can deduct. However, if the property is subject to recourse mortgage debt the Internal Revenue Code generally permits this allocation only to the extent that the limited partners themselves bear the economic risk associated with that debt (such as through additional required capital contributions). Hence, as a practical matter in most instances the limited partners may have the basis allocation they desire without the economic risk only if the mortgage is nonrecourse. See I.R.C. §§ 704(b), 752; Treas. Reg. § 1.752-3. This rule has encouraged widespread use of nonrecourse mortgage financing by limited partnerships engaged in income-producing real estate development or operation.

While no personal liability is necessary to a valid mortgage, it is essential that the mortgage secure some obligation. See In re Janis, 125 B.R. 274 (Bankr.D.Ariz.1991), reversed on other grounds, 151 B.R. 936 (D.Ariz. 1992) (if an obligation is deemed invalid or unenforceable, the security given for that obligation will also fail); County of Keith v. Fuller, 452 N.W.2d 25 (Neb.1990) (mortgage is a nullity if it secures no obligation). Similarly, if the obligation is unenforceable, for example, because it was procured by fraud or is a forgery, the mortgage is likewise unenforceable. See, e.g., Dodd v. Harper, 670 S.W.2d 646 (Tex. Ct. App. 1983) (mortgage unenforceable where note was never introduced into evidence, indicating that consideration had failed); Hendrie v. Hendrie, 94 F.2d 534, 535 (5th Cir.1938) (mortgage unenforceable because note was given for inadequate consideration); Lillienstern v. First National Bank, 288 S.W. 477, 478 (Tex. Ct. Civ. App. 1926) (mortgage unenforceable where note was procured by fraud); Al Baraka Bancorp, Inc. v. Hilweh, 656 A.2d 197 (Vt.1994) (where parties had a corporation-shareholder, and not a debtor-creditor relationship, there was no debt and mortgage was unenforceable).

Some New York cases appear to support the proposition that a mortgage may be enforceable even if its underlying obligation is not. However, on closer inspection these cases stand for no such idea. In two of them, the court found that the note and mortgage had been procured by fraud, but that the mortgagor had already been compensated for the resulting damages by receipt of a money judgment; hence both the note and the mortgage were enforceable. See Jo Ann Homes at Bellmore, Inc. v. Dworetz, 302 N.Y.S.2d 799 (N.Y. 1969); Bankers Trust N.Y. Corp. v. Renting Office, Inc., 458 N.Y.S.2d 720 (N.Y.App.Div.1983). To similar effect, see Keith, Mack, Lewis & Allison v. Boraks, 438 So. 2d 560 (Fla. Dist. Ct. App. 1986) (mortgagors had been compensated for mortgagee's fraud by an offset against the balance owing on the note; the mortgage was enforceable for the remaining balance).

A third New York case, Amherst Factors, Inc. v. Kochenburger, 173 N.Y.S.2d 570 (N.Y. 1958), represents the culmination of a long line of cases involving notes originated at a discount in violation of the state's banking laws. While the statutes in question appeared to render the notes void, the New York courts consistently held that the loans themselves were valid and effectual, and that the mortgages given to secure them were enforceable. Hence, the effect of these decisions is to recognize the continuing presence of the obligation, even if it was originated improperly.

An interesting question arises if the original obligation is rendered unenforceable (e.g., by fraud or mistake), but the mortgagor is nonetheless under an equitable duty to make restitution of the funds advanced, in order to prevent unjust enrichment. Will the mortgage secure (with its original priority) this substituted obligation to give restitution? Such a result seems reasonable and proper, but little authority can be found on the point. See Union Trust Co. v. Biggs, 137 A. 509 (Md. 1927), suggesting that an equitable lien with the priority of the original mortgage arises on such facts.

Illustrations 1 and 2 are supported by Grace v. Golden, 425 S.E.2d 363 (Ga.Ct.App.1992); Bedian v. Cohn, 134 N.E.2d 532 (Ill.Ct.App.1956); Louisiana Nat'l Bank v. O'Brien, 439 So.2d 552 (La.Ct.App.1983); Seieroe v. First National Bank of Kearney, 70 N.W. 220 (Neb.1897); Stern v. Itkin Brothers, Inc., 385 N.Y.S.2d 753 (N.Y. Sup. 1975); Weikel v. Davis, 186 P. 323 (Wash.1919). See also First National Bank of Benson v. Gallagher, 138 N.W. 681 (Minn.1912), in which the court upheld an agreement between mortgagor and mortgagee, entered into after the execution of the mortgage, which excluded the mortgagor from personal liability on the debt. Compare Thomas v. Hartman, 553 So.2d 1256 (Fla.Ct.App.1989), correctly holding that the phrase "[the mortgage] shall be the sole security for this note," did not bar the mortgagor's personal liability, since personal liability is not a form of security.

Illustration 3 is based on Laclede Investment Corp. v. Kaiser, 596 S.W.2d 36 (Mo.Ct.App.1980).

Illustration 4 is based on Laclede Investment Corp. v. Kaiser, 596 S.W.2d 36 (Mo.Ct.App.1980) and Moerring v. Alaska Mutual Bank, 751 P.2d 5 (Alaska 1988).

Illustration 5 is based on Regional Fed. Sav. Bank v. Margolis, 835 F.Supp. 356 (E.D.Mich.1993) (mortgagors liable for 30% of debt); Wells v. Flynn, 184 N.W. 389 (Iowa 1921); and Birkenfeld v. Cocalis, 29 A.2d 902 (N.J. Ct. Err. & App. 1943). A mortgage may be recourse as to some obligations and non-recourse as to others, depending on its terms. See Federal Home Loan Mortg. Corp. v. Inland Industries, Inc., 869 F.Supp. 99 (D.Mass.1994) (mortgagor was not personally liable for principal and interest, but was liable for late fees, insurance, and other costs). Cases in which the non-recourse language was broad enough to cover other fees or charges include Druid Assoc., Ltd. v. National Income Realty Trust, 436 S.E.2d 721 (Ga.Ct.App.1993) (mortgagor was not personally liable for unpaid water bills); Smart v. Tower Land & Inv. Co., 597 S.W.2d 333 (Tex.1980) (mortgagor was not personally liable for unpaid taxes); Georgetown Assoc., Ltd. v. Home Fed. Sav. & Loan Ass'n, 795 S.W.2d 252 (Tex. Ct. App. 1990) (same); In re Pioneer Title Building, Ltd., 133 B.R. 822 (Bankr.W.D.Tex.1991) (same); and Berks Title Ins. Co. v. Haendiges, 772 F.2d 278 (6th Cir.1985) (mortgagor was not personally liable for mechanics' liens filed against the security property). See also Cascade Manor Assoc. v. Witherspoon, Kelley, Davenport & Toole, 850 P.2d 1380 (Wash.Ct.App.1993) (mortgagor was not personally liable for payment of the note, but, under assignment of rents clause, was liable to relinquish rents collected).

§ 1.2 No Consideration Required

(a) Consideration is not necessary to the enforceability of a mortgage.

(b) A mortgage securing an obligation undertaken as a gift is enforceable in the absence of undue influence, duress, fraud, or mistake, notwithstanding the unenforceability of the obligation standing alone.

(c) A mortgage that secures a performance of a preexisting legal obligation is enforceable.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 1.3, Mortgages Securing Obligations of Nonmortgagors; § 2.4, Mortgages Securing Future Advances Not Specifically Described; Restatement, Second, Contracts §§ 71, 82–90; Restatement, Second, Property (Donative Transfers) §§ 31.1, 34.3, 34.7.

Comment:

a. Consideration in general. A mortgage is a conveyance, and like other conveyances, is valid whether or not consideration is given for it. However, since a mortgage is merely security, it is generally enforceable only to the extent that the underlying obligation is enforceable. Two exceptions may be noted: The mortgage is enforceable even if no one has personal liability for the obligation (§ 1.1); and mortgages to secure promised gifts are generally enforceable (§ 1.2(b)).

A sharp distinction is drawn between consideration for the obligation and consideration for the mortgage itself. The enforceability of the obligation may well depend on whether there was consideration for it. Such is the case with ordinary contracts; see Restatement, Second, Contracts § 71. Consideration may also affect the enforceability of the obligation under other legal doctrines. For example, payment of a valuable consideration may determine a mortgage's priority under the operation of the recording acts. Absence of consideration may lead a court to set aside a mortgage note as a fraudulent transfer. A corporation which guarantees a debt for no consideration may be held to have acted *ultra vires*. Inadequacy of consideration might cause the mortgage to be set aside as a fraudulent transfer in bankruptcy. But none of these doctrines imposes any general requirement of consideration upon the mortgage as distinct from the obligation it secures.

Moreover, there are numerous situations in which an obligation may be enforced notwithstanding the absence of consideration. Among them are a promise to pay a debt that is barred by a statute of limitations (Restatement, Second, Contracts § 82); a promise to pay a debt discharged in bankruptcy (§ 83); a promise to perform a duty despite nonoccurrence of a condition (§ 84); a promise to perform a duty that the promisor has a legal power to avoid (§ 85); a promise made in recognition of a benefit previously conferred on the promisor (§ 86); an option contract or guaranty of a debt based on a false recital of consideration (§§ 87, 88); a promise to modify an executory contract

(§ 89); and a promise that reasonably induces detrimental reliance by the promisee (§ 90).

If the mortgagor's underlying promise is enforceable despite the absence of consideration, a mortgage given to secure that promise generally will be enforceable as well, since no independent consideration is necessary to support the mortgage itself.

Many cases appear to require consideration for a mortgage per se, but on closer inspection virtually all of them can be shown merely to demand consideration for enforceability of the underlying obligation.

b. Gift mortgages. One may make a gift by promising some future performance—for example, a promissory note given for no consideration—and may secure it with a mortgage. The note may well be regarded as unenforceable (except as against persons who have the rights of a Holder in Due Course; see U.C.C. §§ 3-303 & 3-305(b) (1995)). Nonetheless, the mortgage is enforceable if it is intended as a gift and is taken without undue influence, duress, fraud, or mistake.

With respect to the requirement of intention to make a gift, see by analogy Restatement, Second, Property (Donative Transfers) § 31.1, Comment *d.* The vitiating elements of undue influence, duress, fraud, and mistake are defined in Restatement, Second, Property (Donative Transfers) § 34.7.

Of course, a variety of other legal doctrines outside the scope of this Restatement may also cause a court to set aside a gift mortgage. For example, the mortgage might be "in fraud of" the mortgagor's creditors under applicable fraudulent conveyance law. See Restatement, Second, Property (Donative Transfers) § 34.3.

Illustrations:

1. A owns Blackacre and is the grandmother of B. Out of concern for B's welfare, A executes a promissory note in favor of B, promising to pay her $10,000 each year for 10 years. A also executes a mortgage on Blackacre to secure this note. Subsequently A desires to sell Blackacre free of the mortgage encumbrance, and brings an action to have the mortgage declared void. The mortgage is enforceable even if the note, standing alone, is not.

2. A owns Blackacre and is the uncle of B, who is a medical student. A promises to give B a tour of Europe, arranged by C Travel Agency and having a value of $5,000, upon B's graduation from medical school, and gives B a mortgage on Blackacre to secure the promise. The mortgage is enforceable even if A's promise, standing alone, is not.

3. A is illiterate and his vision is impaired. He is liable to B Bank on a mortgage loan on A's house. An officer of B Bank visits A and obtains his signature on a new note and mortgage that substantially increase A's indebtedness. The bank's officer misrepresents the nature of the documents, so that A does not understand the transaction and receives no benefit from it. Because A has no intention to make a gift to the bank, and because the new mortgage is obtained by B Bank by fraud, it is unenforceable.

4. A and B are partners in a partnership to develop land. They acquire title to the land, transfer it to a trust, and cause the trustee to execute a note and mortgage to A and B as mortgagees for no consideration. The sole purpose of the mortgage is to establish a lien priority superior to the claims of possible future creditors or mechanics lienors, and there is no intention that any payments be made on the note. Subsequently the partnership is dissolved and A seeks to foreclose his interest in the mortgage. Because the mortgage was created to insulate the partnership's assets from its creditors, and not with the intention of making a gift, it is unenforceable and no foreclosure should be ordered.

c. Failure of consideration distinguished. It is important to distinguish an absence of consideration from "failure of consideration." While the courts are not always consistent in terminology, the latter phrase is often used to describe cases in which the mortgagor executes a note or contract, secured by a mortgage, but does not receive some or all of the value for which she or he bargained. This is simply a material breach of contract, partially or wholly discharging the mortgagor's duty of performance under the note or contract. The mortgage will be unenforceable to the same extent.

Illustration:

5. Mortgagor, a home owner, contracts with Mortgagee to have a new room added to the house. Mortgagor executes and delivers to Mortgagee a note for the price of the improvements, secured by a mortgage on the house. Mortgagee promises to return within one week to commence work, but in fact never returns. The note and mortgage are unenforceable by Mortgagee.

d. Mortgage to secure a preexisting debt. If one who owes a debt or other performance later gives a mortgage to secure that performance, a question arises whether any new consideration is necessary to support the validity of the mortgage. The rule stated in this section requires none. Frequently, of course, there will in fact be new consideration; for example the creditor may agree to forbear enforcing the debt for some period in return for the mortgage. It is often proper to construe the parties' agreement as imposing on the creditor a promise to forbear for a reasonable time, even if no specific understanding of the parties as to forbearance was articulated. But irrespective of whether or not such a promise is found, the mortgage is enforceable.

The position of this Restatement goes beyond that in Restatement, Second, Contracts § 89. That section deals with modifications of preexisting contracts, and regards them as enforceable only if they are fair on the basis of an unanticipated change of circumstances, or if the promisee has detrimentally relied on the modification. A mortgage given to secure a preexisting debt can be viewed as a species of contract modification. In such cases the circumstances outlined in Restatement, Second, Contracts § 89 (particularly detrimental reliance by the mortgagee) will often be present; for example, the mortgagee will frequently delay enforcement of the debt because of its newly secured status. But under this Restatement it is not necessary for the mortgagee to establish such facts in order to enforce the mortgage.

This Restatement follows and expands upon U.C.C. § 2-209(1) (1995), which eliminates any requirement of consideration in the modification of contracts for the sale of goods.

Illustration:

6. O is the sole stockholder of two insurance companies, A and B. Company A owes $1 million to Company B, evidenced by an unsecured promissory note. The state insurance commission determines that Company B's capital is insufficient to satisfy certain regulatory requirements. To correct the insufficiency O causes Company A to execute a mortgage on real property to secure the note to Company B. The mortgage is enforceable, notwithstanding that Company B has given nothing of value and Company A has received nothing of value in return for the mortgage.

Even if there is an antecedent obligation, a mortgage given to secure it will not inevitably be enforceable. A variety of doctrines, not generally within the scope of this Restatement, may warrant the setting aside of the mortgage as they would other types of conveyances. For example, the mortgage may fail to meet the formalities required of conveyances of land, may be rendered void as against subsequent bona fide purchasers by operation of the recording act, or may have been procured by undue influence, duress, fraud, or mistake.

Illustration:

7. Mortgagor owns a tavern and executes an unsecured promissory note to Mortgagee, a liquor distributor. Before the note falls due Mortgagee demands a mortgage on Mortgagor's tavern to secure the note, and threatens to give a false report of liquor law violations to the state liquor commission if Mortgagor refuses. Mortgagor executes the mortgage. The mortgage was obtained by duress and is unenforceable.

Under § 2.4(b), a mortgage may secure a preexisting advance or obligation only if the parties, at the time they enter into the mortgage, specifically identify the advance or obligation to be secured.

REPORTERS' NOTE

Consideration in general, Comment a. Numerous decisions recognize that no consideration requirement is imposed for validity of the mortgage *per se*, and that any such requirement is merely a matter of contract law affecting the enforceability of the underlying note or other obligation. See, e.g., Safety Federal Sav. & Loan Ass'n v. Thurston, 648 P.2d 267 (Kan.Ct.App.1982); Resolution Trust Co. v. Independent Mortg. Services. Inc., 519 N.W.2d 478 (Minn. Ct.App.1994); C & D Investments v. Beaudoin, 364 N.W.2d 850 (Minn.Ct. App.1985); Lillo v. Thee, 676 S.W.2d 77 (Mo.Ct.App.1984); Great Falls Bank v. Pardo, 622 A.2d 1353 (N.J.Super.Ch.1993); Continental Bank v. Barclay Riding Academy, Inc., 459 A.2d 1163 (N.J.1983); Matter of Foreclosure of Deed of Trust by Kitchens, 437 S.E.2d 511 (N.C.Ct. App.1993). See also Isaak v. Idaho First Nat'l Bank, 811 P.2d 832 (Idaho 1991) (consideration was required, and was found to exist, for enforcement of renegotiated note secured by mortgage).

For a discussion of the significance of valuable consideration under the recording acts, see R. Cunningham, W. Stoebuck, & D. Whitman, Property § 11.10 (2d ed. 1993).

A note and mortgage given without consideration may be set aside as a fraudulent transfer; see, e.g., First Union Nat'l Bank v. Smith, 445 S.E.2d 457 (S.C.Ct.App.1994).

Gift mortgages, Comment b. If the obligation is intended as a gift, there is a division of authority as to whether the mortgage securing it should be regarded as enforceable notwithstanding the absence of consideration. See G. Glenn, Mortgages § 5.6 (1943). Under this Restatement, such mortgages are enforceable. This position may seem inconsistent with the general view that the mortgage is merely ancillary to the debt and cannot be enforced if the debt is unenforceable. However, it is supported by the fact that a mortgage has a real property aspect and the proposition that no consideration is necessary for a valid conveyance of land.

Further, the rule denying enforceability of a gratuitous promise to pay money or perform duties in the future has as its purpose the protection of donors who may have acted casually or thoughtlessly; but where the donor executes a formal mortgage on land to secure that promise, the conclusion is almost irresistible that she or he has given the matter serious thought and fully intends to be legally bound. Indeed, if the mortgage is recorded (as will usually be the case) the title to the land will be clouded and the mortgagor will be unable, as a practical matter, to further convey the land free of the mortgage encumbrance without first resorting to an action to quiet the title. This fact is commonly understood by people who make gift mortgages, and strongly suggests that they fully expect the law to uphold their mortgages. Hence the mortgage should be enforced even if the mortgagor later changes his or her mind.

Illustrations 1 and 2 are based on Cooklin v. Cooklin, 244 N.W. 232 (Mich.1932). See also Brooks v. Dalrymple, 94 Mass. (12 Allen) 102 (1866); Goethe v. Gmelin, 239 N.W. 347 (Mich.1931); Brigham v. Brown, 44 Mich. 59 (1880); Campbell v. Tompkins, 32 N.J.Eq. 170, 172 (1880). But see Brown v. Commissioner, 241 F.2d 827 (8th Cir.1957) (Missouri law); Coon v. Shry, 289 P. 815 (Cal. 1930); Cotton v. Graham, 2 S.W. 647 (Ky.1887); Kuhne v. Gau, 163 N.W. 982 (Minn.1917); In re Derrico, 90 N.Y.S.2d 889, aff'd, 107 N.Y.S.2d 815 (N.Y. 1951); Stapleton v. Rathbun, 253 P.2d 164 (Okla.1952); Quazzo v. Quazzo, 386 A.2d 638 (Vt.1978).

Illustration 3 is based on Grant v. Oten, 626 P.2d 764 (Colo.Ct.App. 1981), Bartmess v. Bourassa, 639 P.2d 1147 (Mont.1982), and Berlin v. Dassel, 389 N.Y.S.2d 131 (N.Y.App. Div.1976). In these cases, as in Illustration 2, the mortgagor had no intention to make a gift of the mortgage and note, but was deceived or defrauded. In a case of fraud in the execution, the note (and consequently the mortgage) are unenforceable even against a person with the rights of a Holder in Due Course; see U.C.C. § 3-305(a)(1) (1995). To similar effect are Kremser v. Tonokaboni, 356 So.2d 1331 (Fla.Ct.App.1978) and Mozingo v. North Carolina Nat. Bank, 229 S.E.2d 57 (N.C.Ct.App. 1976).

In Verson v. Steimberg, 548 N.E.2d 363 (Ill. App. Ct. 1989), a husband induced his estranged wife to execute a mortgage on their home to raise funds for the husband's business ventures. He assured the wife that her signature was a mere formality. Following the husband's business failure and bankruptcy, the mortgagee attempted to foreclose on the home. The court refused foreclosure on the ground that the wife had received no consideration for her signature. It appeared to disregard the fact that the mortgagee had plainly parted with valuable consideration (albeit to the husband, not the wife). While the husband's statements to the wife might be regarded as fraudulent, it is difficult to see how those statements can be attributed to the mortgagee. In the absence of such attribution, the case seems incorrectly decided.

Illustration 4 is based on Codo v. Union Nat'l Bank, 370 N.E.2d 140 (Ill. App. Ct. 1977). The basis of the decision is the absence of any bona fide obligation to be secured by the mortgage. See also Turner v. Domestic Inv. & Loan Corp., 375 A.2d 956 (R.I.1977), in which the mortgagor executed a note and mortgage for a loan, but due to a dispute with the lender, never cashed the check for the loan proceeds. Under these circumstances no obligation to repay the loan ever arose, and the court held the mortgage unenforceable.

Failure of consideration distinguished, Comment c. See Hartford Nat. Bank v. Bowers, 491 A.2d 431 (Conn. App. Ct. 1985), in which the lender took a mortgage to secure a preexisting debt, and promised to forbear demanding full payment so long as the borrower maintained payments on schedule, but then demanded full payment only eight days later. The trial court characterized the lender's behavior as "failure of consideration," but the Court of Appeals correctly observed that this terminology was inaccurate, and that the lender had simply breached its contract, thus discharging the borrower's duty of performance under the mortgage.

Illustration 5 is based on Security and Investment Corp. of the Palm Beaches v. Droege, 529 So.2d 799 (Fla.Dist.Ct.App.1988).

Mortgage to secure a preexisting debt, Comment d. Cases recognizing that no new consideration is necessary to support a mortgage given as security for the mortgagor's preexisting debt include United States v. Fidelity Capital Corp., 933 F.2d 949 (11th Cir.1991) (Georgia law); Rankin v. First Nat'l Bank, 437 So.2d 503 (Ala.1983); Crum v. U.S. Fidelity & Guar. Co., 468 So.2d 1004 (Fla.Dist. Ct.App.1985); CBS Real Estate of Cedar Rapids, Inc. v. Harper, 316 N.W.2d 170 (Iowa 1982); Buffalo County v. Richards, 326 N.W.2d 179 (Neb.1982); E. E. E., Inc. v. Hanson, 318 N.W.2d 101 (N.D.1982).

In a large majority of cases in which a mortgage is given to secure a prior debt, there is in fact consideration, typically in the form of the lender's forbearance to sue on the debt or to accelerate an installment debt, or in the form of an advance of additional credit. In these cases the courts often speak of consideration being required, but the "requirement" is readily satisfied. See, e.g., Guarantee Bank v. Magness Constr. Co., 462 A.2d 405 (Del.1983); Westbrook State Bank v. Anderson Land & Cattle Co., 364 N.W.2d 416 (Minn. Ct.App.1985); Moore Bros. Oil Co. v. Dean, 486 N.Y.S.2d 785 (N.Y.App. Div.1985).

Illustration 6 is based on Pioneer Annuity Life Ins. Co. v. National Equity Life Ins. Co., 765 P.2d 550 (Ariz. Ct.App.1988).

Illustration 7 is based on Osage Corp. v. Simon, 613 N.E.2d 770 (Ill. App. Ct. 1993) (mortgagee obtained wife's execution of mortgage by threatening that husband would otherwise be arrested immediately).

§ 1.3 Mortgages Securing Obligations of Nonmortgagors

An obligation whose performance is secured by a mortgage may be that of the mortgagor or of some other person.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 1.2, No Consideration Required.

Comment:

a. In general. It is common for the owner of real property to execute a mortgage on it to secure the obligation of a family member, friend, business associate, or related partnership or corporation. In other situations, a mortgagor may have only an arm's-length relationship with the party whose obligation the mortgage secures; for example, a fee simple owner may execute a mortgage to secure a debt incurred by a tenant under a ground lease on the land.

A mortgage securing the obligation of a person other than the mortgagor is valid, whether or not the mortgagor receives any identifiable benefit in return. However, if there is no consideration for the obligation secured by the mortgage (a relatively rare situation), the mortgage must ordinarily meet the requirements of gift mortgages (§ 1.2(b)).

Illustrations:

1. H and W are married. H wishes to borrow money to start a business, and arranges a loan from Bank. H alone executes a promissory note to Bank, but both H and W execute a mortgage on their jointly owned house to secure the note. The mortgage on the house is enforceable against the interests of both H and W, notwithstanding that W receives no benefit from the loan.

2. A is the sole stockholder of Corporation B. A borrows money from Bank for personal purposes, and A causes Corporation B to execute a mortgage on certain of its business real estate to secure the loan. The mortgage is enforceable notwithstanding that Corporation B receives no benefit from the loan.

b. Mortgages to secure preexisting debts of third parties. When a mortgage is given to secure another person's preexisting debt, there is considerable authority that independent consideration for the mortgage must exist. In virtually all cases such consideration is in fact present, either in the form of a detriment incurred by the mortgagee (e.g., a forbearance in enforcement of the debt) or in the form of a benefit to the debtor (e.g., an advance of additional funds).

However, under this Restatement, as expressed in § 1.2, such independent consideration is not necessary to the enforceability of the mortgage. It is clear that support for the consideration requirement has been waning in recent years. The granting of a mortgage to secure another's preexisting debt is closely analogous to the giving of a guaranty of that debt. Restatement, Second, Contracts § 88 takes the position that the giving of such a guaranty is binding if it contains a mere recitation of nominal consideration, even if the consideration was never paid. This is tantamount to dispensing with the consideration requirement altogether.

The recital of nominal consideration in the guaranty, as required by Restatement, Second, Contracts § 88, appears merely to serve the purpose of calling to the guarantor's attention the fact that he or she is performing an act of legal importance. In the execution of a mortgage by the guarantor, the recitation of consideration can scarcely add anything to the formality or evident importance of the transaction; the very fact that the mortgage is being executed serves the same purpose adequately. Hence the recitation of consideration should be regarded as unnecessary.

In cases in which the secured obligation is an "instrument," as that term is used by the Uniform Commercial Code, it is clear that no contemporaneous consideration is required; U.C.C. § 3-303(a)(3) (1995) provides that no consideration is necessary for an instrument given in payment of, or as security for, an antecedent obligation of any kind. Case law has similarly obviated the requirement of contemporaneous consideration in the giving of an instrument by a guarantor or surety as well.

Illustration:

3. A and B form a partnership to develop a condominium project. The partnership obtains a construction loan from Bank, giving it a note secured by a mortgage on the project. As a result of delays in construction and slow sales, the partnership defaults on the construction loan. Bank threatens to foreclose unless it is given additional security, so A and B execute mortgages on their homes as further security for the construction loan. The partnership is unable to cure the default and Bank forecloses the mortgage on the homes of A and B. The mortgage is enforceable, even if Bank is regarded as not having promised to forbear for any particular period of time.

REPORTERS' NOTE

In general, Comment a. Illustration 1 is based on Peterson Bank v. Langendorf, 483 N.E.2d 279 (Ill. App. Ct. 1985). Similar fact patterns are found in In re Janis, 151 B.R. 936 (D.Ariz.1992); Kennebunk Sav. Bank v. West, 538 A.2d 303 (Me.1988); Parr v. Reiner, 508 N.Y.S.2d 829 (N.Y.Sup. Ct.1986), aff'd, 532 N.Y.S.2d 574 (N.Y.App.Div.1988); Bock v. Bank of Bellevue, 434 N.W.2d 310 (Neb.1989); Matter of Enderle, 431 S.E.2d 549 (N.C.Ct.App.1993); Matter of Owen, 303 S.E.2d 351 (N.C.Ct.App.1983) (in which W was in fact benefited by mortgagee's forbearing to levy on bank account in which W had an interest); Deal v. Christenbury, 274 S.E.2d 867 (N.C.Ct.App.1981) (in which W was in fact benefited by receipt of certain property); First Nat'l Bank v. Brakken, 468 N.W.2d 633 (N.D.1991) (mother executed mortgage to secure previous loans to her sons); Theodore v. Mozie, 95 S.E.2d 173 (S.C.1956). But see Kittle v. Sand Mountain Bank, 437 So.2d 100 (Ala.1983); Verson v. Steimberg, 548 N.E.2d 363 (Ill. App. Ct. 1989), in which the wife did not understand the nature of the mortgage and was told that her signature was merely a formality.

It is clear in most jurisdictions that merely executing the mortgage does not ordinarily make one liable personally on the secured obligation if one does not sign a note, bond, or other evidence of debt. Garretson Investment Co. of San Diego v. Arndt, 77 P. 770 (Cal.1904); Halderman v. Woodward, 22 Kan. 734 (1879). However, personal liability may arise if the mortgage itself contains a covenant to pay the debt; see Noble County Bank v. Waterhouse, 163 N.E. 119 (Ind.Ct.App.1928). Moreover, the mortgagor will be personally liable on covenants actually found in the mortgage, such as a promise to avoid waste, to pay taxes, or to insure the property.

Illustration 2 is based on Landmark Bank v. Ciaravino, 752 S.W.2d 923 (Mo.Ct.App.1988); Reliance Ins. Co. v. Brown, 399 N.Y.S.2d 286 (N.Y. App. Div. 1977); and Malsberger v. Parsons, 75 A. 698 (Del.Super.Ct.1910). See also Pitrolo v. Community Bank, 298 S.E.2d 853 (W.Va. 1982); Pioneer Lumber & Supply Co. v. First–Merchants Bank, 349 N.E.2d 219 (Ind.Ct.App.1976) (mortgage given by lot owner to secure construction loan note of contractor who was to build house on the lot held enforceable).

Mortgages to secure preexisting debts of third parties, Comment b. Illustration 3 is based on Metro Federal Sav. & Loan Ass'n v. Adams, 356 N.W.2d 415 (Minn.Ct.App.1984). See also Home Center Supply v. Certainteed Corp., 476 A.2d 724 (Md.Ct.App. 1984), which involved not a mortgage but rather an indorsement of the principal debtor's note by the surety. There are numerous similar cases in which consideration was said to be necessary, but the mortgagee's promise to forbear or its actual forbearance were regarded as sufficient consideration despite the fact that the promise was vague as to time and terms. See, e.g., Matter of Slodov, 419 F.Supp. 64 (S.D.Ohio 1976).

The view of Comment *b*, holding that no new consideration is necessary to support a mortgage to secure the preexisting debt of another person, is supported by O'Neill Production Credit Ass'n v. Mitchell, 307 N.W.2d 115 (Neb.1981) and Kitzer v. Kitzer, 312 N.E.2d 699 (Ill. App. Ct. 1974). However, there are numerous cases stating that consideration is required for a mortgage to secure the preexisting debt of a third party. Virtually all of these cases find the requisite consideration and uphold the mortgage on that basis. See, e.g., State Bank of Geneva v. Sorenson, 521 N.E.2d 587 (Ill. App. Ct. 1988), appeal denied, 530 N.E.2d 265 (Ill. 1988); Huntingburg Production Credit Association v. Griese, 456 N.E.2d 448 (Ind.Ct.App.1983); Bock v. Bank of Bellevue, 434 N.W.2d 310 (Neb. 1989); Continental Bank of Pennsylvania v. Barclay Riding Academy, Inc., 459 A.2d 1163 (N.J.1983), cert. denied, 464 U.S. 994 (1983); Howell v. Butler, 295 S.E.2d 772 (N.C.Ct.App. 1982) (consideration was the settlement of a threatened legal action on the debt); Tuller v. Nantahala Park Co., 281 S.E.2d 474 (S.C.1981).

Because consideration is so readily found, commonly in the form of the creditor's forbearance or the advancement of additional credit, it is difficult to identify cases in which there was in fact no consideration. One such case is Baker v. Citizens State Bank of St. Louis Park, 349 N.W.2d 552 (Minn.1984): B was the principal stockholder of H Corporation, which was indebted to C Bank. The Bank threatened to demand payment on H Corporation's note unless B gave the Bank a mortgage on B's farm. B did so, but the Bank nonetheless demanded payment only five days later, and commenced foreclosure proceedings on the farm. The court held the mortgage invalid for lack of consideration. An alternative and better basis for the decision, also articulated by the court, is that the Bank had implicitly agreed, in return for the mortgage, to forbear enforcement of the Corporation's note for a reasonable time, and that it breached that agreement by its precipitous action.

See also Turner v. Porter, 264 Ill. App. 15 (1931): White owed money to Turner. White was introduced to Ms. Porter by a mutual friend and persuaded Porter, who had little business experience, to execute a note and mortgage on her land to secure White's debt to Turner. Porter did not understand the nature of the transaction or the risks she was assuming, and counsel for Turner, who prepared the documents, was apparently aware of her misapprehensions and did nothing to correct them. The court refused to enforce the mortgage on the ground of lack of consideration, but the case could have been better decided on the basis of the mortgagor's mistake or the fraud practiced by the mortgagee and his counsel.

§ 1.4 Obligation Must Be Measurable in Monetary Terms

A mortgage is enforceable only if the obligation whose performance it secures is measurable in terms of money or is readily reducible to a monetary value at the time of enforcement of the mortgage.

Cross-References:

Section 1.5, Description of the Mortgagee and the Mortgage Obligation.

Comment:

Mortgage enforcement would break down if mortgages were permitted to secure performance of obligations that could not be measured in terms of money. There would be no means of determining whether a foreclosure sale produced a surplus or a deficiency. If a junior lienholder desired to redeem, there would be no means of determining the amount necessary to accomplish a redemption. For these reasons, the mortgage obligation must be stated in terms of money or the nature of the obligation must be such as to permit a court to reduce it to a monetary value with reasonable certainty.

In some cases an obligation may initially be uncertain in terms of monetary value, but may become reducible to a monetary value after a period of time. The rule of this section is satisfied if this occurs by the time enforcement of the mortgage is sought. See Illustration 6.

A mortgage may secure several obligations, some of which meet the requirements of this section while others do not. The mortgage is enforceable as security for the obligations that are reducible to monetary value, but not for those that are not so reducible. See Illustration 7.

Illustrations:

1. A owns Blackacre and contracts with B for the construction of an apartment building by B on the land. A is concerned about B's reliability and capacity to perform the contract. Hence, A demands that B give A a mortgage on Whiteacre, a separate parcel of land owned by B, to secure B's performance of the contract. Subsequently B defaults in performance of the construction contract and A brings an action to foreclose the mortgage. The mortgage is valid for an amount equal to the value of B's promised but unperformed construction, and foreclosure will be ordered.

2. A is the daughter of B. B owns a house, and deeds it to A in return for A's promise to provide B's necessary financial support for the remainder of B's life. A gives B a mortgage on the house to secure this promise. A performs the promise for a period of time, but ceases doing so two years prior to B's death. After B dies, her executor (who has succeeded to ownership of the mortgage) brings an action to foreclose it. The mortgage is enforceable in an amount equal to the value of the promised financial support, and foreclosure will be ordered.

3. The facts are the same as Illustration 2, except that the foreclosure action is brought by B herself prior to her death. If the court finds that a monetary award for A's breach (past, future, or both) can be fashioned, the mortgage will be enforceable for this amount, and foreclosure will be ordered.

4. The facts are the same as Illustration 2, except that A promises not only to provide financial support for B, but also "love, affection, and kindness." The mortgage is valid for the value of the financial support promised but not given, and foreclosure will be ordered. Because the promised emotional support cannot be reduced to a monetary equivalent, no foreclosure will be ordered for breach of that promise alone.

5. B owns Blackacre and enters into a contract with A, a "zoning consultant," under which A promises unconditionally to obtain a beneficial change in zoning for Blackacre. A gives a mortgage on Whiteacre, a separate parcel of land owned by A, to B as security for the performance of A's promise. A fails to obtain the zoning change and B brings an action to foreclose the mortgage. The mortgage is valid for the value of A's promise.

6. A is the developer of a shopping center, and borrows money from Bank to finance the construction and ownership of the center. A promises to repay the loan with interest at a rate of eight percent per annum, and also to pay Bank, 10 years from the date of the loan, 20 percent of the amount by which the appraised market value of the shopping center has risen since the loan was made. After 10 years A defaults in making the required value-based payment. Even though the appreciation in value cannot be predicted accurately at the time the loan is made, it can be measured with reasonable accuracy at the time the payment is due. The mortgage will be enforced.

7. A is the daughter of B. B owns a house and deeds it to A in return for A's promises to provide emotional support and attention, and to pay the property taxes on the house, for the remainder of B's life. A gives B a mortgage to secure these promises. If A defaults on both promises, B may foreclose the mortgage for the amount of the unpaid taxes, even though the promise of emotional support is not reducible to a monetary value.

A court may consider a variety of types of evidence in determining the monetary value of a promise secured by a mortgage. For example, an expert witness may testify as to the value of the construction work promised in Illustration 1, or the value of the rezoning promised in Illustration 5. An appraiser may testify as to the increase of the value of the shopping center in Illustration 6. In Illustrations 3 and 7, actuarial tables may be consulted to estimate B's life expectancy.

REPORTERS' NOTE

Illustration 1 is based on Pawtucket Institution for Savings v. Gagnon, 475 A.2d 1028 (R.I.1984) (promise by mortgagor to construct apartment building); In re Jeffrey Towers, Inc. v. Straus, 297 N.Y.S.2d 450 (N.Y.App. Div.), aff'd, 309 N.Y.S.2d 350 (N.Y. 1970) (promise by mortgagor to construct driveway and sewer line); Hyman v. Hauff, 33 N.E. 735 (N.Y. 1893); and Dover Lumber Co. v. Case, 170 P. 108 (Idaho 1918). Ordinarily the value of a construction project can be readily established by the testimony of the parties and expert witnesses.

See also Devlin v. Wiener, 656 A.2d 664 (Conn.1995) (promise to return property to the mortgagee, to give the mortgagee a lot and building materials, or to convey a condominium to the mortgagee, at the mortgagor's option); Plummer & Co. v. National Oil, 642 N.E.2d 291 (Ind.Ct.App.1994) (payment for accounting services rendered by mortgagee).

There is no objection to the granting of a mortgage to secure a contingent obligation, even if that obligation may never accrue, provided of course that, if it does accrue, it can be measured in monetary terms. See In re Cofield, 138 B.R. 341 (Bankr.D.Mass. 1992) (upholding a mortgage securing a promise to reimburse the issuer of a letter of credit).

Illustration 2 is based on DeClow v. Haverkamp, 189 N.Y.S. 617 (N.Y.App.Div.1921). The evaluation of an obligation of support is made simpler when the person entitled to receive the support has died, since the time period over which support should have been paid is known precisely. See also Abbott v. Sanders, 66 A. 1032 (Vt.1907), recognizing the right of a mortgagee under a mortgage securing a support obligation to foreclose.

Illustration 3 is based on Cook v. Bartholomew, 22 A. 444 (Conn.1891); Eugley v. Sproul, 99 A. 443 (Me. 1916); and Parsons v. Parsons, 189 S.E. 448 (Va.1937). Even though the person entitled to support for life is still living, a court may consult actuarial tables and other evidence to estimate her life expectancy, and may thus evaluate the obligation of support. See also Hann v. Crickler, 43 A. 1063 (N.J.Ch.1899) (mortgage given by husband, pursuant to divorce, to secure his undertaking to support his wife and child, held enforceable).

Illustration 4 is based on Bethlehem v. Annis, 40 N.H. 34 (1860), in which the court found the support obligation to be personal in nature and consequently refused to order strict foreclosure.

Characteristics of mortgages for support. When a mortgage secures an obligation of support that is deemed personal in nature or includes duties of kindness, affection, comfort, or the like, the preferable view is to treat the obligation to provide emotional benefits as not being secured by the mortgage, since it cannot be reduced to a monetary value. This is the approach taken in Illustrations 4 and 7 above.

Some decisions regard these mortgages as enforceable but endow them with other unique characteristics. Such mortgages have sometimes been held nonassignable by the mortgagee, since the obligation can only be performed for the benefit of the original mortgagee; see Bethlehem v. Annis, 40 N.H. 34 (1860); Bryant v. Erskine, 55 Me. 153 (1867). And since the mortgagor's obligations cannot, by their nature, be performed by other persons, there is authority that the mortgagor is disabled from transferring title to the land subject to the mortgage, at least unless the mortgagee consents to the transfer. See id.; Eastman v. Batchelder, 36 N.H. 141 (1858). This last result seems a complete *non sequitur*, since there is no apparent reason to prevent a transfer of the realty so long as it is understood that the obligation is owed only by the original mortgagor. See Bodwell Granite Co. v. Lane, 21 A. 829 (Me.1891), recognizing the validity of such a transfer by the mortgagor.

The principal difficulty with support mortgages involving highly personal or emotional services is with redemption. If the mortgagor defaults in providing the requisite support, may either she or the holders of junior interests redeem? And if redemption is to be permitted, what amount must the redemptionor pay? Several cases recognize that, in principle, redemption in equity should be permitted, but skirt the issue of the amount. See, e.g., Bethlehem v. Annis, 40 N.H. 34 (1860); Bryant v. Erskine, 55 Me. 153 (1867). As noted, that issue is avoided under this Restatement, since such personal or emotional services cannot be reduced to a monetary equivalent, and hence cannot be secured by a mortgage.

§ 1.5 Description of the Mortgagee and the Mortgage Obligation

(a) A mortgage need not describe the obligation whose performance it secures, provided the parties have otherwise reached agreement identifying that obligation.

(b) As against suhsequent grantees, a mortgage must identify the mortgagee with reasonable certainty.

(c) A mortgage need not recite the monetary value of the obligation whose performance it secures. Errors or variations in any recitation of the monetary value or other details of the obligation do not impair the enforceability of the mortgage except to the extent that persons subsequently acquiring interests in the real estate are misled to their detriment.

Cross-References:

Section 1.4, Obligation Must Be Measurable in Monetary Terms; § 1.6, Mortgagee's Duty to Disclose Balance and Status of Obligation; § 2.4, Mortgages Securing Future Advances Not Specifically Described; § 5.4, Transfer of Mortgages and Obligations Secured by Mortgages; § 6.4, Redemption from Mortgage by Performance or Tender.

Comment:

a. Obligation need not be described. Except as specifically required by statute, it is unnecessary that the mortgage itself identify or describe the obligation it secures. Alternatively, that obligation may be embodied exclusively in another writing or, to the extent that the Statute of Frauds permits, may be oral in character.

This follows from the rule that the Statute of Frauds may be satisfied by a combination of documents, no one of which states all of the essential elements of the transaction. So long as there is sufficient evidence that the mortgage and the additional documents refer to the same transaction, a court should have no reluctance to read them together.

Illustrations:

1. A borrows $1,000 from B and gives B a written promissory note agreeing to repay the sum, with interest at 10 percent per annum, in monthly installments of $100. A also executes a mortgage on Blackacre to B, intending to secure repayment of the note. The note recites that it is secured by a mortgage of the same date. The mortgage is in fact executed on the same date, but contains no statement describing the secured obligation. The mortgage is enforceable by B against A.

2. The facts are the same as in Illustration 1, except that neither the note nor the mortgage contains any statement as to what obligation the mortgage secures. If the court is satisfied from extrinsic evidence, such as testimony concerning the parties' oral negotiations, the nearly simultaneous execution of the note and the mortgage, and the parties' subsequent conduct with respect to the land, that the mortgage was intended to secure the note, the mortgage is enforceable by B against A.

b. Identification of mortgagee. The rule requiring a mortgage to identify the mortgagee with reasonable certainty is necessary to protect third parties who take subordinate interests in the real estate. Such parties may include grantees or junior mortgagees, as well as those who stand in the position of grantees, such as bankruptcy trustees or debtors in possession. The mortgagee must be identified so that a third party who acquires an interest in the land will know to whom inquiry should be made as to the balance and status of the obligation (see § 1.6), and to whom a tender of payment should be made (see § 6.4). The identification of the mortgagee must be sufficiently specific to permit a subsequent grantee actually to locate and inquire of the mortgagee with a reasonable effort. Frequently this will mean that an address as well as a name must be included, particularly if the name is a common one. This requirement of identification may be relaxed in the case of a grantee who has actual knowledge of the mortgagee's identity, even if that identity is not clear on the face of the mortgage. See Illustration 3.

Illustration:

3. A executes a note and mortgage on Blackacre, which A owns, to B. B is identified in the mortgage only as "Uncle Bob." Subsequently A dies, and the land passes by intestate succession to A's heir, C. C sells the land to D, and in response to D's

inquiry, explains that he is not certain to whom the phrase "Uncle Bob" refers. D has no actual knowledge of "Uncle Bob's" identity. Even if the phrase "Uncle Bob" would be sufficient to sustain the validity of the mortgage as between the original parties under the law of conveyancing, a court may be warranted in holding that "Uncle Bob" does not identify the mortgagee to D with reasonable certainty, and may refuse to enforce the mortgage.

In Illustration 3, if "Uncle Bob" is a person whose identity is in fact known to D because of family or community reputation, the court will enforce the mortgage against D.

As noted above, no description of the obligation need be included in the mortgage. Once the mortgagee is located, any person who desires to make an inquiry should have no difficulty focusing that inquiry on the particular mortgage in question, merely by making reference to the identities of the parties to the mortgage itself and to other information contained in the mortgage, such as the date and the description of the land.

Mortgages often contain fairly detailed descriptions of the obligation. There is no legal objection to inclusion of such a description. However, the recitations in the mortgage are not, of themselves, an adequate substitute for making an inquiry of the mortgagee. Even if the mortgage states the amount of the loan, for example, the actual amount owing at any given time may be greater or less than the stated figure as a consequence of the accrual of interest, payments made on the principal, attorneys' fees, advances by the mortgagee for taxes, insurance, or expenses of the mortgagee for other protective measures. The statement appearing on the face of the mortgage is therefore only a starting point for inquiry and cannot be regarded as conclusive. Anyone acquiring a subordinate interest in mortgaged property is charged with understanding this principle.

In one respect, however, a statement of amount in the mortgage, while not required, does possess legal significance. If the parties to the mortgage have no agreement for future advances, the principal amount of the obligation (exclusive of accrued interest, payments made to protect the security, attorneys' fees, and the like) may never exceed the stated amount. See § 2.1(d).

Only information about the identity of the original mortgagee need be included in the mortgage. The obligation may subsequently be assigned to another person, and the mortgage will generally be regarded as running with that obligation to the benefit of the assignee (see § 5.4(a)), but there is no requirement that the assignee be identified in the original mortgage or in a recorded assignment.

REPORTERS' NOTE

Obligation need not be described, Comment a. Cases holding that the debt or obligation need not be described in the mortgage include In re Duncan, 116 B.R. 146 (Bankr. W.D.Mo.1990) ("a promissory note" was sufficient description); Pioneer Annuity Life Ins. Co. v. National Equity Life Ins. Co., 765 P.2d 550 (Ariz. Ct.App.1988); Smith v. Haertel, 244 P.2d 377 (Colo.1952); Security Loan and Trust Co. v. Mattern, 63 P. 482 (Cal.1901); Sease v. John Smith Grain Co., 479 N.E.2d 284 (Ohio.Ct.App. 1984); Unger v. Shull, 7 P.2d 881 (Okla.1931). Moreover, errors in the description of the obligation are not fatal to enforcement of the mortgage if the parties' true intent can be determined. See, e.g., In re Brucap Associates, 158 B.R. 10 (Bankr.E.D.N.Y. 1993) (mortgage which secured guaranties "of even date herewith" was enforceable although the guaranties in question were in fact executed at an earlier date); Matter of Enderle, 431 S.E.2d 549 (N.C.Ct.App.1993) (mortgage which misidentified the obligation as a debt of A, when in fact it was a debt of B, could not be foreclosed, but might be reformed to reflect the parties' intent); Matter of Bailey, 999 F.2d 237 (7th Cir.1993) (approving foreclosure on similar facts).

Some cases suggest that there is a risk of fraud on third parties if the nature of the obligation is not described in the mortgage; see In re Spears, 39 B.R. 91 (Bankr.E.D.Tenn. 1984) and James v. Lawson, 136 S.E. 851 (W.Va.1927). However, this position has little force. Once the mortgagee is identified, an inquiry of that person can (and in prudence, must) be made by anyone acquiring a subsequent interest in the land. If the mortgagee misrepresents the nature or amount of the obligation to the detriment of the prospective grantee, the mortgagee will, of course, be estopped by that representation; see § 1.6. Hence, it is difficult to see how any fraud can be perpetrated by omission of a description of the obligation in the mortgage.

The principle that the debt need not be described with any specificity is illustrated by the cases upholding "dragnet" clauses, in which the obligation is typically described as "all debts, present and future, owed by the mortgagor to the mortgagee" or the like. See Hamlin v. Timberlake Grocery Co., 204 S.E.2d 442 (Ga.Ct. App.1974); The Michigan Ins. Co. v. Brown, 11 Mich. 265 (1863); Seymour v. Darrow, 31 Vt. 122 (1858) ("all the notes I now owe, or have with him"). See, however, § 2.4, which disallows enforcement of such clauses with respect to *preexisting* indebtedness unless the parties have specifically identified it.

The following cases illustrate that the absence of particular details from the mortgage's description of the obligation does not impair validity of the mortgage.

Amount of debt need not be stated: In re Duncan, 116 B.R. 146 (Bankr. W.D.Mo.1990); Oaks v. Weingartner, 234 P.2d 194 (Cal. Dist. Ct. App. 1951); Commercial Factors of Denver v. Clarke & Waggener, 684 P.2d 261 (Colo.Ct.App.1984); Plummer & Co. v. National Oil, 642 N.E.2d 291 (Ind.Ct. App.1994); Commercial Bank v. Rockovits, 499 N.E.2d 765 (Ind.Ct.App. 1986); Gardner v. Cohn, 61 N.E. 492 (Ill.1901); Fetes v. O'Laughlin, 17 N.W. 764 (Iowa 1883); Hampshire Nat'l Bank v. Calkins, 339 N.E.2d 244 (Mass. Ct. App. 1975); Wilson v.

Vaughan, 61 Miss. 472 (1884); Williams v. Moniteau Nat'l Bank, 72 Mo. 292 (1880); Burnett v. Wright, 32 N.E. 253 (N.Y.1892); Somersworth Sav. Bank v. Roberts, 28 N.H. 22 (1859); Allen v. Stainback, 118 S.E. 903 (N.C.1923); Cabbage v. Citizens Bank and Trust Co., 214 S.W.2d 572 (Tenn.Ct.App.1948); Clementz v. M.T. Jones Lumber Co., 18 S.W. 599 (Tex. 1891); General Glass Corp. v. Mast Construction Co., 766 P.2d 429 (Utah Ct.App.1988); Haas v. Teets, 188 S.E. 113 (W.Va.1936).

A minority view holds that, if the amount of the obligation is known or ascertainable when the mortgage is executed, the amount must be stated. See, e.g., Smith v. Haertel, 244 P.2d 377 (Colo.1952); Hart v. Chalker, 14 Conn. 77 (1840); Bullock v. Battenhousen, 108 Ill. 28 (1883); People's Bank v. Morgan County Nat'l Bank, 98 S.W.2d 936 (Ky.1936). See generally Annot., 145 A.L.R. 369. This view has very little modern acceptance.

Under the prevailing view, even gross errors or misstatements of the amount of the mortgage debt have been held not to impair the mortgage's enforceability as security for the actual debt owed. See, e.g., In re Sweatte, 76 B.R. 822 (W.D.Okla.1987) (recitation of $1 million debt); Cabbage v. Citizens Bank, 214 S.W.2d 572 (Tenn.Ct.App.1948) (recitation of $1 debt).

Date of note need not be stated: Concordia Bank v. Lowry, 533 So.2d 170 (La.Ct.App.1988), rev'd in part, 539 So.2d 46 (La.1989).

Maximum term or due date need not be stated: Dart & Bogue Co. v. Slosberg, 522 A.2d 763 (Conn.1987); Hollenbeck v. Woodford, 41 N.E. 348 (Ind.Ct.App.1895). But see Flexter v. Woomer, 197 N.E.2d 161 (Ill. App. Ct. 1964) (mortgage omitting amount and maturity date is invalid). Some cases hold that, if the due date is known but is not stated in the mortgage, it becomes a demand obligation; this result seems nonsensical. See Cates v. White, 41 So.2d 401 (Ala. 1949). Cf. In re Boyd, 185 B.R. 529 (Bankr.E.D.Mich.1995) (under Michigan statute, the mortgage cannot be enforced if it lacks a due date).

The omission of a due date in the mortgage, while not fatal to the mortgage's validity, may have important consequences in the application of the statute of limitations. Commonly such statutes run from the due date if it is stated, but run (often for a longer period) from the date of the mortgage itself if no due date is given.

Special rules in Connecticut. Connecticut has historically been the most rigorous jurisdiction in the nation in demanding specificity and accuracy of description of the obligation in a mortgage. Cases holding mortgages invalid include Thomaston Savings Bank v. Warner, 127 A.2d 495 (Conn.1956) (failing to describe the debt as a preexisting one); Matz v. Arick, 56 A. 630 (Conn.1904) (describing a future debt as current); Andrews v. Connecticut Properties, Inc., 75 A.2d 402 (Conn.1950); and North v. Belden, 13 Conn. 376 (1840) (misidentifying a contingent obligation as absolute); Bramhall v. Flood, 41 Conn. 68 (1874) (misidentifying a promise for future service as a promise for a sum certain); Hart v. Chalker, 14 Conn. 77 (1840) (failing to state the amount of the mortgage when it could have been definitely ascertained); Bridgeport Land and Title v. Orlove Co., 100 A. 30 (Conn.1917) (holding too indefinite a mortgage given to secure any loss suffered by mortgagee as a result of mortgagor's inability to deliver certain flour under a contract); McKnight v. Gizze, 140 A. 116 (Conn.1928) and Ives v. Stone, 51 Conn. 446 (1884) (claiming security in excess of the amount due).

This Restatement rejects the strict approach that was historically followed in Connecticut. Recent Connecticut developments signal a relaxation of these strict requirements. Conn. Gen. Stat. § 49–31b(a) provides that the mortgage is sufficient if it provides information from which the obligation's date, principal amount, and maximum term can be determined. This has been held merely a "safe harbor" provision, so that conceivably a mortgage which does not fully comply with the statute may nonetheless be valid. See Dart & Bogue Co. v. Slosberg, 522 A.2d 763 (Conn.1987) (mortgage is valid despite failure to state maximum term, absent showing that third parties have been misled); Connecticut Nat'l Bank v. Esposito, 554 A.2d 735 (Conn.1989) (where mortgage secures a guaranty, so that the principal amount cannot be computed, it is valid against third parties if it contains information from which a title examiner could discover the amount by further inquiry); Burt's Spirit Shop, Inc. v. Ridgway, 576 A.2d 1267 (Conn. 1990) (as between original parties, mortgage is valid despite failure to state amount or interest rate).

Identification of mortgagee, Comment b. The requirement that the mortgagee be identified with reasonable certainty within the mortgage applies only when the rights of third parties are at stake; it has no application as between the original mortgagor and mortgagee, since they obviously know each other. Illustration 3 is based on Bank of Oak Grove v. Wilmot State Bank, 648 S.W.2d 802 (Ark.1983) (mortgage void against a junior lienholder where mortgagee was identified only as "any future holder").

§ 1.6 Mortgagee's Duty to Disclose Balance and Status of Obligation

(a) Upon written request, made for good cause by a person described in Subsection (b), a mortgagee has a duty to disclose in writing, witbin a reasonable time,

(1) the amount owing on the obligation whose performance is secured by the mortgage;

(2) the current interest rate on the obligation, and the basis for adjustment if the rate is adjustable;

(3) the amount of any additional fees or charges owed to the mortgagee in connection with the mortgage;

(4) whether the mortgagee considers the obligation to be in default or to be accelerated;

(5) if the mortgage provides for future advances or reserves a right in the mortgagee to modify the

mortgage, whether any notice has been issued to the mortgagee under § 2.3(b) or § 7.3(d);

(6) the amounts of any funds held by the mortgagee in escrow or impound accounts in connection with the mortgage; and

(7) the identity and address, if known to the mortgagee, of any person who has acquired an interest in the mortgage or the obligation.

(b) A request under Subsection (a) may be made by:

(1) the mortgagor;

(2) any person whose performance of an obligation is secured by the mortgage;

(3) the holder of any interest in the mortgaged real estate; or

(4) a prospective bidder at a foreclosure sale of a lien subordinate to the mortgage.

(c) A mortgagee who, without good cause, fails to comply with this section or discloses erroneous information is liable for the damages caused by the failure or error, and may also be subjected to a court order to comply. A mortgagee who discloses erroneous information may be estopped to deny its accuracy as against one who has reasonably and detrimentally relied on the disclosure.

Cross-References:

Section 1.5, Description of the Mortgagee and the Mortgage Obligation; § 2.3, Priority of Future Advances; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; U.C.C. § 9–208 (1995), Request for Statement of Account or List of Collateral; Uniform Land Security Interest Act § 209, Request for Statement of Account.

Comment:

The duty to disclose information about the status of the mortgage obligation, as articulated in this section, arises from state statutes in a number of jurisdictions. However, this section recognizes such a duty whether or not a statute provides for it. Some of the statutes deal with such issues as the frequency with which requests may be made to the mortgagee and the charges the mortgagee may make for disclosing requested information. While this Restatement does not deal specifically with these matters, it recognizes existing statutory treatment of them.

Under § 1.5 of this Restatement, as against subsequent grantees, a mortgage is required to identify the mortgagee. However, in numerous situations a person who holds, or who is contemplating acquisition of, an interest in real estate that is subject to a mortgage will desire and need more detailed information about the status of the obligation secured by the mortgage.

A request for information under this section must be made for good cause. Idle curiosity or a desire to harass the mortgagee will not justify a request. The mortgagor will virtually always have good cause for inquiries, provided they are not made with unreasonable frequency. In addition, there are a wide variety of situations in which the other persons described in Subsection (b) will have good cause to make a request under this section. For example, one who is planning to sell real estate subject to, or with an assumption of, a mortgage that secures a money debt needs to inform the buyer of the information listed in § 1.6(a) in order to plan the transaction intelligently. Others with a similar need for such information include a mortgagor or titleholder who wishes to discharge the mortgage obligation; a person holding a junior lien on the property who wishes to effect a redemption from a prior mortgage; and a purchaser of the real estate under a "wraparound" mortgage or an installment contract that "wraps" a preexisting mortgage.

Even a senior mortgagee may need to know a junior mortgage's status. For example, the senior mortgage may provide for future advances and the senior mortgagee may be considering making such an advance. If applicable state law would make the advance subordinate to intervening liens (a result not generally countenanced under § 2.3) the senior mortgagee would have a legitimate interest in knowing the balance and status of the intervening mortgage.

This section is consistent with U.C.C. § 9-208 (1995), which deals with obligations secured by personal property. Under that section the secured party has a duty to provide to the debtor, upon request, verification of the amount of the unpaid indebtedness, a correct list of the collateral, and a disclosure of the name and address of any successor in interest. It is also similar to Uniform Land Security Interest Act (U.L.S.I.A.) § 209, which requires a mortgage creditor to provide a written statement of the principal amount and accrued interest due, the interest rate in effect, and the status of any escrow account held in connection with the loan.

The request for information about the obligation must be made in writing and must reasonably identify the mortgage in question, a requirement that should pose no difficulty since the mortgage will ordinarily be recorded in the public records. For example, a reference to the mortgage's date, the names of the parties to the mortgage, and the mortgage's book and page number in the public records would be sufficient. Alternatively, the request might give a loan number or other unique identifier if such is found on the face of the mortgage. The request may specify that only some of the items listed in § 1.6(a) above be provided, but if the request is general in nature, all of the matters in § 1.6(a) must be disclosed.

Under this section, the mortgagee must respond to a request for information within a reasonable time. What is reasonable will vary with the circumstances, but some guidance may be found in the statutes cited in the Reporters' Note, which typically require the mortgagee's response within 10 to 21 days. By analogy, both U.C.C. § 9-208 (1995) and U.L.S.I.A. § 209 require a response within 14 days. There is no objection to the mortgagee's charging a reasonable fee to cover the actual cost of providing the information.

In general this section imposes a duty on the mortgagee to provide information on the obligation only to those who owe the obligation or who hold interests in the real estate; a stranger to the title and the obligation has no right to demand it. Hence, the mortgagee has no direct duty to a person who is contemplating a purchase of the property. When an attorney, escrow agent, or other closing agent needs payoff information in order to conduct the settlement, it must ordinarily be obtained indirectly by means of a request originating with the mortgagor or present title-holder; alternatively, the mortgagor may authorize the closing agent to request it from the mortgagee on the mortgagor's behalf. See Illustration 1.

However, if a stranger to the title (as of the time the information is supplied) reasonably and detrimentally relies upon it, the data thus supplied is binding against the mortgagee and in favor of the stranger. See Illustration 5.

In one situation, this section provides a right of information to a party with no interest in the property or the obligation: one who is considering bidding at the foreclosure sale of a lien junior to the mortgage in question. Obviously a bidder cannot formulate an intelligent bid without this information, but in a foreclosure setting an indirect inquiry may not suffice because there may be no person with an interest in the property who wishes to facilitate third-party bids by demanding that the senior mortgagee release the information. See Illustration 2. Where foreclosure is by nonjudicial power of sale, the mortgagee can fulfill its duty by giving the information to the trustee or other person conducting the sale, and authorizing that individual to disclose it to prospective bidders.

A sale or assignment of a mortgage loan on the secondary market to another investor will make the latter responsible for the duties imposed by this section. In such cases the investor frequently appoints either the originating mortgagee or some other entity to "service" the loan, acting as the holder's agent for purposes of collecting payments, maintaining records, and handling relations with the mortgagor. It is the servicer to whom a request for information about the status of the loan is most likely to be directed. Since the servicer is an agent of the mortgage holder, and the giving of such information is undoubtedly within the scope of the agent's authority, the holder will be bound by the agent's statements as indicated in this section.

Similarly, participation interests in mortgage loans are sometimes sold to multiple investors. Almost invariably one of them, or some independent trustee, is authorized by the investors to "service" the loan. Statements concerning the mortgage loan's status issued by that servicer are binding on all the participants.

Illustrations:

1. A obtains a loan from B and gives B a promissory note secured by a mortgage on A's land. Subsequently A desires to sell the land to C, who agrees to purchase subject to the mortgage. Upon A's reasonable request, B has a duty to provide to A the information listed in Subsection (a).

2. A executes a promissory note, secured by a first mortgage on Blackacre, to B and another note, secured by a second mortgage, to C. Thereafter A defaults on the note to C, and C commences a foreclosure proceeding. D is interested in bidding at the foreclosure sale, and requests B to provide information about the first mortgage and note. B has a duty to provide to D the information listed in Subsection (a).

3. B is the mortgagee of land owned by A. The mortgage secured a debt owed by A to B. C performs construction work on the land at A's request, but A refuses to pay for the work and C files a notice of mechanic's lien. The lien is subordinate to B's mortgage. In order to determine whether a foreclosure of the lien is worthwhile, C requests that B provide the information listed in Subsection (a). B has a duty to provide this information to C.

In most cases the obligation secured by a mortgage is a money debt. However, the principle of this section applies to non-monetary obligations as well. See Illustration 4.

Illustration:

4. A is a contractor, and is employed by B to construct a building. B insists that A provide assurances to B that the work will be completed in a timely fashion. To secure this performance, A gives B a mortgage on Blackacre. During the course of completion of the contract, A desires to sell Blackacre to C. Upon A's reasonable request, B has a duty to provide to A such information under Subsection (a) as is applicable, including a written statement indicating whether any default by A has occurred and estimating the value of the work remaining to be performed under the contract if such an estimate can reasonably be made.

If a mortgagee fails to respond, or makes a false statement in response to a request under this section, the mortgagee is liable for any harm caused. This is consistent with U.C.C. § 9-208 (1995), which makes a party secured by personal property liable for any loss caused by the secured party's failure to comply with that section's requirements of verification of the amount of the unpaid indebtedness and listing of the collateral. If the mortgagee who responds falsely and the person making the inquiry are both negligent or at fault, a court may allocate the loss between them and charge the mortgagee with damages on a proportionate basis.

If the mortgagee understates the burdens secured by the mortgage, a person who reasonably and detrimentally relies upon that statement can treat it as binding on the mortgagee, who may thus be estopped to deny its accuracy. See Illustration 5. Estoppel claims are not limited to persons in the categories mentioned in Subsection (b); as Illustration 5 suggests, a third-party purchaser is permitted to make such a claim, despite lack of privity with the mortgagee.

It will usually be difficult for the current holder of the equity of redemption to establish such reliance, since that individual will ordinarily have been paying on or performing the obligation, and hence will have possession of books and records that will show at least the approximate status of the obligation.

If the mortgagee overstates the obligation secured by the mortgage, the mortgagee is liable for the actual damages that result. See Illustration 6. Moreover, a mortgagee who refuses to provide the information required under this section within a reasonable time is liable for actual damages caused by the refusal, and may also be ordered by a court to comply.

Illustrations:

5. B is the mortgagee of land owned by A. The mortgage secures a debt owed by A to B. A contracts to sell the land to C subject to the mortgage, and asks B in writing to disclose the balance owing on the debt. The actual debt is $100,000, but B's statement erroneously states that the debt is $90,000. A shows the statement to C, who reasonably relies on it and purchases the land. C is entitled to treat the debt as having a $90,000 balance as of the date of the statement.

6. B is the mortgagee of land owned by A. The mortgage secures a debt owed by A to B. A contracts to sell the land to C subject to the mortgage, and asks B in writing to disclose the balance owing on the debt. The actual debt is $100,000, but B's statement erroneously states that the debt is $110,000. Because of the discrepancy between B's statement and the information C has obtained from A, C decides not to purchase the land and refuses to complete the contract. B is liable to A for the loss of the bargain A had with C.

In Illustration 6 the party claiming damages on account of the erroneous statement is the party who requested the statement. However, other persons may also recover damages. Mortgagors, for example, frequently obtain statements from their mortgagees and pass them on to others, such as real estate purchasers and subordinate lenders, in order to facilitate sales or further loans of the real estate. Such parties may well be able to prove and recover damages.

The mortgagee's liability for damages under Subsection (c) is limited to cases in which there was no good cause for the mortgagee's failure to comply or for errors in the information supplied. Good cause may exist if the failure or error resulted from circumstances beyond the mortgagee's control, such as natural disasters or vandalism of the mortgagee's files or records. Relief of the mortgagee from liability for damages where there is good cause for the mortgagee's noncompliance is consistent with U.C.C. § 9–208 (1995), dealing with debts secured by personal property.

REPORTERS' NOTE

The duty under this section to provide an appropriate statement of the mortgage loan's condition, and the corresponding liability for failure to comply, is analogous to liability arising under statutes in many states. See the Statutory Note following this Reporter's Note. The Nevada statute, in particular, is well-considered and comprehensive, and provides substantial support for this section.

In Black v. Sullivan, 122 Cal.Rptr. 119 (Cal.Ct.App.1975), trustors under a deed of trust sued the beneficiaries and various assigns of the beneficiaries for their failure to provide a statement of the amount due on the loan, thereby attempting to prevent the closing of a sale of the property. The court held that the beneficiaries' refusal to provide a statement violated Cal. Civil Code § 2943, which requires such a statement. However, the court found no liability on the part of certain attorneys who had taken an assignment of the deed of trust to secure a debt owed to them by the original beneficiaries; this sort of collateral assignment, the court held, did not trigger the statutory duty to provide a statement.

A mortgagee may be estopped by a statement of the mortgage loan's balance that is lower than the actual balance. However, cases so holding rarely involve an estoppel claim by the mortgagor or the holder of the equity of redemption. More typically, they involve third parties. For example, in Rissman v. Kilbourne, 643 So.2d 1136 (Fla. Dist. App. Ct. 1994), the purchaser of land subject to an existing mortgage obtained a payoff statement from the lender. This balance was confirmed by several subsequent annual statements. The lender then discovered that its computations were in error, and demanded an additional $67,000 to pay off the loan. The court found that the purchaser had detrimentally relied on the statements given, and held the lender estopped to claim the additional amount.

The same principle is illustrated by Mutual Life Ins. Co. v. Grissett, 500 F.Supp. 159 (M.D.Ala.1980), where a lender refinanced the real estate by paying off an existing mortgage loan on the basis of an inaccurate balance statement issued by the holder of the mortgage. The lender receiving payment was held estopped to deny the accuracy of its statement.

An estoppel will not arise when the misstatement is made by one other than the lender or a person authorized by the lender. In Poco-Grande Investments v. C & S Family Credit, Inc., 391 S.E.2d 735 (S.C.Ct.App. 1990), a judicial foreclosure of a second mortgage was held. The master who conducted the sale advertised that the balance owing on the first mortgage was about $2,000, while it was in fact about $12,000. The successful bidders at the sale, upon discovery of the error, sued the second mortgagee for damages. The court held that the second mortgagee had no liability for the error, pointing out that the bidders had made no attempt to verify the amount due on the prior mortgage and observing that "a party must avail himself of the knowledge or means of knowledge open to him."

In Maddox v. Wright, 489 N.E.2d 133 (Ind.Ct.App.1986), the vendor of a real estate installment contract sued to foreclose the purchaser's interest. Because the vendor had refused to provide a payoff amount to the purchasers, who had desired to prepay the contract, the vendor was held estopped to assert a default by the purchasers.

It is often questionable whether a mortgagor can reasonably rely on a payoff statement later alleged to have been in error, since the mortgagor obviously has rather direct and intimate knowledge of the transaction and the status of the debt. See Ram Co. v. Estate of Kobbeman, 696 P.2d 936 (Kan.1985), in which the mortgagee sent a notice to the mortgagor stating that zero interest was being charged on the loan. The court rejected the argument that the mortgagee was estopped by this statement, observing that the mortgagor knew or should have known that it was in error, and therefore could not reasonably have relied upon it.

The difficulty faced by the holder of the equity of redemption in establishing an estoppel, because of an erroneous statement from the mortgagee, is also illustrated by First Wisconsin Trust Co. v. Schroud, 916 F.2d 394 (7th Cir.1990). There an assuming grantee proposed to resell the real estate, and requested a statement from the mortgagee. The mortgagee's statement was erroneous in failing to mention some $105,000 of deferred interest. After the sale the mortgagee demanded payment of this interest by the seller. The court held that since the seller had actual knowledge of the deferred interest, no estoppel arose against the mortgagee.

To the same effect is In re Royal Meadows Stables, Inc., 187 B.R. 516 (Bankr.E.D.Va.1995), where the mortgagor was held to "at least constructive knowledge" of the actual balance owing on the debt, despite the mortgage holder's erroneous quotation of the payoff amount, because the mortgage holder had filed a proof of claim in the mortgagor's bankruptcy proceeding that stated the debt accurately.

Even a third-party lender may be unable to assert that it reasonably relied on an erroneous statement from the prior mortgagee. In Merchants State Bank v. First Tennessee Bank, 1993 WL 424817 (Tenn.Ct.App. 1993) (not reported in S.W.2d), the loan officer for the new lender obtained a payoff statement from the old lender and issued a check in that amount to pay off the real estate loan secured by the old mortgage. However, the officer had actual knowledge that the old mortgage contained a cross-collateralization clause, and that there were additional loans secured by the old mortgage. The court held that the new lender could not reasonably have understood that its check was sufficient to discharge the old mortgage. Compare Freedom Financial Thrift & Loan v. Golden Pacific Bank, 25 Cal.Rptr.2d 235 (Cal. Dist. Ct. App. 1993), in which the old lender issued a payoff statement that inadvertently understated the balance owing on the loan. The new lender paid that amount. The court held that the remaining balance on the loan could be recovered from the mortgagor, but not from the new lender.

STATUTORY NOTE

Uniform Land Security Interest Act § 209. The debtor may request a statement of account from a secured creditor. The creditor must comply within two weeks of receipt of the request. The statement must disclose the principal due, accrued interest and other sums due, the interest rate in effect, a current per diem interest amount, and the status of any escrow account held by the creditor. A creditor who fails to comply is liable for damages. The debtor is entitled to one free statement every six months, and the creditor may make a reasonable charge for additional statements.

California Civil Code § 2943. Authorizes a mortgagor, a successor in interest, or an agent of either to demand a "beneficiary statement" or a "payoff demand statement"; sets out in detail the content such a statement must include; and provides that the statement may be relied upon in accordance with its terms.

Connecticut Gen. Stat. Ann. § 49-8a. Defines "payoff statement" as a statement of the unpaid principal, interest, and other charges owing on a mortgage loan, and a statement of the per diem amount of interest. Authorizes the mortgagor to pay the amount required by the payoff statement, and if the mortgagee does not release the mortgage within 30 days thereafter, to record an affidavit reciting the payment, which then serves as a release of the mortgage lien.

Connecticut Gen. Stat. Ann. § 49-10a. When a mortgage has been assigned, requires the mortgagee to provide a payoff statement to the mortgagor within 10 days after a written request.

Florida Stat. § 701.04. Within 14 days after written request, the mortgagee must deliver to the mortgagor a statement of the unpaid principal balance, interest due, and per diem rate.

Iowa Code Ann. § 535B.11. Applies only to those who service residential mortgage loans for other parties. Requires the servicer to answer, within 10 days of receipt, any written request for payoff information received from a mortgagor or the mortgagor's designated representative.

Maryland Commercial Law § 12-1025. A lender receiving monthly payments on more than five loans secured by residential real property must furnish to each borrower a written statement of payments credited to principal and to interest and fees, and the remaining outstanding unpaid principal balance of the loan. The statement must be furnished at least annually, and also within a reasonable time after receipt of a written request from the borrower.

Massachusetts Gen. Laws Ann. c. 183 § 55. Substantially similar to the Connecticut statute described above.

Michigan Comp. Laws Ann. § 445.1674. A mortgage servicer must deliver, within 25 days after receipt of written request from the borrower, a statement of amount and date of all payments during the preceding 12 months, and the total unpaid balance.

McKinney's New York Real Property Law § 274-a. Authorizes an owner of mortgaged real property, upon entering into a contract to convey or a written commitment to obtain a mortgage loan upon that property, to demand a statement from the mortgagee. The statement must state the unpaid principal, the date to which interest has been paid, and any unpaid amounts of principal and interest. If the mortgagee does not provide the statement within 20 days, the property owner may petition a court for an order compelling it.

Nevada Laws Ch. 475 (1995). The beneficiary of a deed of trust must, within 21 days of request, provide a statement of the amount of the unpaid balance, the interest rate, the total amount of principal and interest due and unpaid, the amount of the periodic payments, the date the payment is due, the balance in any account held for payment of taxes and insurance, the amount of any additional charges which are a lien on the property, and whether the debt may be transferred to a person other than the grantor. In addition, the beneficiary must state, if known, the period for which real estate taxes and assessments have been paid, and the amount, term, and premium of insurance on the property. The beneficiary must also provide, upon request, a statement of the amount of money necessary to discharge the debt, and the additional *per diem* amount for a period not to exceed 30 days from the date of the statement. Requests for these statements may be made by the grantor or his successor, any person holding a subordinate lien or encumbrance on the property, a title insurer, or an agent of any of these persons. A beneficiary who willfully fails (intentionally and without just cause) to provide these statements within 21 days after requested is liable to the requestor for $300 plus any actual damages. A person who receives these statements may rely upon their accuracy.

7 Purdon's Pa. Stat. Ann. § 6610. Applies only to second-mortgage loans. Requires the holder to give the borrower, within 10 days of receipt of a request, a written statement of the borrower's account, showing the dates and amounts of all payments, the amount and explanation of all other charges and credits, and the unpaid balance. Only two such statements need be furnished in any 12-month period.

R.I. Gen. Laws § 19-25.2-26. Substantially similar to the Pennsylvania statute described above.

Tennessee Code Ann. § 45-13-114. Requires the holder of a mortgage loan, within 14 days from receipt of written request, to deliver to the mortgagor a statement of account showing date and amount of all payments received during the previous 12-month period, and the total unpaid balance.

Utah Code Ann. § 57-15-8. In a mortgage loan assumption transaction, requires the mortgagee to furnish the seller, within 14 days of a request, a statement of (a) the amount of the unpaid balance on the loan; (b) the interest rate; (c) the amount of the monthly installments; (d) the date any real estate taxes or assessments were last paid; (e) the amount of hazard insurance in effect, if the lender has records of that fact; (f) the amount of any impound balance reserve for payments of taxes, assessments, and insurance.

Virginia Code § 6.1-330.82. The owner of mortgaged real estate, if entitled to prepay the obligation, is entitled to receive from the holder of the obligation a written statement, setting forth the total amount to be paid in order to obtain a release. The holder shall mail or deliver the statement within 10 business days of receipt of a written request.

CHAPTER 2

FUTURE ADVANCES

Introductory Note: The law of future advances has not developed satisfactorily in the American courts. As a result of dissatisfaction with court-made doctrine, the area has been occupied to a significant extent in the past few decades by state statutes. This Chapter draws on the best of case law and statutory sources, both of which are summarized state-by-state in the Notes following § 2.1, to arrive at a modern and doctrinally coherent approach.

Section 2.1 deals with the validity of mortgages as security for future advances, both as between the parties and as against persons who subsequently acquire interests in the realty. Section 2.2 is devoted to expenditures by a mortgagee for the special purpose of protection of the security, and deals with both the question of whether such advances are secured by the mortgage and the matter of their priority against subsequently arising interests.

The controversial matter of priority of future advances is covered in § 2.3. It rejects the traditional distinction between obligatory and optional advances, which has proven highly troublesome. All future advances are given the priority of the mortgage. In lieu of the optional advance doctrine, § 2.3 draws on a statutory concept known as the "cut-off" notice and adapts it to judicial usage. By this means the priority of all future advances is assured, while at the same time mortgagors who wish to "cap" such advances in order to obtain subordinate financing can do so.

Limitations on the operation of "dragnet" clauses, which purport to make a mortgage secure the repayment of as yet unidentified future advances, are set forth in § 2.4. In general its thrust is to impose rather stringent limits on such clauses, but to permit some relaxation if the clause is sufficiently specific.

§ 2.1 Future Advances

(a) A mortgage secures "future advances" if it secures performance of an obligation that comes into existence or is enlarged after the mortgage becomes effective.

(b) As between the parties to a mortgage, repayment of future advances will be secured by the mortgage if the parties have so agreed. The agreement need not be in the mortgage and need not be written. If a separate agreement for future advances is made at the time the mortgage becomes effective, but is unwritten, it will be enforceable only to the extent permitted by the Parol Evidence Rule.

(c) As against a person acquiring an interest in the mortgaged property subsequent to the mortgage, repayment of future advances will be secured only if an agreement of the kind described in Subsection (b) exists and

(1) the mortgage states that repayment of future advances is secured; or

(2) the person has other notice of the parties' agreement concerning future advances at the time the interest is acquired; or

(3) the mortgage states a monetary amount to be secured.

(d) If the mortgage states a monetary amount to be secured and makes no provision for future advances in excess of that amount, the total amount of the principal obligation secured by the mortgage may never exceed the stated amount, except as provided in Subsection (e) of this section.

(e) If the parties to the mortgage have agreed, in the mortgage (or otherwise, to the extent recognized under the Parol Evidence Rule) that the secured obligation includes the following items, the mortgage will secure their payment to the extent permitted by local law, notwithstanding that when added to the principal obligation they cause the total balance to exceed the stated amount:

(1) interest (including interest on amounts accruing as interest during previous periods and added to principal);

(2) costs of collection or foreclosure;

(3) attorneys' fees;

(f) A mortgage to secure repayment of future advances is valid whether or not any advances are made at the time the mortgage becomes effective.

Cross-References:

Section 1.6, Mortgagee's Duty to Disclose Balance and Status of Obligation; Section 2.2, Expenditures for Protection of the Security; § 2.3, Priority of Future Advances; § 2.4, Mortgages Securing Future Advances Not Specifically Described; § 6.4, Redemption from Mortgage by Performance or Tender; Statutory Note and Case Note following § 2.1.

Comment:

This section deals only with the validity and enforceability of mortgages securing future advances; the priority of mortgages with respect to such advances is governed by § 2.3.

a. Definition of future advances. The term "future advances" is used here to refer to all situations in which a mortgagor's obligation or the amount or value of a mortgagor's secured performance arises or is enlarged after the mortgage becomes effective. Most future advances are sums of money disbursed to the mortgagor by the mortgagee. Typical examples include draws on construction loans and disbursements under secured lines of credit.

However, an obligation secured by a mortgage may accrue by virtue of circumstances other than a monetary advance. For example, a mortgage may secure the mortgagor's guarantee of another person's debt. If the other person defaults, the mortgagor's obligation to pay accrues. That sort of obligation is governed by the rules of this and the following sections. Similarly, a mortgagor and mortgagee may enter into a mortgage to secure a particular debt, and may later agree to extend the mortgage's coverage to other debts, either preexisting or incurred at the time of the modification. Such cases are regarded as future advances.

Case law in some jurisdictions continues to distinguish between optional and obligatory future advances; see § 2.3. However, this Restatement rejects any such distinction, which has proven impossible to apply coherently in practice. For purposes of this and the following sections, all future advances are treated alike, whether or not the mortgagee has a contractual duty to make them.

b. Agreements to secure future advances, as between the parties. Where the parties to a mortgage intend it to secure future advances, they will commonly include their agreement to that effect in the mortgage itself. However, their agreement may instead be found in a separate document executed either simultaneously with the mortgage or later, or it may arise from an oral conversation. In the absence of an agreement of any kind on the matter, the mortgage will not secure future advances. If the separate agreement is oral, and if the mortgage is determined to be a complete integration of the parties' agreement, the Parol Evidence Rule may preclude a court from considering the oral agreement. See Restatement, Second, Contracts § 216.

Illustrations:

1. A borrows $100,000 from B. A executes a promissory note for $100,000 secured by a mortgage on A's real estate in favor of B. The mortgage makes no mention of future advances. The parties subsequently reach an oral agreement that the mortgage will also secure an additional $20,000 advance that B may make to A in the future. If the additional advance is in fact made, and if the Parol Evidence Rule does not exclude the oral agreement, the mortgage secures repayment of the advance.

2. A borrows $100,000 from B. A executes a promissory note for $100,000, secured by a mortgage on A's land in favor of B. The mortgage recites that it secures indebtedness of $200,000. However, it makes no mention of future advances and the parties never enter into any other agreement providing that the mortgage secures future advances. If B makes a further advance or loan to A, the mortgage does not secure its repayment.

3. The facts are the same as Illustration 2, except that A and B also enter into a separate agreement that the mortgage will secure future advances. If further advances are in fact made which make the total principal loan balance $200,000 or less, the mortgage will secure them. If further advances are made in an amount which makes the total principal loan balance exceed $200,000, whether the mortgage secures the excess over $200,000 depends on whether the parties intended their agreement concerning future advances to be or not to be limited by the $200,000 amount recited in the mortgage.

c. Agreements to secure future advances, as against third parties. One who examines the title to land in contemplation of acquiring an interest in it is entitled to fair notice that the obligation secured by an existing mortgage may be increased by future advances. The mortgage itself may give such notice in either of two ways: The mortgage may state that it secures future advances, or it may state a maximum principal balance that will be secured. In general no statement of maximum principal is necessary to the validity of a mortgage; see § 1.5(c). Inclusion of a statement of the amount secured is merely one method of ensuring that advances (including future advances) up to that total amount will be secured.

If the mortgage merely mentions that future advances will be secured, a subsequent grantee or lienor cannot tell from a reading of the mortgage what the secured amount may be, but will be on notice that an inquiry must be made of the mortgagee to discover that amount. Even if the mortgage states the maximum principal amount, such an inquiry is highly prudent, since the mortgage's statement will not inform the subsequent grantee or lienor of the accrued interest, advances to protect security, or other similar items to which he or she will be subordinate. Nevertheless, the statement of maximum principal provides at least a rough gauge of the maximum total balance.

Since a statement of the maximum principal amount will ordinarily mention a figure which represents the largest possible sum the parties expect to be advanced, the actual amount will often be smaller. In a sense this may be misleading to subsequent grantees or lienors who examine the title. However, they can hardly complain, since the overstatement of the amount will tend to make them more rather than less conservative in dealing with the mortgagor and the real estate. Moreover, future grantees or mortgagees can discover the exact status of the obligation by insisting that the mortgagor obtain a statement of it from the mortgagee; see § 1.6. Some detriment to potential judgment creditors may occur, since a prospective plaintiff who examines the mortgagor's title before deciding whether to file an action may elect not to do so because of the large apparent encumbrance on the mortgagor's land.

Illustrations:

4. A wishes to establish a secured fluctuating line of credit with B, a bank. A signs a promissory note for $100,000, secured by a mortgage on A's land, in favor of B. The mortgage makes no mention of future advances, but recites that a principal amount of $100,000 is secured. The parties agree separately that the mortgage will secure future advances. At that time B does not disburse any funds to A. However, one month later A borrows $75,000 from B, and two months later A borrows an additional $15,000 from B. A subsequently sells the land to C. The full balance of $90,000 is secured by the mortgage as against C.

5. A borrows $100,000 from B evidenced by a note for this amount, secured by a mortgage on A's land. The funds are to be used in A's retail store business. The mortgage recites, "This mortgage shall also secure all future loans or advances made by B to A," but states no maximum amount of indebtedness. Subsequently A borrows an additional $50,000 from B, which is also

used in A's business, and which the parties agree is to be secured by the mortgage. A thereafter sells the land to C. The full $150,000 balance is secured by the mortgage as against C.

6. The facts are the same as Illustration 5, except that the mortgage recites, "This mortgage secures the sum of $100,000 which has been loaned to A, and also secures all future loans or advances made by B to A." The full $150,000 balance is secured by the mortgage as against C.

If a mortgage states a maximum principal amount to be secured, but does not otherwise refer to future advances, a question arises as to whether the parties can effectively enlarge this amount by an agreement external to the mortgage. As between the parties to the mortgage and their successors with notice, the parties' agreement determines this question. However, as against subsequent grantees without notice of the separate agreement, the total principal sum secured may not exceed the stated amount.

The restriction in Subsection (d) limits only the principal amount of advances. Accrued interest, collection and foreclosure costs, and attorneys' fees may be added if the parties have so agreed, and may cause the total balance secured to exceed the stated maximum. It does not matter whether the mortgage itself states the mortgagor's obligations with respect to these matters, or that agreement is contained in some other document. However, local law may restrict these items, and if so, the effectiveness of the mortgage as security will be similarly restricted. For example, in some states attorneys' fees associated with mortgage foreclosure are limited by statute. In other states, statutes may prohibit the collection of interest on accrued interest.

Advances for the protection of the security, as provided in § 2.2, are also secured by the mortgage, and may cause the mortgage's balance to exceed the stated maximum principal amount; this follows whether or not the parties have explicitly agreed that the mortgagee may make such advances.

The types of advances mentioned above are likely to be relatively small in relation to the principal amount debt. They cannot readily be estimated or predicted in advance, and are nearly always present when a mortgage is defaulted upon or foreclosed. Thus they are to be expected and should be taken into account by junior grantees or lienors.

Illustrations:

7. A borrows $100,000 from B and executes a mortgage on A's land. The mortgage recites: "This mortgage is given to secure

payment of $100,000, and shall secure future advances, but the total principal shall not exceed $100,000." Subsequently the parties enter into a separate agreement that B will advance an additional $50,000 to A, and that this advance will be secured by the mortgage. Thereafter A sells the land to C, who has no notice of the separate agreement. Only $100,000 of the total principal debt is secured by the mortgage as against C; the remaining $50,000 is unsecured.

8. A borrows $50,000 from B for a one-year term, giving B a mortgage on A's land as security for repayment. The parties agree, in the promissory note or otherwise, that the debt will bear interest at 10 percent per annum. The mortgage states that it secures a debt of $100,000 with interest. The parties agree separately that the mortgage will secure future advances, but the mortgage itself makes no reference to such advances. During the course of the year A draws down two additional advances of $30,000 each. At the end of the loan term the balance owing is $120,000, consisting of the three disbursements of $50,000, $30,000, and $30,000 and accrued interest (computed on all disbursements) of $10,000. A then sells the land to C, who has no notice of the separate agreement regarding future advances. As against C, the mortgage secures only a principal amount of $100,000 (the amount stated in the mortgage) plus interest on the $100,000 principal.

d. Future advance mortgages with an initial zero balance. Every mortgage must secure some obligation. However, there is no objection to the creation of a mortgage to secure an obligation which has not yet been entered into or whose amount is not yet certain. Such arrangements are highly convenient, and cause no harm to any other party. While the mortgage may not be foreclosed until an actual obligation has been assumed and its value determined, the mortgage is nonetheless valid from the outset, and it is unnecessary to reexecute the mortgage when the first advance is made.

Illustrations:

9. A desires to develop a residential subdivision, and arranges a construction loan for $1 million from B. The parties' agreement provides that A will submit paid invoices for labor and materials to B on a monthly basis, and B will then make advances in the amounts shown on those invoices. The parties immediately execute and record a mortgage on the land A is to develop, but no funds are advanced until the end of the first month of construc-

tion. The mortgage is valid notwithstanding that the balance secured is zero until the first advance is made.

REPORTERS' NOTE

With respect to the formalities required for mortgages to secure future advances, see generally 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.7 (3d ed. 1994); G. Glenn, Mortgages §§ 397–98 (1943); L. Jones, Mortgages § 458 (8th ed. 1928).

Agreements to secure future advances, as between the parties, Comment b. As between the parties, the written mortgage is not the only source of information about the nature of the security agreement. Off-mortgage agreements, whether written or oral, can modify or supplement the written mortgage. See, e.g., Ferguson v. Mueller, 169 P.2d 610 (Colo. 1946).

This principle is widely accepted when the supplementing agreement is written; it is then treated simply as an extension of the mortgage itself. However, where the supplementing agreement is oral, the case law is divided. For authority that such oral agreements respecting future advances are excluded by the Parol Evidence Rule, see Schmitz v. Grudzinski, 416 N.W.2d 639 (Wis. Ct. App. 1987); Willamette Production Credit Ass'n v. Day, 118 P.2d 1058 (Or.1941); Barnhart v. Edwards, 47 P. 251 (Cal. 1896); G. Glenn, Mortgages § 399.1 (1943); L. Jones, Mortgages § 118 (1928). See also Weatherwax v. Heflin, 12 So.2d 554 (Ala.1943) (parol agreement would violate Statute of Frauds).

For authority approving admission of parol evidence to show or modify an agreement to secure future advances, see Turner v. Houston Agricultural Credit Corp., 601 S.W.2d 61 (Tex. Ct. Civ. App. 1980); Western Pennsylvania Nat'l Bank v. Peoples Union Bank, 266 A.2d 773 (Pa.1970); Gosselin v. Better Homes, Inc., 256 A.2d 629 (Me.1969); Clark v. Howard, 192 So.2d 302 (Fla.Dist.Ct.App.1966); Rinaldo v. Holdeen, 246 N.Y.S.2d 807 (N.Y.App.Div.1964); Langerman v. Puritan Dining Room Co., 132 P. 617 (Cal.Ct.App.1913). Illustration 1 is based on these cases.

Under the view of the Parol Evidence Rule stated in Restatement, Second, Contracts § 216, an agreement is regarded as not fully integrated if the writing omits a consistent additional agreed term if, in the circumstances, such a term might naturally be omitted from the writing. Cases in which this is so with respect to the securing of future advances are entirely conceivable. Of course there may still be conflicting testimony as to the content of the parties' oral agreement which must be resolved by the trier of fact.

Illustrations 2 and 3 are based on County of Keith v. Fuller, 452 N.W.2d 25 (Neb.1990). Even if the mortgage states a larger amount than is actually advanced when the mortgage is executed, it will not secure future advances unless the parties have in fact agreed that it will do so. Of course, a case might arise in which the court will infer the existence of such an agreement from the parties' conduct despite a lack of direct evidence of it; the court refused to do so in County of Keith v. Fuller, id. See also Harmon v. Bank of Danville, 339 S.E.2d 150 (S.C. Ct. App. 1985).

In Illustration 3 there is *both* a future advances agreement and a statement in the mortgage of maximum amount. Whether future advances may then cause the principal balance to exceed the maximum is a matter of construction of the mortgage. See, e.g., Home State Bank v. Johnson, 729 P.2d 1225 (Kan.1986); Malkove v. First Nat'l Bank, 326 So.2d 108 (Ala.1976). In both of these cases the stated maximum was held to control. Contra, see Citizens' Sav. Bank v. Kock, 75 N.W. 458 (Mich. 1898) (statement of maximum amount does not restrict future advances).

Agreements to secure future advances, as against third parties, Comment c. With respect to the two methods by which a mortgage may show that future advances are to be secured (either a statement of the total principal amount to be secured, or a statement that future advances will be secured), see Commercial Bank v. Rockovits, 499 N.E.2d 765 (Ind.Ct.App.1986); First National Bank v. Bain, 188 So. 64 (Ala.1939); Tapia v. Demartini, 19 P. 641 (Cal. 1888); G. Osborne, Mortgages § 116 (1951); 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.7 (3d ed. 1994). But see Tyler v. Butcher, 734 P.2d 1382 (Or.Ct.App.1987) (where mortgage lacked future advances clause, it was valid for future advances only as between the parties, and not as against intervening lienors who had no notice of the parties' agreement with respect to future advances, despite the fact that the advances were within the stated maximum amount); Sadd v. Heim, 124 A.2d 522 (Conn.1956) (same).

Where neither of these two methods mentioned is employed, and where there is no other recorded document revealing the parties' agreement that the mortgage is to secure future advances, the mortgage will not do so as against a subsequent grantee without notice of that agreement; Leche v. Ponca City Prod. Credit Ass'n, 478 P.2d 347 (Okla. 1970).

In numerous jurisdictions the formalities necessary to make a mortgage secure future advances, as against third parties, are set forth in statute. See the Statutory Note following this section.

Illustration 4 is based on Peterson Bank v. Langendorf, 483 N.E.2d 279 (Ill. App. Ct. 1985). See also Biersdorff v. Brumfield, 468 P.2d 301 (Idaho 1970). Contrary authority is found in Tyler v. Butcher, 734 P.2d 1382 (Or.Ct.App.1987) and Sadd v. Heim, 124 A.2d 522 (Conn.1956).

Illustration 5 is based on Commercial Bank v. Rockovits, 499 N.E.2d 765 (Ind.Ct.App.1986) and Monroe County Bank v. Qualls, 125 So. 615 (Ala. 1929). See also Oaks v. Weingartner, 234 P.2d 194 (Cal.Ct.App. 1951) (where mortgage states that future advances are secured, a statement of maximum amount is unnecessary); Potwin State Bank v. J.B. Houston & Son Lumber Co., 327 P.2d 1091 (Kan.1958) (same); Bank of Maysville v. Brock, 375 S.W.2d 814 (Ky.1964); Industrial Supply Corp. v. Bricker, 306 So.2d 133 (Fla.Dist.Ct. App.1975) (under Florida statute, mortgage was valid as against third-party lienors, where language of mortgage, although vague, was sufficient to place them upon notice that mortgage would secure future advances); Snead Constr. Corp. v. First Fed. Sav. & Loan Ass'n, 342 So.2d 517 (Fla.Dist.Ct.App.1976); State Bank of Hartland v. Arndt, 385

N.W.2d 219 (Wis.App.1986) (same, but not under statute). Cf. Jacobs v. City Nat'l Bank, 313 S.W.2d 789 (Ark.1958) (terms of mortgage insufficient to show an intent to secure future advances).

In many cases involving "dragnet" clauses of the type employed in Illustration 5, where the future debts are not described with specificity in the original mortgage, a question may arise as to whether the parties intended the future debt to be within the scope of the mortgage clause. See § 2.4. In Illustration 4, however, this is not an issue since the parties agreed at the time of the future advance that it was secured by the mortgage.

Illustration 6 is based on Home State Bank v. Johnson, 729 P.2d 1225 (Kan.1986) and Reuben E. Johnson Co. v. Phelps, 156 N.W.2d 247 (Minn. 1968). If the language limiting the total principal to $100,000 had not been present, the mortgage would have secured the entire $150,000 debt. The case would thus have been similar to Illustration 5.

Illustration 7 is based on Poulos v. Mountainwest Sav. & Loan Ass'n, 680 P.2d 1073 (Wyo.1984).

Future advance mortgage with a zero obligation, Comment d. Illustration 8 is based on Whitice Bonding Agency, Inc. v. Levitz, 559 So.2d 755 (Fla.Dist.Ct.App.1990). Illustration 9 is based on Central Production Credit Ass'n v. Page, 231 S.E.2d 210 (S.C. 1977). See also Goetz v. Selsor, 628 S.W.2d 404 (Mo.Ct.App.1982) (if mortgage debt is fully paid and parties have no intent to keep mortgage alive, it is extinguished).

STATUTORY NOTE ON FUTURE ADVANCES

The majority of American jurisdictions have enacted statutes governing some aspects of mortgages securing future advances. There is wide variation in the effect and coverage of these statutes, and in many cases they are ambiguous or difficult to interpret. The table below summarizes their more important features.

Validity of mortgages securing future advances. When considering the enforcement of mortgages securing future advances, it is critical to distinguish between issues of validity and issues of priority. Validity (that is, effectiveness of the mortgage security) is the subject of § 2.1 of this Restatement. The rules stated there have been stable for many decades, and are relatively noncontroversial.

In essence, those rules provide that, as against a person acquiring an interest in the mortgaged property without other notice of a future advances agreement, future advances may be secured either by keeping them within a maximum amount stated in the mortgage, or by stating in the mortgage that future advances will be secured.

As the table below shows, the rules of § 2.1 have been modified to some extent by statutes in numerous jurisdictions. About 15 statutes require both a statement of maximum amount and a specific reference in the mortgage to future advances. Some of the statutes appear to require this dual statement only for priority purposes—that is, against intervening lienors—while others require it even for validity as between the original parties. In several cases, it is difficult to tell which of these effects was intended by the legislature.

Requiring a dual statement seems unnecessary, since either a statement of maximum amount or a statement that future advances may be secured is surely sufficient to place subsequent grantees and lienors on notice that they may be subordinate to a larger amount than the current balance. A more sensible approach is represented by the Maine statute, which only requires a statement mentioning future advances if the mortgage states no amount or a nominal amount. Section 2.1 of this Restatement rejects the necessity for a dual statement, such as is found in the other statutes mentioned above.

Advances for protection of the security. The statutes frequently recognize (as do the common law and § 2.2 of this Restatement) the validity and priority of advances for "protection of the security," a phrase typically taken to include, at a minimum, payment of property taxes, special assessments, and hazard insurance by the lender. Some of the statutes list additional types of disbursements by the lender that are given this same recognition. These "protective" advances are typically given the full priority of the original mortgage, notwithstanding (a) that they cause the loan balance to exceed the mortgage's stated maximum; (b) that the statute requires the mortgage to state a maximum amount or prohibits advances exceeding the stated maximum; and (c) the issuance by the mortgagor of a "cutoff notice," a concept discussed below. See, e.g., Leroux v. Bank of New Hampshire, 567 A.2d 561 (N.H.1989) (accrued interest, late charges, and foreclosure costs receive original mortgage priority despite the fact that they raise loan balance above the principal amount stated in the mortgage).

However, it is sometimes difficult to tell whether a statutory provision dealing with advances for protection of security is intended to have all of the consequences mentioned in the preceding paragraph. Other interpretive difficulties also exist. For example, if the statute states, as does Idaho's, that the "mortgage shall provide for" such advances, it is clear enough that an explicit mortgage provision will be enforceable; but if the provision is omitted from the mortgage, does this mean that advances for protection get no priority? No security at all? Such questions are impossible to answer in the absence of judicial construction of the statute.

Priority. As discussed in the Reporters' Note to § 2.3, the common law denies priority to advances that the mortgagee is not contractually obligated to make, as against intervening liens of which the mortgagee has notice when the advance is made. There is widespread dissatisfaction with this rule, as evidenced by the fact that many of the statutes repeal it and give priority to all future advances, whether optional or obligatory.

However, some of the legislatures have obviously been concerned that a simple reversal of the optional advance rule goes too far. The traditional objection to giving priority to all future advances is that doing so may place the mortgagor in the unhappy position of being unable to demand additional credit from the senior mortgagee (who has no contractual obligation to lend further funds), and at the same time unable to obtain a loan from a new creditor taking a junior priority position (since any such junior lender is subject to the risk that the senior mortgagee will in fact advance further funds and thereby eat up the security value of the property). To avoid this result, some of the statutes permit the mortgagor to issue a "cut-off notice" to the mortgagee, in effect canceling the future-advance feature of the loan, stipulating that he or she will not draw down additional funds, and limiting the mortgagee's lien to the then-existing loan balance plus accruing interest, costs, and advances for protection of the security as discussed above. If a borrower is liable on a future-advances mortgage but wishes to seek a loan from a new junior lender, the borrower need only issue the notice and "cap" the senior lien.

Section 2.3 of this Restatement adopts and refines the cut-off notice concept. The statutory provisions respecting cut-off notices listed in the table below vary considerably. Some statutes permit the mortgagor to issue such a notice only as against optional advances, while others permit the notice to apply against both optional and obligatory advances. If the senior lender makes a further advance despite the receipt of a cut-off notice, some of the statutes merely subordinate the priority of the advance (which is all that is really necessary to carry out the notice's purpose), while others hold the advance to be entirely unsecured.

In the table that follows, some of the conclusions represent the Reporters' interpretations of the statutes. The statutory language is not always clear and there are few judicial decisions to provide guidance. It is therefore possible that future case law will not agree with some of the conclusions stated. The letter "V" in the table indicates that the particular statutory provision must be complied with in order for the mortgage to have validity as security for future advances; the letter "P" indicates that compliance is necessary only to preserve the mortgage's priority as against intervening liens. Where the Reporters have been unable to determine which of these two interpretations was intended by the legislative body, the entry is "V/P?"

Future Advances: Statutory Note

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
Alaska Alaska Stat.[1] § 06.30.560-.565	No	No	The following take the mortgage's priority: taxes, assessments, insurance, and similar charges for protection	Yes, unless mortgagee has received written notice of intervening liens [2]	Yes, mortgagor or successor may record a notice limiting *optional* advances to presently outstanding amount
California Cal. Civ. Code § 3136	P (priority granted may not exceed lender's original obligatory commitment as shown in the mortgage)	No	Not mentioned	Yes, but only against unfiled mechanics' liens,[3] and only for advances to pay lien claims or costs of improvements [4]	No
Connecticut [5] Conn. Gen. Stat. §§ 49-2 to 49-4b	V	V (Mortgage must state the event or condition upon which advances depend)	Yes: repairs, alterations, improvements, and completion of construction; see note 5	Yes	Yes, mortgagor may record a notice limiting optional advances to the amount then actually advanced
Delaware Del. Code Ann. Tit. 25 § 2118	V (or in other instrument incorporated by reference)	V (or in other instrument incorporated by reference)	Yes: interest, service charges, taxes, assessments, insurance	Yes	No
Florida [6] Fla. Stat. Ann. § 697.04	V	V [7]	Yes: taxes, levies, insurance, deferred interest, and construction loan advances, plus interest on all such advances [8]	Yes (except against landlords' liens) if made within 20 years from mortgage date;[9] later advances are apparently unsecured	Yes, mortgagor or successor may file a notice limiting the maximum principal to the amount actually advanced at the time of the filing
Georgia Ga. Code Ann. §§ 44-14-1 & 44-14-2			Yes: taxes, insurance, amounts due on senior liens, repairs, completion of improvements, and expenses of collection and foreclosure	Not by statute, but by judicial decision [10]	
Hawaii Haw. Rev. Stat. § 506-1	P			Yes (except as against tax and assessment liens)	No
Idaho [11] Idaho Code § 26-1931			Yes: mortgage "shall provide for" taxes, assessments, ground rents, insurance, and similar charges	Yes	No

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
Illinois [12] Ill. Stat. Ann. Ch. 110 ¶15-1302	See notes	See notes	Yes: interest, payments to preserve or restore the property, to preserve the lien, or to enforce the mortgage	Yes, if under a "revolving credit arrangement" or made pursuant to commitment [13]	No
Iowa Iowa Code Ann. § 572.18, § 654.12A	P (§ 654.12A)	P (must state that the mortgage secures advances "up to" the stated amount) (§ 654.12A)	Yes: interest; other items are not mentioned	Yes, except where the mortgagee has received notice of foreclosure or other action to enforce the intervening lien [14]	No
Kansas [15] Kan. Stat. Ann. § 58-2336	P [16]		Not mentioned	Yes [17]	No
Kentucky Ky. Rev. Stat. § 289.441 [18]			Yes: taxes, assessments, insurance, similar charges, and life insurance premiums	Yes	No
Ky. Rev. Stat. § 382.520	V	V	Not mentioned	Yes	Yes, upon written request from mortgagor, mortgagee must release of record the lien to secure additional indebtedness
Louisiana La. Civ. Code Ann. art. 3158	P	P	Not mentioned	Yes, when a "collateral mortgage" is used and the subsequent pledges are made in good faith [19]	No
Maine [20] Me. Rev. Stat. Ann. tit. 9B, § 436	P/V?	V (if mortgage states zero or nominal amount)	Yes, but types of protective advances are not itemized by the statute	Yes, unless holder of intervening interest notifies mortgagee in writing	Yes, mortgagor or successor may record and file with mortgagee a notice limiting *optional* future advances to the amount actually advanced
Maryland Md. Real Prop. Code Ann. § 7-102	V		Not mentioned	Yes [21]	No

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
Michigan Mich. Stat. Ann. §§ 565.901–.906 [22]	P (residential only)	P (residential only)	Yes: advances to fulfill an obligation of the mortgagor with respect to the property, to preserve the priority of the mortgage or the value of the property, and for attorneys' fees and collection costs	Yes. However, construction mortgage advances have priority over mechanics' liens only if proper lien waivers are obtained; Mich. Stat. Ann. § 570.1119	No
Missouri [23] Mo. Ann. Stat. § 443.055	P	P	Yes: taxes, insurance, maintenance fees under condominium or covenant, and construction advances	Yes, if made within 10 years from mortgage date; later advances are unsecured [24]	Yes, borrower may send notice electing to terminate mortgage as to further advances. Mortgage is invalid as to any principal amounts exceeding balance owing on date of notice [25]
Montana Mont. Code Ann. § 71-1-206	V [26] (interest may be added to amount stated)			Yes	Yes, borrower may send notice that no further advances will be drawn; mortgage loses priority as to any further advances
Nebraska Neb. Rev. Stat. § 76-238.01	V		Yes, but types of protective advances are not itemized by the statute	Yes, but optional advances lose priority to intervening lienors who give written notice to the mortgagee [27]	Yes, mortgagor or successor may record a notice limiting *optional* advances to the amount advanced as of the date of the notice
Nevada Nev. Rev. Stat. § 106.300–.400	V [28]	V; must also state whether advances will be optional or obligatory		Yes	Yes, borrower may give lender notice terminating the mortgage's operation as to further advances. Further advances are unsecured (§ 106.400)
New Hampshire N.H. Rev. Stat. Ann. § 479:3–5	V	V [29]	Not mentioned	Yes (§ 479:3) [30]	No

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
New Jersey N.J. Stat. Ann. § 46:9-8.1 to § 46:9-8.4 (not applicable to construction loans) [31]	P		Yes: accrued interest, taxes, insurance, and other payments pursuant to the mortgage	Yes	No
New Mexico N.M. Stat. Ann. § 48-7-9	V [32]		Yes: Costs, interest, and attorneys' fees [33]	Yes	No
New York N.Y. Real Prop. Law § 281 (not applicable to construction loans) [34]	V/P?	V/P?	Yes: interest plus disbursements made to protect the security	Yes, as to advances made within 20 years of mortgage recording	No
North Carolina [35] N.C. Gen. Stat. §§ 45-67 to 45-74	P (must also state amount of present obligations and maximum period advances will be made)	P (inapplicable to equity lines of credit; see below)	Yes: interest, insurance, taxes, assessments, and other necessary expenditures for preservation of the security	Yes, as to advances made within 15 years of the date of the mortgage (§ 45-68(1)(c))	Yes, maker of the instrument may request holder to record a notice stating current balance; no further advances (except for protection) may be secured by the mortgage (§ 45-72)
N.C. Gen. Stat. §§ 45-81 to 45-84 ("Equity Lines of Credit")	P	P (must state that it is an equity line of credit governed by this statute)	Yes: insurance, taxes, assessments, and other payments made pursuant to the mortgage	Yes, as to advances made within 15 years of the mortgage (§ 45-81(a)(1))	No, but borrower may request satisfaction of the instrument if balance owing is zero
North Dakota N.D. Cent. Code § 6-03-05.1		V	Yes: taxes, assessments, and insurance	Yes, but optional advances lose priority to intervening mortgagees who give the future advance mortgagee written notice [36]	No
Ohio Ohio Rev. Code Ann. § 5301.232	V	V (must also contain at the beginning the words "Open-end mortgage")	Yes: taxes, assessments, insurance, and costs incurred for the protection of the mortgaged premises	Yes, but optional advances are subordinated to intervening liens of which the mortgagee has received written notice [37]	Yes, mortgagor may limit secured debt to that in existence at time of serving and recording a written notice; the limitation does not apply to interest, obligatory advances, or advances on construction loans [38]

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
[39] Oregon Or. Rev. Stat. § 86.155	P (must also state the term, if any)	P (must contain the title "line of credit mortgage")	Yes: interest, lawful charges, and amounts (including attorneys' fees) to protect the security	Yes	Yes, debtor may limit indebtedness to the amount then outstanding by delivery of a notice to the mortgage holder
Pennsylvania Pa. Cons. Stat. §§ 8143, 8144	V	V	Yes: taxes, assessments, maintenance charges, insurance premiums, expenses of collection, and construction advances	Yes, but optional advances lose priority to intervening liens of which the mortgagee has written notice	Yes, mortgage may record and send to mortgagee a notice limiting the indebtedness to that in existence at the time notice is delivered
Rhode Island R.I. Gen. Laws §§ 34-25-8 to 34-25-14	P	P [40]	Yes: interest, taxes, insurance, and obligations which the mortgagee has been given the right to pay	Yes, but optional advances lose priority to intervening liens of which the mortgagee has written notice [41]	Yes, mortgagor may send notice terminating the mortgage's security as to further advances
South Carolina S.C. Code Ann. §§ 29-3-40 and 29-3-50	P	P (mortgage must state that interest will be deferred or capitalized, if such is the case)	Yes, if mortgage so authorizes: taxes, insurance, public assessments, and repairs	Yes, but all advances made after the filing and service of a mechanic's lien are subordinate to such lien	No
South Dakota S.D. Cod. L. Ann. § 44-8-26	P	P [42]	Not mentioned, except for interest	Yes, but the mortgage secures only advances made within 5 years and 60 days.[43] Later advances are apparently unsecured	No
Tennessee Tenn. Code Ann. §§ 47-28-01 to 47-28-110	P (must also state maximum term, which may not exceed 20 years) [44]	P	Yes: interest, loan charges, commitment fees, taxes, insurance, and expenses of collection and foreclosure	Yes, for "open-end" mortgages only.[45] For other mortgages, optional advances lose priority to intervening liens of which the mortgagee has actual notice [46]	Borrower may serve a "notice of limitation," stating a new credit limit not less than existing balance; any advance exceeding this limit loses priority to junior interests
Vermont Vt. Stat. Ann. tit. 8, § 1207		V	Not mentioned	Yes, but all advances made after the mortgagee receives written notice of an intervening mortgage are subordinated to it	No

Statutory Treatment of Future Advance Mortgages

Statutory Citation	Maximum Amount Must be Stated?	Mortgage Must Refer to Future Advances?	Advances for Protection of Security May Exceed Stated Maximum Amount?	Priority Given to Optional Advances?	Cut-off Notice Provisions?
Virginia Va. Code Ann. §§ 55-58.2 -59	P (must also state note-holder's name and address)	P [47]	Yes: mortgagor's covenants, taxes, assessments, maintenance, and interest (§ 55-59)	Yes [48]	Yes, grantor may require a modification at any time surrendering priority over subsequent deeds of trust as to discretionary future advances
Washington Wash. Rev. Code Ann. § 60.04.220				Yes [49]	No
West Virginia W. Va. Code § 38-14-1	V	V (must also be entitled "A CREDIT LINE DEED OF TRUST") [50]	Yes: interest, taxes, insurance premiums, and other obligations	Yes, but optional advances do not have priority over intervening liens of which the mortgagee has been given written notice [51]	No

Notes to Statutory Citations

1. Applicable only to savings and loan associations. See also Alaska Stat. § 34.35.060, providing that all disbursements under a mortgage, whether optional or obligatory, have priority over subsequent mechanics' liens.

2. Under Alaska Stat. § 34.35.060, all recorded mortgages have priority from their date of recording as against mechanics' liens that are unfiled as of that date. This priority extends to future advances, whether optional or obligatory.

3. The cited statute, enacted in 1957, applies on its face only against mechanics' liens. It reverses the common law and protects the priority of optional advances on an earlier recorded mortgage as against mechanics' liens, provided (a) the advances are in fact used to pay for either filed mechanics' lien claims or for the improvement of the property; and (b) the total priority sought does not exceed the original obligatory commitment. See Coast Central Credit Union v. Superior Court, 257 Cal.Rptr. 468 (Cal.Ct.App.1989).

The statute's rationale (although not its literal language) has been employed to protect the priority of optional future advances against a junior deed of trust, where the advances were in fact used in improvement of the property. Turner v. Lytton Sav. & Loan Ass'n, 51 Cal.Rptr. 552 (Cal.Ct.App.1966).

4. This statute has very narrow application. In cases to which it does not apply, California follows the traditional optional/obligatory distinction. Optional advances lose priority only to intervening liens of which the mortgagee has actual notice; see Imhoff v. Title Ins. & Trust Co., 247 P.2d 851 (Cal.Ct.App.1952); Oaks v. Weingartner, 234 P.2d 194 (Cal.Ct.App.1951); Tapia v. Demartini, 19 P. 641 (Cal.1888).

5. The statutory requirements for open-end mortgages (i.e., title of document, description of the debt as open-ended, and setting forth of repayment terms) were construed to be mandatory, and the court refused to order foreclosure where they were not met, in Naugatuck Sav. Bank v. Fiorenzi, 654 A.2d 729 (Conn.1995). See generally American Bank of Conn. v. Eagle Constr. Co., 522 A.2d 835 (Conn.Ct.App.1987), applying the statute to an advance made simultaneously with the replacement of a previous mortgage by an "open end mortgage."

6. See Ford, Future Advance Financing in Florida, Fla. B. J., Mar. 1989, at 27.

7. This requirement has been held inapplicable to construction loans; see Snead Constr. Corp. v. First Fed. Sav. & Loan Ass'n, 342 So.2d 517 (Fla.Dist.Ct.App.1976); but see Industrial Supply Corp. v. Bricker, 306 So.2d 133 (Fla.Dist.Ct.App.1975), applying the requirement to a construction loan.

8. See United States v. First Nat. Bank of Crestview, 513 So.2d 179 (Fla.Dist.Ct. App.1987), in which the court held that an advance for the purpose of settling an unrelated civil suit against the mortgagor in another jurisdiction was not "necessary to the protection of the security."

9. In NCNB Nat'l Bank v. Barnett Bank, 560 So.2d 360 (Fla.Dist.Ct.App.1990), the senior mortgage contained a future advances clause, but the mortgage holder had agreed with a junior mortgagee that it would not make certain types of advances. It subsequently made such an advance and claimed priority under Fla. Stat. Ann. § 697.04. The court held that the statutory grant of priority was overridden by the express agreement between the two mortgagees.

10. Under Georgia case law, all advances take the original mortgage's priority, whether optional or obligatory, and apparently whether or not the mortgagee has notice of intervening liens. (In each of the reported cases the mortgagee lacked actual notice, but dictum indicates that the presence of such notice would be irrelevant.) See Commercial Bank v. Readd, 242 S.E.2d 25 (Ga.1978); Courson v. Atkinson & Griffin, Inc., 198 S.E.2d 675 (Ga.1973); Hurst v. Flynn-Harris-Bullard Co., 143 S.E. 503 (Ga.1928).

11. Applies only to savings and loan associations. For other lenders, Idaho Code § 45-108 gives priority to a future advance, as against intervening liens of which the mortgagee has actual notice, only if the advance is obligatory or is for the protection of the security. See Idaho First Nat'l Bank v. Wells, 596 P.2d 429 (Idaho 1979), finding that the mortgagee had actual notice of the intervening lien and denying it priority to the extent of optional future advances. The obligatory character of the advances must be shown from express contractual language. However, the contractual obligation may be oral; see Biersdorff v. Brumfield, 468 P.2d 301 (Idaho 1970).

12. Three other Illinois statutes deal with revolving credit loans by financial institutions: banks (Ill. Ann. Stat. ch. 17, ¶ 312.2); savings and loan associations (Ill. Ann. Stat. ch. 17, ¶ 3301-6b); and credit unions (Ill. Ann. Stat. ch. 17, ¶ 4447). These statutes (which are essentially identical) contain a grant of priority for mortgages securing revolving credit loans, but impose additional conditions on that grant: that a maximum principal amount must be specified in the mortgage; that an intent to secure future advances must be "expressed therein"; and that the advances be made within 20 years of the mortgage's execution.

However, these requirements appear to conflict with the unconditional grant of priority for mortgages securing revolving credit loans given by the Illinois Mortgage Foreclosure Act, cited in the chart, and since that Act is lator in time it appears to control. Hence, it is doubtful that the additional requirements mentioned above with respect to financial institutions actually apply.

13. The term "revolving credit arrangement" does not appear to be limited to consumer transactions; however, the amount of credit must exceed $5,000 and the lender must render bills or statements to the debtor at regular intervals. Ill. Stat. Ann. ch. 17, ¶ 6405. See Berger, New Statutory Priority for Mortgages Securing Revolving Credit, Chicago Bar Rec., Nov.-Dec. 1984, at 158.

"Pursuant to commitment" means that the mortgagee is contractually bound to make the advance, whether or not a subsequent default or other event outside the mortgagee's control has relieved it of the obligation to make the advance. Ill. Stat. Ann. ch. 110, ¶ 15-1302(b)(1).

14. See First State Bank v. Kalkwarf, 495 N.W.2d 708 (Iowa 1993), finding that a bank's advances lost priority to an intervening judgment lien where the bank had actual knowledge at the time of the advance of the lienor's levy of execution on the land. See also National Bank of Waterloo v. Moeller, 434 N.W.2d 887 (Iowa 1989), holding that the

Iowa common law is identical in result to the statute; National Loan Investors, L.P. v. Martin, 488 N.W.2d 163 (Iowa 1992), holding that advances exceeding $50,000 were unsecured where the mortgage specified that advances could not exceed that sum.

Under Iowa Code Ann. § 572.18, construction mortgage advances have priority over mechanics' liens if work was commenced after the mortgage was recorded. "Commencement of work" refers to the overall work of improvement, not the work of the specific contractor who files the notice of lien.

15. To the same effect is Kan. Stat. Ann. § 9–1101, applicable only to banks.

16. See Halliburton Co. v. Board of County Comm'rs, 755 P.2d 1344 (Kan.Ct.App. 1988); First Nat. Bank v. Fink, 736 P.2d 909 (Kan.1987), both treating the maximum amount as a limit on priority rather than validity.

17. See Fidelity Sav. Ass'n v. Witt, 665 P.2d 1108 (Kan.Ct.App.1983).

18. Section 289.441, which makes the mortgage secure advances for protection, applies only to savings and loan associations.

19. See Texas Bank of Beaumont v. Bozorg, 457 So.2d 667 (La.1984); New Orleans Silversmiths, Inc. v. Toups, 261 So.2d 252 (La.Ct.App.1972). If an ordinary mortgage, rather than a collateral mortgage, is employed or if the requirements mentioned are not met, optional advances take priority only from the date of advancement.

20. Applies only to financial institutions. For other lenders, Maine appears to follow the optional/obligatory distinction; see Canal Nat'l Bank v. Becker, 431 A.2d 71 (Me.1981).

21. See Angelos v. Maryland Cas. Co., 380 A.2d 646 (Md.Ct.App.1977).

22. Aside from the limited situation covered by this statute, Michigan follows the traditional option/obligatory distinction. Even constructive notice (from the records) of an intervening lien is sufficient to deny priority to a mortgagee who makes optional future advances; Ladue v. Detroit & Milwaukee R.R., 13 Mich. 380 (1865).

23. This statute applies only if the mortgage states on its face an intention to be governed by the statute. Alternatively, an existing mortgage may be amended to so state, but the statutory priority will then date only from recordation of the amendment. If no such statement is made in the mortgage or an amendment, the common law controls, and the mortgage may be enforceable to secure future advances under common-law principles; Bank of Urbana v. Wright, 880 S.W.2d 921 (Mo.Ct.App.1994). See also American Realty Trust v. First Bank, 902 S.W.2d 884 (Mo.Ct.App.1995), holding that a future advances clause in a mortgage did not constitute a credit agreement obligating the lender to fund any additional advances.

24. Only contractual obligations may be secured under this statute.

25. The cutoff notice is inapplicable to business or agricultural transactions in which the mortgage is collateral for an irrevocable letter of credit or for a guarantee. See South Side Nat'l Bank v. Commerce Bank, 897 S.W.2d 657 (Mo.Ct.App.1995), stating in dictum that a cutoff notice under the statute would be effective when received, not when the lender provided a certificate of receipt.

26. See Service Funding, Inc. v. Craft, 763 P.2d 1131 (Mont.1988), finding such a statement adequate although the future advances clause, which stated the additional amount to be advanced, appeared on a page of the deed of trust that was not recorded. The recording statute authorized the recordation of "abstracts" of instruments, and the court held that it was the junior lienor's duty to inquire and discover the content of the document.

27. As against intervening mechanics' liens, the mortgagee loses priority for optional future advances if the mortgagee has been given written notice of labor commenced or material furnished.

28. The statute applies only if the mortgage states on its face that it is governed by the statute. Nev. Rev. Stat. § 106.350. The maximum amount may be increased or decreased by amendment; Nev. Rev. Stat. § 106.360(2)(c). If an amendment increases

the amount, advances exceeding the original stated amount have priority only from the recordation of the amendment.

If the statute is inapplicable, Nevada case law grants priority to all obligatory future advances but denies priority to optional advances; it is unclear whether such a denial is predicated on the mortgagee's notice of the intervening lien. Chartz v. Cardelli, 279 P. 761 (Nev.1929).

29. The mortgage must state "the nature of the obligations ... , the amount thereof presently to be issued, if any, and the limitation, if any, ... with respect to the total or maximum amount thereof ultimately to be issued." N.H. Rev. Stat. Ann. § 479:5. Hence, if there is in fact a maximum amount established, it must be stated in the mortgage.

30. There is an exception to this priority for disbursements on construction loans. They lose priority to mechanics' liens unless the construction mortgagee has made the disbursements on the basis of invoices of subcontractors or suppliers, or on receipt of affidavits that the work has been completed and the subcontractors and suppliers paid. N.H. Rev. Stat. Ann. § 447:12a.

31. Construction loan priority over mechanics' liens is governed by N.J. Stat. Ann. § 2A:44-87 to-89. Priority is granted to the extent the funds are applied to purchase money, prior liens, taxes, or for labor and materials for construction. With respect to construction loan priority over other types of intervening liens, New Jersey continues to follow the optional/obligatory distinction; see Lincoln Federal Sav. & Loan Ass'n v. Platt Homes, Inc., 449 A.2d 553 (N.J. Super. Ct. 1982), holding that constructive notice derived from the recordation of an intervening lien would deprive a construction lender of priority for optional advances.

32. The statute has been construed to make advances in excess of the face amount of the mortgage *unsecured*, not merely *subordinate* to intervening liens; Pioneer Sav. & Trust v. Rue, 784 P.2d 415 (N.M.1989); In re Bass, 44 B.R. 113 (Bankr.D.N.M.1984).

33. The court specifically approved the addition of these items in Pioneer Sav. & Trust v. Rue, 784 P.2d 415 (N.M.1989). The statutory warrant for doing so is not clear. N.M. Stat. Ann. § 47-1-41 sets up certain "statutory mortgage conditions," among which are obligations by the mortgagor to perform under prior encumbrances, pay taxes and assessments, keep the premises in good repair, pay grazing lease fees, and insure the property. If the mortgagor fails to make these payments, the mortgagee is authorized to do so and add the amount expended to the mortgage balance. It is possible that this statute would be construed, in conjunction with the future advances statute cited in the table, to grant full priority to these advances for protection of the security even though they cause the loan balance to exceed the maximum amount stated in the mortgage.

34. Construction loan mortgages generally have priority over mechanics' liens, as to advances made prior to the filing of a notice of lien. N.Y. Lien Law § 13(2). As against other types of intervening liens, the common law optional/obligatory advance doctrine continues to apply in New York; see Briarwood Towers 85th Co. v. Guterman, 523 N.Y.S.2d 98 (N.Y.App.Div.1988), upholding the priority of a construction loan mortgage, as against an intervening mortgage. The construction advances were held to be obligatory upon the lender, notwithstanding that they were subject to certain objective conditions relating to title insurance.

35. See Richardson Corp. v. Barclays American/Mortgage Corp., 432 S.E.2d 409 (N.C.Ct.App.1993), holding that a deed of trust lost priority, as against an intervening lien, with respect to advances in excess of the cumulative sum authorized by the lender's commitment letter.

In order for the "Equity Line of Credit" statute to apply, the lender must be contractually bound to provide advances, but may be excused by an event of default or other event outside the lender's control, as set forth in the mortgage. Apparently the lender may also reserve a power to cancel the obligation. N.C. Gen. Stat. § 45-81(b).

36. Intervening liens which are not mortgages, such as mechanics' liens and judgments, have priority over optional advances irrespective of whether the mortgage had written notice of the lien when making the advance.

37. See Four Seasons Developers, Inc. v. Security Fed. Sav. & Loan Ass'n, 456 N.E.2d 1344 (Ohio.Ct.App.1983) (finding that an intervening lienor had not given notice as required by the statute); Colonial Mortg. Serv. Co. v. Southard, 384 N.E.2d 250 (Ohio 1978) (upholding the priority of the mortgage, as against an intervening lien, because the advance under the mortgage was obligatory rather than optional); Schalmo Builders, Inc. v. Malz, 629 N.E.2d 52 (Ohio.Ct.App.1993) (same). See generally Smith & Cobbe, Questions of Priority Between Mechanics' Lienors and Construction Loan Mortgagees, 38 Ohio St. L. J. 3 (1977).

38. An advance is obligatory if the lender has a contractual commitment to make it, even if the commitment is conditioned upon some event or fact. Ohio Rev. Stat. Ann. § 5301.232(E)(4).

39. Since the statute applies only if the mortgage is given a specific title, the parties may avoid the statute by omitting the relevant language. In the absence of statute, Oregon holds that a mortgage may secure future advances whether its wording so provides or not. However, if optional advances are made, they will have priority over intervening encumbrances only if the junior lienor had notice of the future advance agreement, only to the extent of the maximum amount stated in the mortgage, and only if the advances were for a purpose similar to that of the original loan. Tyler v. Butcher, 734 P.2d 1382 (Or.Ct.App.1987).

40. This statute applies only if the mortgage is entitled "Open-end mortgage to secure present and future loans under chapter 25 of title 34." Hence, the parties may opt out of the statute's operation by omitting this title.

If the statute is inapplicable, Rhode Island follows the traditional optional/obligatory test; obligatory advances take priority from the date of the original mortgage. See Blackmar v. Sharp, 50 A. 852 (R.I.1901). If the advance is optional, constructive notice (from the records) of an intervening lien is sufficient to defeat the advance's priority. People's Savings Bank v. Champlin Lumber Co., 258 A.2d 82 (R.I. 1969).

41. An advance is deemed obligatory if the mortgagee is obligated to make it absent the occurrence of an event of default. R.I. Gen. Laws § 34-25-10.

42. This statute applies only if the mortgage states "THE PARTIES AGREE THAT THIS MORTGAGE CONSTITUTES A COLLATERAL REAL ESTATE MORTGAGE PURSUANT TO SDCL 44-8-26" and if the mortgage is entitled "MORTGAGE—COLLATERAL REAL ESTATE MORTGAGE." Hence the parties may opt out of the statute's operation by omitting the statement or caption.

43. The initial period may be renewed for successive five-year terms by the mortgagee's filing of addenda in the real estate records.

44. Certain items may exceed the maximum mortgage amount, as well as the amount stated in a cut-off notice: negative amortization, obligatory advances made to third parties, advances to protect the security, advances under construction or home improvement loans, and interest on the above. Tenn. Stat. Ann. § 47-28-109.

45. "Open-end mortgages," are defined to include those with variable balances, advances at the request or demand of the borrower, and a non-commercial purpose.

46. Even a mortgage securing obligatory advances, if for commercial purposes, must identify itself as such or it will apparently lose priority to intervening liens; see Tenn. Stat. Ann. § 47-28-104(b).

47. This statute applies only to mortgages which state, on the front page in capital letters or underscored, "THIS IS A CREDIT LINE DEED OF TRUST."

In cases in which the statute is inapplicable, Virginia appears to follow the traditional optional/obligatory rule, although it is unclear whether mere constructive notice (from the recordation of the intervening lien) will deny priority to an optional advance; see Alexandria Savings Inst. v. Thomas, 70 Va. (29 Grat.) 483 (1877).

48. Special priority rules as against mechanics' liens are provided by Va. Code Ann. § 43-21. A mortgage created before the work was commenced has priority as to the value of the land, but not the buildings constructed, notwithstanding the provisions of § 55-58.2 described above.

49. While the caption of this section reads "Interim or construction financing—Priorities," the actual text of the section is not limited to interim or construction loans.

50. Omission of this title will apparently make the statute inapplicable to the transaction. In such cases, West Virginia appears to follow the traditional optional/obligatory rule, but only actual (and not constructive) notice of the intervening lien will defeat the priority of an optional advance. Simms v. Ramsey, 90 S.E. 842 (W.Va.1916); Hall v. Williamson Grocery Co., 72 S.E. 780 (W.Va.1911).

51. An advance is deemed obligatory, rather than optional, if the mortgagee is obligated to make the advance in the absence of "the occurrence of a specific event" under the loan documents. W. Va. Code § 38-1-14(d).

CASE NOTE ON FUTURE ADVANCES

This Note summarizes the law of future advances in jurisdictions in which judicial decisions, rather than statutes, comprise the primary or exclusive source of law on the subject.

Alabama: Validity of a mortgage for future advances must be predicated on either a statement of maximum amount or a statement in the mortgage that future advances will be secured; First National Bank v. Bain, 188 So. 64 (Ala.1939).

With respect to priority, Alabama follows the American common-law rule: Optional future advances madė after the mortgagee has actual knowledge of intervening liens are subordinate to those liens. Mobley v. Brundidge Banking Co., 347 So.2d 1347 (Ala.1977); Hampton v. Gulf Fed. Sav. & Loan Ass'n, 249 So.2d 829 (Ala. 1971); City National Bank v. First National Bank, 232 So.2d 342 (Ala. 1970). Constructive notice from the recordation of the intervening lien will not suffice to deprive the future advance mortgagee of priority; Farmers' Union Warehouse Co. v. Barnett Bros., 137 So. 176 (Ala.1931).

Arizona: A mortgage which states that it secures future advances will in fact do so; Griffith v. State Mutual Bldg. & Loan Ass'n, 51 P.2d 246 (Ariz.1935).

The Arizona Court of Appeals adopted the traditional optional/obligatory advance doctrine in La Cholla Group, Inc. v. Timm, 844 P.2d 657 (Ariz.Ct.App.1992). See also Watson Constr. Co. v. Amfac Mortg. Corp., 606 P.2d 421 (Ariz.Ct.App.1979), discussing with apparent approval two cases from Washington and Delaware that had followed the optional/obligatory distinction. See Comment, Priority Disputes In Future Advance Mortgages: Picking the Winner in Arizona, 1985 Ariz. St. L.J. 537.

Arkansas: The validity of a mortgage for future advances depends on a sufficient statement to that effect, in the mortgage, to place third parties on notice; State National Bank v. Temple Cotton Oil Co., 50 S.W.2d 980 (Ark.1932).

With respect to priority, Arkansas follows the American common-law rule: Optional future advances made after the mortgagee has actual knowledge of intervening liens are subordinate to those liens. Constructive notice from the recordation of the intervening lien will not suffice to deprive the future advance mortgagee of priority; see Union National Bank v. First State Bank, 697 S.W.2d 940 (Ark.Ct.App.1985).

The Arkansas courts have been liberal in finding advances to be obligatory despite the presence of some discretion in the mortgagee; see Dempsey v. McGowan, 722 S.W.2d 848 (Ark.1987); National Lumber Co. v. Advance Development Corp., 732 S.W.2d 840 (Ark.1987).

Under a special statutory rule, if the prior mortgage is given for the purpose of raising funds for construction of buildings or improvements, all obligatory advances under the mortgage have priority over intervening mechanics' liens, even if the mortgagee has actual notice of them. See Ark. Stat. Ann. §§ 18-44-110,-111. The statute itself would appear to reach this result irrespective of whether the advances are obligatory or optional, but case law has refused to extend the statute's protection to optional advances made with actual notice of the intervening liens; see Ashdown Hardware Co. v. Hughes, 267 S.W.2d 294 (Ark.1954). Moreover, the mortgage must show on its face that the mortgagee is obligated to advance the funds for construction purposes; Spickes Bros. Painting Contractors, Inc. v. Worthen Bank, 771 S.W.2d 258 (Ark.1989). But if the funds are in fact diverted to some other use without the mortgagee's knowledge, the statutory priority given to the mortgage is not jeopardized thereby.

Colorado: Validity of a mortgage for future advances, as between the original parties, may be established by a statement of maximum amount in the mortgage, by a statement that future advances will be secured, or even by silence in the mortgage if other evidence shows the parties agreed that such advances would be secured; Ferguson v. Mueller, 169 P.2d 610 (Colo.1946). Whether silence in the mortgage would suffice against third parties was not discussed in the opinion.

With respect to priority, Colorado holds that optional future advances made after the mortgagee has knowledge of intervening liens are subordinate to those liens. However, it is unclear whether actual knowledge is required, or whether constructive notice from the recordation of the lien will suffice; see Kimmel v. Batty, 451 P.2d 751 (Colo.1969), in which the mortgagee had neither actual nor constructive notice at the time of the advance in question.

District of Columbia: There appears to be no general statute or case law dealing with the validity or priority of mortgages securing future advances.

Mortgage priority as against mechanics' liens is governed by D.C. Code § 38-109. It provides generally that mortgages recorded prior to the commencement of the construction are superior to mechanics' liens, but that construction loan advances made after the filing of a lien are subordinated to that lien. See Waco Scaffold & Shoring Co. v. 425 Eye St. Associates, 355 A.2d 780 (D.C.Ct.App.1976) (advances on construction loan have priority over unfiled mechanics' liens, even though construction mortgage was recorded after work on the project commenced); Electrical Equipment Co. v. Security Nat'l Bank, 606 F.2d 1357 (D.C.Cir.1979) (accruing interest on advances made before the filing of mechanics' liens has priority over those liens).

Indiana: Validity of a mortgage for future advances must be predicated on either a statement of maximum amount or a statement in the mortgage that future advances will be secured. See Commercial Bank v. Rockovits, 499 N.E.2d 765 (Ind.Ct.App. 1986) (if mortgage states the intention to secure future advances, they will be secured despite the absence of a maximum dollar amount). Numerous cases uphold future advance mortgages which both state a maximum amount and contain a specific future advance clause; see, e.g., Citizens Bank & Trust Co. v. Gibson, 463 N.E.2d 276 (Ind.Ct.App.1984), modified on other grounds, 490 N.E.2d 728 (Ind.1986); Merchants Nat'l Bank v. H.L.C. Enterprises, 441 N.E.2d 509 (Ind.Ct.App.1982).

There appears to be no Indiana statute or case law dealing with the priority of future advances. In Commercial Bank v. Rockovits, 499 N.E.2d 765 (Ind.Ct.App.1986), the court upheld the priority of a future advance (in the form of a suretyship agreement subsequently signed by one of the mortgagors) as against an intervening lien; the future indebtedness seems to have been optional with the lender, but its priority was not attacked on this ground.

Minnesota: There appears to be no specific statute or case law governing requirements for validity of a mortgage to secure future advances. If a mortgage fixes an upper dollar limit to the advances, amounts exceeding that limit will not be secured; Reuben E. Johnson Co. v. Phelps, 156 N.W.2d 247 (Minn.1968).

With respect to priority, Minnesota follows the optional/obligatory distinction; see Reuben E. Johnson Co. v. Phelps, id.; National Lumber Co. v. Farmer & Son, Inc., 87 N.W.2d 32 (Minn.1957). Actual notice of the intervening lien is necessary to deprive a future advance mortgagee of priority; Axel Newman Heating & Plumbing Co. v. Sauers, 47 N.W.2d 769 (Minn.1951). However, where the intervening lien is a mechanic's lien, the case law treats the "attachment" of the lien (generally, the date of visible commencement of the improvement) as imparting notice to the prior mortgagee. See R. B. Thompson, Jr. Lumber Co. v. Windsor Development Corp., 374 N.W.2d 493 (Minn.Ct.App. 1985).

Mississippi: There appears to be no specific statute or case law governing requirements for validity of a mortgage to secure future advances. With respect to priority, Mississippi recently rejected the optional/obligatory distinction and held, as does § 2.3, that all advances take the priority of the original mortgage recording. Shutze v. Credithrift of America, Inc., 607 So.2d 55 (Miss.1992). However, if the future advances are made under a construction loan and the intervening lien is a mechanic's lien, the construction advances are subordinated to the mechanic's lien to the extent that the lender did not use reasonable diligence to ensure that the funds were used in payment for labor and materials on the site. Peoples Bank & Trust Co. v. L & T Developers, Inc., 434 So.2d 699 (Miss. 1983); Deposit Guaranty Nat'l Bank v. E.Q. Smith Plumbing & Heating, Inc., 392 So.2d 208 (Miss.1980).

Pennsylvania: Pennsylvania adopted a statute in 1990 that governs future advances under "open-end mortgages"; see the Statutory Table for citation and description. However, the statute applies only when the mortgage is identified "at the beginning thereof as an 'open-end mortgage,'" and only if, in the case of a home equity plan, the lender has a contractual obligation to lend the funds. In the case of other future advance mortgages that do not meet the foregoing description, the previous Pennsylvania law, as described below, apparently continues to govern.

With respect to priority, Pennsylvania follows the optional/obligatory distinction. Actual notice of the intervening lien is necessary to deprive a future advance mortgagee of priority. In re Johnson, 124 B.R. 648 (Bankr. E.D.Pa.1991); Central Pennsylvania Savings Ass'n v. Carpenters of Pennsylvania, Inc., 444 A.2d 755 (Pa. Super. Ct. 1982), aff'd, 463 A.2d 414 (Pa.1983); Trustees of C.I. Mortgage Group v. Stagg of Huntington, Inc., 372 A.2d 854 (Pa. Super. Ct. 1977), reversed on other grounds, 399 A.2d 386 (Pa.1979); Conshohocken Fed. Sav. & Loan Ass'n v. Period and Country Homes, Inc., 430 A.2d 1173 (Pa. Super. Ct. 1981); Housing Mortgage Corp. v. Allied Construction, Inc., 97 A.2d 802 (Pa.1953).

The Pennsylvania courts have recognized, for construction loans, a scheme under which the entire loan commitment amount may be placed in an escrow account at the commencement of construction, and disbursements then made from this account. In such a transaction they consider the advances to have been made when the escrow account is funded, so that even though disbursements from the account may be optional, their entire sum has priority over intervening liens. See, e.g., Central Pennsylvania Savings Ass'n v. Carpenters of Pennsylvania, Inc., id.

Texas: Validity of a mortgage for future advances must be predicated on either a statement of maximum amount or a statement in the mortgage that future advances will be secured; Willis v. Sanger, 40 S.W. 229 (Tex. Ct. Civ. App. 1897); Regold Manufacturing Co. v. Maccabees, 348 S.W.2d 864 (Tex. Ct. Civ. App. 1961).

Texas case law grants priority, as against intervening liens, to all future advances whether optional or obligatory, and whether or not the mortgagee has notice of the intervening liens; Coke Lumber & Manufacturing Co. v. First National Bank in Dallas, 529 S.W.2d 612 (Tex. Ct. Civ. App. 1975); Wood v. Parker Square State Bank, 390 S.W.2d 835 (Tex. Ct. Civ. App. 1965), rev'd on other grounds, 400 S.W.2d 898 (Tex.1966); M.S. Foundations, Inc. v. Perma-Crete Bldg. Systems, Inc., 666 S.W.2d 568 (Tex. Ct. App. 1984).

Utah: There appears to be no specific statute or case law governing requirements for validity of a mortgage to secure future advances. A mortgage given to secure future advances has been held supported by consideration; Abraham v. Abraham, 394 P.2d 385 (Utah 1964).

With respect to priority, Utah follows the optional/obligatory distinction. Western Mortgage Loan Corporation v. Cottonwood Constr. Co., 424 P.2d 437 (Utah 1967). Actual notice of the intervening lien is necessary to deprive a future advance mortgagee of priority. Bank of Ephraim v. Davis, 559 P.2d 538 (Utah 1977).

While obligatory future advances will ordinarily have the priority of the original mortgage recording, a special rule is imposed for construction loans. If the mortgagee knows that contractors and suppliers are relying on the loan as a source of funds for payment of their bills, and further knows that the funds are being diverted by the mortgagor with the result that the contractors and suppliers are not being paid, the mechanics' liens of those parties are given priority over the construction mortgage. Utah Savings & Loan Association v. Mecham, 356 P.2d 281 (Utah 1960).

Wisconsin: With respect to priority, Wisconsin follows the optional/obligatory distinction; optional future advances made after the mortgagee has actual knowledge of intervening liens are subordinate to those liens. Colonial Bank v. Marine Bank, 448 N.W.2d 659 (Wis. 1989). See also First Interstate Bank v. Heritage Bank, 480 N.W.2d 555 (Wis.Ct.App.1992), refusing to subordinate the prior mortgagee's position on the basis of constructive rather than actual knowledge. Wisconsin statutes governing financial institutions provide that a recorded mortgage has priority over all liens, except taxes and assessments, filed after the mortgage recording. Wis. Stat. Ann. §§ 215.21, 706.11(1). However, the court in the *Colonial Bank* case, supra, refused to construe these statutes as guaranteeing priority to optional future advances as against intervening liens.

Wyoming: With respect to priority, Wyoming follows the optional/obligatory distinction. However, it is unclear whether actual notice of the intervening lien is necessary to deprive a future advance mortgagee of priority, or whether construction notice would suffice. See Poulos Investment, Inc. v. Mountainwest Sav. & Loan Ass'n, 680 P.2d 1073 (Wyo.1984).

§ 2.2 Expenditures for Protection of the Security

(a) Whether or not a mortgage so provides, a mortgagee may expend funds reasonably necessary for the protection of the security, and may add the sums so expended to the principal amount secured by the mortgage. Such expenditures may be made

(1) to protect the value of the mortgaged real property and improvements on it; or

(2) to protect against the assertion of liens having priority over the mortgage.

(b) Sums expended under Subsection (a) have the priority of the original mortgage, except that an expenditure to pay a prior lien has the priority of that lien to the extent provided by the doctrine of equitable subrogation.

(c) Sums expended under Suhsection (a) may be recovered by way of foreclosure of the mortgage or, to the extent personal liability exists under local law and the terms of the mortgage documents, by an action on the mortgage debt or an action for reimbursement of the expenditure itself.

Cross-References:

Section 2.1, Future Advances; § 2.3, Priority of Future Advances; § 2.4, Mortgages Securing Future Advances Not Specifically Described; § 7.6, Subrogation; Statutory Note and Case Note following § 2.1.

Comment:

a. Protection of the value of the security. Various acts or failures to act by the mortgagor or others may jeopardize the value of the mortgagee's security. These generally fall into two categories: increased risk of physical harm, and legal risk raised by other interests that have or may gain priority over the mortgage.

Expenditures to prevent physical harm may include sums spent to make repairs or to correct waste committed by the mortgagor or by third parties, premiums for casualty insurance on the mortgaged property that the mortgagor was obligated to carry, and costs of completion by the mortgagee of improvements which the mortgagor was obligated to make but failed to complete. In some cases, the mortgagor may have made an express promise to take specific measures to protect the real estate, such as the payment of sums to obtain governmental permits or to preserve or obtain desirable zoning. Upon the mortgagor's failure te pay, the mortgagee may expend the necessary funds and receive the protection of this section.

Expenditures to protect the mortgage from prior interests may include payment of property tax and assessment liens, payments on prior mortgages or other privately held liens, ground rents, and assessments imposed by an owners association in a condominium or under covenants on the land.

Many mortgages contain express provisions both imposing duties upon the mortgagor to make the sorts of expenditures mentioned above and providing that the mortgagee may make the expenditure if the mortgagor does not, and may add it to the mortgage debt. In general, the principles of this section govern whether the mortgage or other documents include such terms or not.

However, in the case of expenditures to protect the value of the mortgaged property, the mortgagee is privileged to act only where the mortgagor has a corresponding duty to protoct the property. The doctrine of waste imposes certain basic duties of this sort. See Illustration 1. Under § 4.6(a), waste is broadly defined, and includes failure by the mortgagor to comply with a variety of obligations imposed by the mortgage or other legal principles. For example, the mortgagee may show that the mortgagor promised to insure the property and failed to do so. Similarly, the mortgagor's failure to finish an incomplete structure on the land may be waste if the mortgagor covenanted to complete it, as will ordinarily be the case with a construction loan. In these situations the mortgagee may pay the insurance premiums or the cost of completion and add the amount to the mortgage debt.

Expenditures to protect the mortgage from prior liens may be made, and added to the mortgage debt, only where there exists a real risk of harm to the mortgagee. For example, a second mortgagee is not entitled to pay off a first mortgage unless the first mortgage is in default so that foreclosure is an imminent risk. Likewise, a mortgagee is not entitled to pay off a property tax lien unless it is delinquent. In these situations the law imputes to the mortgagor an obligation to keep the prior liens current, and not permit them to enter a default status that would raise a risk of foreclosure. See Illustration 2.

Illustrations:

1. Mortgagor borrows money from Mortgagee and executes a mortgage on Mortgagor's house to secure repayment. Mortgagor then commences a remodeling project on the house, but ceases work without completing the project. The house is left in an uninhabitable condition, and Mortgagor's actions constitute waste. Mortgagee may expend funds reasonably needed to restore the house to a habitable state, and may add the expenditure to the debt secured by the mortgage.

2. Mortgagor borrows money from Mortgagee and executes a mortgage on Mortgagor's condominium unit to secure repayment. Under applicable law the lien of the condominium owners association for assessments has priority over Mortgagee's mortgage. Mortgagor fails to pay the assessments levied against the unit when they fall due. Mortgagee may pay the delinquent assessments and add the expenditure to the debt secured by the mortgage.

b. Priority of the lien for sums expended for protection. In general, a mortgagee that advances sums to protect the security may simply add the amount expended to the debt secured by the mortgage. However, when a mortgagee pays a prior lien in full to protect the mortgage, a further question of priority may arise. The doctrine of equitable subrogation generally holds that such a mortgagee acquires the security rights and the priority of the antecedent lienor. See § 7.6 and Illustration 1 thereunder.

The issue of priority is of importance only when there is an intervening lien or other interest between the prior lien being paid and the paying mortgagee's own interest; otherwise, subrogation offers the mortgagee no advantage over merely adding the payment to the balance owing on the mortgage loan. While some case law limits the paying mortgagee to subrogation in cases in which it has no notice of the intervening lien, § 7.6 approves subrogation in all cases in which the mortgagee reasonably expected to obtain security with the priority of the lien being paid. This test may well be met even if the mortgagee had notice of the intruding lien. See Illustration 3.

The purpose of the doctrine of subrogation is to prevent unjust enrichment of the intervening lienor, which would occur if that lien were advanced in priority because of the payment made by the junior mortgagee. Hence subrogation will not be ordered where it would unfairly prejudice the intervening lienor's position. See Illustration 4.

Illustrations:

3. Mortgagor's land is subject to three mortgages, held (in order of priority) by A, B, and C. Mortgagor defaults in payments to A, who threatens foreclosure. C learns of the default and, to prevent the destruction of C's mortgage by A's foreclosure, pays in full the debt owed to A. If C reasonably expected to acquire A's priority, C will be subrogated to A's rights, giving C priority over B's lien for the payment made by C to A.

4. The facts are the same as in Illustration 3, except that after A's mortgage is paid by C, B examines the title and discovers that A's mortgage has been satisfied. B is unaware that funds advanced by C were used to pay A, and B therefore reasonably believes that B's mortgage now has first priority. In reliance on that position B forecloses her own mortgage, bidding in the full amount of her debt and thus precluding any claim against Mortgagor for a deficiency. A court may be warranted in denying C's claim of subrogation against B on the ground that to order subrogation would unjustly prejudice B. See also § 7.6, Illustrations 30 and 31.

c. Priority of sums expended for property taxes and assessments. Where the prior lien being paid is a property tax or assessment lien, which has a priority higher than all private liens, there is a division of case authority as to whether the mortgagee acquires its priority as against intervening liens, or merely acquires the right to add its amount to the mortgagee's own mortgage. Under this section the mortgagee may acquire the tax or assessment lien's priority, just as would be the case if a prior private mortgage were being paid.

Illustration:

5. Mortgagor's land is subject to two mortgages in favor of A and B (in that order of priority). The property taxes on the land are delinquent. B pays the taxes while having actual knowledge of A's prior mortgage. If B reasonably expected to acquire the tax lien's priority, B is subrogated to the county's tax lien and

acquires its priority to the extent of the taxes paid. In a mortgage foreclosure proceeding in which A is made a party, B is entitled to have the tax payment treated as a claim superior in priority to A's mortgage.

d. Direct recovery of sums expended for protection. When a mortgagee pays sums to protect the land and improvements from physical damage or devaluation, it is clear that the sums expended may be added to the debt secured by the mortgage and may be collected by an action on that debt or by foreclosure.

There is considerable authority that this is the only means for the mortgagee to obtain reimbursement, and that no separate action to recover the expenditure itself is permitted. Under this view, only an action on the entire debt or a foreclosure of the mortgage are appropriate. It might be thought that this rule protects the mortgagor from the hardship of a multiplicity of actions, but in reality it is apt to impose unnecessary hardship on the mortgagor. If the mortgagor disputes the propriety of the mortgagee's expenditure and refuses to reimburse it voluntarily, but is not otherwise in default under the mortgage, and if the mortgage contains an acceleration clause, the mortgagee will as a practical matter have little choice but to accelerate the entire indebtedness and foreclose. Thus a foreclosure may result from a dispute over a rather minor expenditure of, say, a few hundred dollars for property taxes or hazard insurance.

However, under this Restatement the mortgagee may not only add the expenditure to the mortgage debt, but alternatively may bring a separate action for the expenditure in question. This may permit the resolution of a dispute concerning the expenditure without the necessity of resorting to foreclosure. See Illustration 6. In some jurisdictions a one-action or antideficiency statute may preclude this approach. It might also be precluded by language in the mortgage itself restricting the form of the mortgagee's recovery.

Illustration:

6. Mortgagor borrows money from Mortgagee and executes a mortgage on Mortgagor's farm to secure repayment. Mortgagor fails to pay when due the county property taxes on the farm. These taxes are a lien having priority over the mortgage. Mortgagee is privileged to pay the delinquent taxes and may then bring a separate action for the taxes paid or may add the tax payment to the mortgage debt and employ appropriate foreclosure and non-foreclosure remedies.

REPORTERS' NOTE

Many jurisdictions have adopted by statute the general principles set forth in this section. Summaries and citations are found in the Statutory Note following § 2.1. The concepts embodied in this section are also similar to those adopted in Uniform Land Security Interest Act § 302.

Protection of the security, Comment a. A large number of cases adopt the view that reasonably necessary expenditures to protect a mortgagee's security interest in real estate may be added to the mortgage debt. A representative sample is presented here, categorized by the type of expenditure.

(a) Property taxes and assessments: See generally L. Jones, Mortgages § 1381 nn.79–80 (8th ed. 1928).

Tolson v. Pyramid Life Ins. Co., 254 S.W.2d 53 (Ark.1953).

McNally v. Currigan, 301 P.2d 136 (Colo.1956).

Equitable Life Assur. Soc. v. Bennion, 346 P.2d 1053 (Idaho 1959).

Van Dusseldorp v. State Bank of Bussey, 395 N.W.2d 868 (Iowa 1986).

People's Wayne County Bank v. Wesolowska, 239 N.W. 367 (Mich. 1931).

Long-Bell Petroleum Co. v. Hayes, 109 So.2d 645 (Miss.1959).

Grady v. Utica Mut. Ins. Co., 419 N.Y.S.2d 565 (N.Y.App.Div.1979).

Kronenberg v. Ellenville Nurseries & Greenhouses, Inc., 196 N.Y.S.2d 106 (N.Y.Sup.Ct.1960).

Goldsboro Milling Co. v. Reaves, 804 F.Supp. 762 (E.D.N.C.1991) (trustee under deed of trust may pay taxes on parcel B, which is not subject to the mortgage, if necessary to prevent foreclosure of property tax lien on parcel A, which is subject to the mortgage).

Garland v. Federal Land Bank, 140 A.2d 568 (N.H.1958).

Law v. Dewoskin, 447 S.W.2d 361 (Tenn.1969).

Smart v. Tower Land & Invest. Co., 597 S.W.2d 333 (Tex.1980).

Gesa Fed. Credit Union v. Mutual Life Ins. Co., 696 P.2d 607 (Wash.Ct. App.1985), aff'd, Enkidu banc GESA Federal Credit Union v. Mutual Life Ins. Co., 713 P.2d 728 (Wash.1986) (payment of prior irrigation district assessments).

But see Devereux v. Taft, 20 S.C. 555 (1884) (payment of taxes may not be added to mortgage debt, absent mortgage language so providing).

See generally Annot., 84 A.L.R. 1366 (1933), supplemented by 123 A.L.R. 1248 (1939).

(b) Payments on senior mortgages or other private liens: See 2 G. Nelson & D. Whitman, Real Estate Finance Law § 10.5 (3d ed. 1993); 2 L. Jones, Mortgages §§ 1122, 1381 (8th ed. 1928).

Osbourne v. Capital City Mortg. Corp., 667 A.2d 1321 (D.C.Ct.App. 1995).

Mason v. Bates, 304 S.E.2d 724 (Ga.1983).

Bowman v. Poole, 91 S.E.2d 770 (Ga.1956).

Thompson v. Kirsch, 677 P.2d 490 (Idaho.Ct.App.1984).

Tymon v. McArdle, 145 N.Y.S.2d 298 (N.Y.Sup.Ct.1955) (payment by junior holder of contract vendee's interest).

First Vermont Bank v. Kalomiris, 418 A.2d 43 (Vt.1980).

But see Realty Sav. & Inv. Co. v. Washington Sav. & Bldg. Ass'n, 63 S.W.2d 167 (Mo.Ct.App.1933) (advances to pay unperfected mechanics' liens were not warranted and could not be added to mortgage amount); Edwards v. Bridgetown Community Ass'n, 486 So.2d 1235 (Miss.1986) (advances to pay community association assessments could not be added to mortgage amount, where the lien of the assessments was inferior to the mortgage).

(c) Costs of defending title to mortgaged property:

Skach v. Gee, 484 N.E.2d 441 (Ill. App. Ct. 1985) (mortgage contained a general attorneys' fee clause; it was held applicable to the costs of defending collateral litigation attacking the property's title).

(d) Costs of completing required construction:

Hemmerle v. First Fed. Sav. & Loan Ass'n, 338 So.2d 82 (Fla.Dist.Ct. App.1976).

But see Dime Sav. Bank v. Romundy, Inc., 195 N.Y.S.2d 314, modified, 204 N.Y.S.2d 559 (N.Y. App.Div. 1960) (expenses of completion of construction could not exceed maximum amount stated in mortgage, as against a junior lienor).

(e) Costs of preventing or repairing waste or physical damage:

Hamilton v. Rhodes, 83 S.W. 351 (Ark.1904) (advances to prevent loss of growing crop on the land).

Thompson v. Kirsch, 677 P.2d 490 (Idaho App.1984) (advances for maintenance, where mortgage authorized mortgagees to make such expenditures).

Title Guar. & Trust Co. v. Haven, 89 N.E. 1082 (N.Y.1909).

Cedar v. W.E. Roche Fruit Co., 134 P.2d 437 (Wash.1943) (costs of preserving a perishable crop).

But see Goss v. Iverson, 238 P.2d 1151 (Idaho 1951) (advances to protect crop could not be added to mortgage debt, where there was no showing that mortgagor neglected the crop or breached any agreement concerning it).

(f) Payment of insurance premiums:

In re Ferguson, 85 B.R. 89 (Bankr. W.D.Ark.1988) (mortgage clause authorized mortgagee to pay mortgage insurance premiums if mortgagor failed to do so).

Lewis v. Culbertson, 199 A. 642 (Conn.1938) (based on statute).

Morrissette v. Perpetual Bldg. Ass'n, 150 A.2d 262 (D.C.Mun.App. 1959).

Priority of the lien for sums expended for protection, Comment b. On the application of the doctrine of equitable subrogation to the payment of a senior lien by a junior mortgagee, see § 7.6, Comment *e* and accompanying Reporters' Note. See also Restatement, Second, Restitution § 31, Comment *f* & Illustration 10 (Tentative Draft No. 2, 1984); 2 G. Nelson & D. Whitman, Real Estate Finance Law § 10.6 (3d ed. 1993); G. Osborne, Mortgages § 282 (1951); Annot., 70 A.L.R. 1396 (1931).

Illustration 4 is based on Heegaard v. Kopka, 212 N.W. 440 (N.D.1927). Other cases declining to order subrogation because it would unfairly prejudice the position of the intervening lienor include Richards v. Griffith, 28 P. 484 (Cal.1891); Wilkins v. Gibson, 38 S.E. 374 (Ga.1901).

Priority of sums expended for property taxes and assessments, Comment c. Where the senior lien being paid is not privately held, but is a property tax or assessment lien, the cases are divided as to whether the payor may have by subrogation the tax lien's priority, as against intervening lienors. See G. Osborne, Mortgages § 179 (1951); Annot., 123 A.L.R. 1248, 1262–66 (1939). Cases awarding the tax-paying mortgagee such a priority include Prudential Ins. Co. v. Baylarian, 168 So. 7 (Fla. 1936); Weadock v. Noeker, 78 N.W. 669 (Mich.1899); McKenzie v. Evans, 29 P.2d 657 (Mont.1934); Fiacre v. Chapman, 32 N.J.Eq. 463 (1880); Vista Devel. Joint Venture II v. Pacific Mut. Life Ins. Co., 822 S.W.2d 305 (Tex. Ct. App. 1992); Fischer v. Woodruff, 64 P. 923 (Wash.1901).

Cases denying subrogation of the paying mortgagee to the property tax or assessment lien include Cantley v. Danaher, 87 S.W.2d 81 (Ark.1935); Farmers' & Bankers' Life Insur. Co. v. Zeigler, 38 P.2d 132 (Kan.1934); Laventall v. Pomerantz, 188 N.E. 271 (N.Y.1933); Buskirk v. State-Planters' Bank, 169 S.E. 738 (W.Va.1933); Riley v. Bank of Commerce, 23 P.2d 362 (N.M.1933). See also Warranty Bldg. & Loan Ass'n v. Cimirro Const. Co., 160 A. 847 (N.J. Ch. 1932) (where second mortgagee paid taxes but represented to first mortgagee that they had been discharged, he was estopped to claim subrogation against first mortgagee).

Direct recovery of sums expended for protection, Comment d. It is virtually universally accepted that the payor of taxes or assessments may not employ the governmental taxing jurisdiction's statutory procedure. The prevailing view also prohibits the mortgagee from recovering the expenditure in a separate action; see Jackson v. Stonebriar Partnership, 931 S.W.2d 635 (Tex. Ct. App. 1996); Henry S. Miller Co. v. Wood, 584 S.W.2d 302 (Tex. Ct. Civ. App. 1979); Stallings v. Erwin, 419 P.2d 480 (Mont.1966); First Carolinas Joint Stock Land Bank v. McNiel, 181 S.E. 21 (S.C.1935); G. Glenn, Mortgages § 91.1 (1943) at 553. Contra, see Equitable Life Assur. Soc. v. Bennion, 346 P.2d 1053 (Idaho 1959) (separate action permitted where mortgage language so provided).

§ 2.3 Priority of Future Advances

(a) If a mortgage secures repayment of future advances, all advances have the priority of the original mortgage. Whether or not the mortgage secures repayment of future advances, if the parties have agreed that the mortgage secures payment of interest, costs of collection or foreclosure, or attorneys' fees, these items have the priority of the original mortgage.

(b) Except as provided in Subsection (c), the mortgagor may at any time issue a notice to the mortgagee

(1) terminating the validity of the mortgage with respect to further advances; or

(2) subordinating the priority of the mortgage, as against intervening interests, with respect to further advances.

Such a notice is effective even if the termination or subordination with respect to further advances violates a contractual obligation of the mortgagor to draw further advances, but the mortgagor may be liable in damages for breach of such an obligation. Upon receipt of the notice, the mortgagee must provide the mortgagor with a certificate in recordable form stating that the notice has been received. If the notice provides for subordination of the mortgage with respect to further advances, the mortgagee may elect to treat it as terminating the validity of the mortgage with respect to such advances.

(c) The mortgagor may not issue the notice described in Subsection (b) above and any notice issued by the mortgagor is ineffective, if:

(1) a termination or subordination of further advances would unreasonably jeopardize the mortgagee's security for advances already made; or

(2) the further advances will benefit persons other than the mortgagor, and the mortgagee has a contractual duty to provide such benefit.

(d) Even if the mortgagor issues a notice under Subsection (b), the mortgage continues to secure, with its original priority, the items listed in Subsection (a) and any expenditures reasonably necessary for protection of the security (§ 2.2).

Cross-References:

Section 2.1, Future Advances; § 2.2, Expenditures for Protection of the Security; § 2.4, Mortgages Securing Future Advances Not Specifically Described; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests.

Comment:

a. Priority of future advances in general. This section recognizes that all future advances take the priority of the original mortgage. There is no distinction between advances that the mortgagee is contractually obligated to make and those that are optional.

Illustration:

1. Mortgagor borrows $50,000 from Mortgagee, and executes a note and mortgage which state that future advances up to an additional $25,000 may be made by Mortgagee in the future. However, Mortgagee has no obligation to make such advances. The mortgage also states that it secures interest at 10 percent per

annum and Mortgagee's attorneys' fees in any collection actio; Thereafter J obtains a judgment against Mortgagor and properly records it so as to impose a lien on Mortgagor's real estate. Mortgagee has actual knowledge of this lien. Then Mortgagee lends and Mortgagor accepts an additional $25,000 advance. Mortgagor defaults in payment on the loan, owing the full balance and $10,000 in interest. Mortgagee may recover in foreclosure the $75,000 balance, the $10,000 of interest, and Mortgagee's attorneys' fees to the extent permitted by local law. All of these items have priority over J's lien.

The principles of this section must yield, of course, to contrary statutes. Federal tax liens and other statutory liens, in particular, may achieve a priority over mortgages that is contrary to this section.

b. Mortgagor's notice to terminate or subordinate future advances. In order to protect the mortgagor's right to obtain further financing from other lenders, the mortgagor is given the right to issue a "cut-off notice" to the mortgagee. At the mortgagor's option, the notice may have the effect either of terminating the mortgage's operation, so that further advances will be unsecured, or of subordinating the mortgage's priority, as to further advances, to any intervening liens or other interests. Under the latter option, any further advances will take priority only from the date they are actually made. This option will ordinarily be used only if the mortgagor expects to request additional advances from the mortgagee in the future, and believes that such advances are more likely to be made if they are secured, even with a subordinate priority. Since it would be unfair to force the mortgagee to make additional advances with a subordinate priority that was not bargained for when the original loan was negotiated, the mortgagee has the right to treat a subordination notice as a termination of further advances instead. In effect, the mortgagor's issuance of a subordination notice relieves the mortgagee of any contractual duty it may have had to provide further advances.

It may be noted that the problem of priority of future advances is analogous to the problem raised by modification of the mortgage obligation. Indeed, in a sense a future advance is nothing more than a modification that increases the balance owing on the mortgage loan. Hence § 7.3, which deals with modifications, adopts a notice procedure that is essentially identical to the one employed here for cutting off or subordinating future advances.

The right of the mortgagor to cause a termination or subordination of the mortgage as to further advances exists even if the mortgagor has entered into a binding contract with the mortgagee to draw down the additional funds. However, if such a contract has been entered into, the mortgagor's issuance of the notice may breach this contract. The mortgagee's sole remedy in such a situation is damages; the mortgagee may not obtain a decree of specific performance of a contract to make future advances.

Illustration:

2. Mortgagor borrows $50,000 from Mortgagee A, and executes a note and mortgage which state that future advances up to an additional $25,000 may be made by Mortgagee A in the future. However, Mortgagee A has no obligation to make such advances. Thereafter Mortgagor desires to borrow $10,000 from Mortgagee B on the security of the same real estate. Mortgagor sends a notice to Mortgagee A stating that further advances by Mortgagee A are to be subordinated; Mortgagee A provides and Mortgagor records a statement confirming that the notice has been received. Then Mortgagor borrows $10,000 from Mortgagee B, who records a second mortgage. Finally, Mortgagee A makes an additional $25,000 advance to Mortgagor. The priorities of the parties' mortgages are as follows: Mortgagee A has a first priority for $50,000 (plus interest, collection costs, and attorneys' fees, if applicable); Mortgagee B has a second priority for $10,000; and Mortgagee A has a third priority for $25,000.

This section imposes a duty on the mortgagee who receives a cut-off notice to provide a certificate in recordable form showing that the notice has been received. The purpose of the certificate is to permit the mortgagor to prove to prospective junior lenders that the future advances provision of the senior mortgage has indeed been terminated or subordinated. Recording of the certificate is not required, but it provides a convenient way to establish to all prospective junior lenders that the notice has been sent and received.

If the senior mortgagee to whom a cut-off notice is sent fails to provide the required certificate within a reasonable time after receipt of the notice, the mortgagor may file a judicial action against the mortgagee for appropriate relief, including specific performance, damages, or other suitable remedy. The mortgagor may also record his or her own certificate that the notice was sent, or may record the notice itself. It must be recognized, however, that the mortgagor's recording of such a notice or certificate is by nature self-serving, and may not be acceptable to prospective junior lenders.

c. Cases in which there is no right to terminate or subordinate future advances. In certain circumstances the mortgagor is not permitted to issue a notice terminating or subordinating the mortgage as to future advances. First, the mortgagor may not do so where unreasonable jeopardy to the mortgagee's security would result. The mortgagee is entitled to maintain approximately the same ratio of security value to debt as was contemplated in the original loan transaction. See Illustration 3.

Second, a borrower is not permitted to give an effective notice of termination or subordination when the mortgage secures a benefit in favor of a third party, and the mortgagee has a duty to confer that benefit. Examples include mortgages securing guaranties, letters of credit, and similar undertakings. In such situations the mortgagee is obligated to make the future advance, and hence should not be deprived of the benefit and priority of the real estate security. To do so would unfairly prejudice the mortgagee's position. See Illustration 4.

Illustrations:

3. Mortgagee makes a loan of $100,000 to enable Mortgagor to build an office building. The funds are to be disbursed in monthly installments as construction progresses. After drawing $50,000 and completing approximately half of the work on the building, Mortgagor issues a notice of termination or subordination of future advances to Mortgagee. The partially completed structure is not reasonably equivalent, as security for a $50,000 loan, to the security which the completed building would have represented for a $100,000 loan. Mortgagee is not obligated to terminate or subordinate future advances. However, if Mortgagor provides reasonable assurance to Mortgagee that the construction of the building will be completed expeditiously from other sources of funds, then Mortgagee's security is not placed in unreasonable jeopardy and Mortgagee is obligated to honor the request for termination or subordination.

4. Mortgagor wishes to start a business, and must order a large quantity of inventory. S, the supplier of the inventory, is willing to sell it to Mortgagor on credit, but only if S obtains an irrevocable letter of credit from a bank for the price of the inventory. Mortgagor approaches the Mortgagee bank, which issues the letter of credit to S, but only after taking a mortgage on Mortgagor's real estate to secure Mortgagor's obligation to reimburse the Mortgagee bank if it is required to pay the letter of credit. Thereafter, while the letter of credit is still outstanding, Mortgagor sends a notice to the Mortgagee bank terminating the mortgage as to future advances. The notice is ineffective, and the Mortgagee bank may properly disregard it.

d. Mortgage priority for other future expenditures. Some items that may be added to the mortgage balance after the original loan is made might be considered analogous to future advances. One such category consists of expenditures reasonably necessary to protect the security. These expenditures may be added to the mortgage debt whether or not any mortgage language or other agreement so provides. See § 2.2. If the parties have so agreed and local law permits, accrued but unpaid interest, costs of collection or foreclosure, and attorneys' fees may also be added to the debt. The priority of all of these items is unaffected by the issuance by the mortgagor of a request to terminate or subordinate future advances.

REPORTERS' NOTE

Priority of future advances in general, Comment a. The priority of a mortgage as to future advances (that is, its effectiveness as against "intervening" liens which were imposed on the property after the mortgage was executed, but before the making of the advance in question) has traditionally been limited by what is commonly termed the optional/obligatory advance distinction. It holds that, if future advances are optional with the mortgagee (that is, the mortgagor has no contractual right to demand the advances), and if the mortgagee has notice of an intervening lien at the time the advances are made, they lose priority to the intervening lien.

This doctrine had its roots in Hopkinson v. Rolt, 9 H. of L. 514, 11 Eng. Rep. 829 (1861). See Annot., 80 A.L.R. 2d 179 (1961); Nelson & Whitman, Rethinking Future Advance Mortgages: A Brief for the Restatement Approach, 44 Duke L. J. 657 (1995); Hughes, Future Advance Mortgages: Preserving the Benefits and Burdens of the Bargain, 29 Wake For. L. Rev. 1101 (1994); Korngold, Construction Loan Advances and the Subordinated Purchase Money Mortgagee: An Appraisal, A Suggested Approach, and the ULTA Perspective, 50 Ford. L. Rev. 313, 329–39 (1981); Skipworth, Should Construction Lenders Lose Out on Voluntary Advances if a Loan Turns Sour?, 5 Real Est. L.J. 221 (1977); Kratovil & Werner, Mortgages for Construction and the Lien Priorities Problem—The "Unobligatory" Advance, 41 Tenn. L. Rev. 311 (1974); 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.7 (3d ed. 1993). Numerous cases are cited in the Case Note following § 2.1.

The purpose of this doctrine is not to protect the intervening lienor per se; that individual already has notice from the wording of the prior mortgage that future advances may be given. Rather, the objective is to assist the mortgagor by avoiding a situation in which he or she is unable to obtain further secured financing from any source: not from the original mortgagee, since that lender has no contractual obligation to make further advances, and not from any third party, since such lenders will be fearful that any existing "cushion" of value in the property may be "eaten up" by further advances made by the prior mortgagee.

The optional/obligatory distinction thus attempts to prevent the mortgagor's being placed in the awkward and unfair position of being unable to use the real estate as security for additional financing, despite the fact that it may have value well in excess of the existing indebtedness owing under the mortgage.

While this objective is laudable, the optional/obligatory advance doctrine has turned out to be an exceedingly blunt and unsatisfactory tool for accomplishing it. A principal problem has been the difficulty of distinguishing between optional and obligatory advances. For example, in a construction loan a lender agrees to fund the costs of constructing a building, but often hedges its commitment with conditions: satisfactory inspections by its architects, satisfactory proof of the costs of labor and materials used, satisfactory evidence that the project is within a preestablished budget, and so forth. Lenders are apt to reserve copious amounts of discretion in determining that these conditions have been met; but if too much discretion is reserved, a court may determine that the lender in fact had no contractual obligation to make further advances, and hence that all of its advances should lose priority to intervening liens. Mechanics' lien claimants are commonly the beneficiaries of this determination.

It is extremely difficult, under the cases, to judge how much discretion the lender may retain without jeopardizing its priority. Compare National Bank of Washington v. Equity Investors, 506 P.2d 20 (Wash.1973) (lender's duty was too discretionary; advances lost priority) with Dempsey v. McGowan, 722 S.W.2d 848 (Ark. 1987) (lender must be permitted reasonable discretion; advances maintained priority). See also J. I. Kislak Mortg. Corp. v. William Matthews Builder, Inc., 287 A.2d 686 (Del.Super.Ct.1972), aff'd, 303 A.2d 648 (Del. 1973) (where lender does not insist that the conditions stated in the construction loan agreement must actually be met before disbursing advances, the advances are optional and lose priority); cf. Home Lumber Co. v. Kopfmann Homes, Inc., 535 N.W.2d 302 (Minn.1995) (where lender does not insist that the conditions stated in the construction loan agreement must actually be met, the advances are nonetheless obligatory and retain priority).

A related problem arises when a default occurs by the borrower under a construction loan. The mortgage will invariably empower the lender to cease advances, accelerate the loan and foreclose. But in many cases both the lender's and borrower's best interests are served by the lender's continuing to fund construction, notwithstanding the default. Nevertheless, a court may hold that advances under these conditions are obviously optional, since the lender might have refrained from making them and foreclosed instead.

A further difficulty with the optional/obligatory advance doctrine is the definition of notice, for the mortgagee loses priority only to intervening liens of which it has notice at the time of the advance. A sharp split of authority has developed as to whether constructive notice or actual knowledge is necessary. The intervening lien is usually recorded, so if constructive notice is the test, the consequence is that the prior mortgagee may safely make optional advances only if a title examination is made before each of them. This is the view taken, for example, in Tyler v. Butcher, 734 P.2d

1382 (Or.Ct.App.1987); Lincoln Fed. Sav. & Loan Ass'n v. Platt Homes, Inc., 449 A.2d 553 (N.J. Super. Ct. 1982); People's Sav. Bank v. Champlin Lumber Co., 258 A.2d 82 (R.I. 1969). To the contrary, that only actual knowledge will count against the prior mortgagee, see La Cholla Group, Inc. v. Timm, 844 P.2d 657 (Ariz.Ct.App.1992); Idaho First Nat. Bank v. Wells, 596 P.2d 429 (Idaho 1979); McMillen Feed Mills, Inc. v. Mayer, 220 S.E.2d 221 (S.C.1975); First Interstate Bank v. Heritage Bank, 480 N.W.2d 555 (Wis.Ct.App. 1992). See additional cases cited in the Case Note following § 2.1.

The concept of actual notice is especially problematic where the intervening lien is a mechanic's or materialman's lien. Some authority holds that, if the mortgagee is aware that suppliers or subcontractors have not been paid on time, such knowledge is the equivalent of actual notice of mechanics' liens, whether the lender truly knows that liens have been filed or not. See, e.g., First Nat'l Bank v. Worthley, 714 P.2d 1044 (Okla.Ct. App.1985). Compare Grider v. Mutual Fed. Sav. & Loan Ass'n, 565 S.W.2d 647 (Ky.Ct.App.1978) (mortgagee must know that there are unpaid claims and that "the [mortgagor] is unable to pay such claims or that the claimant intends to file a lien.").

While construction lenders have long disliked the optional/obligatory test, the 1980s witnessed great growth of a new type of loan with which the test was equally incompatible: the "home equity loan," typically a second mortgage to secure a fluctuating line of credit. Credit line mortgages had been used for many decades in business lending, but this more recent surge of activity involved the use of personal residences as security for lines of credit. Some of these arrangements contemplated advances over which the lender had sufficient discretion that they were very likely to be regarded as optional; and of course the lenders had no wish to be put to the trouble of examining the record title before every disbursement.

As a consequence of these objections raised by construction and home equity lenders, numerous states attacked the problem by statute. Some of the statutes retain the basic concepts of the optional/obligatory doctrine, but attempt to refine it in three specific respects to make it more workable. These modifications of the doctrine may be described as follows:

(1) *Redefining "notice."* In a number of the jurisdictions the legislation redefines "notice" to make it clear that only actual written notice delivered to the mortgagee will be sufficient to jeopardize its priority position. This approach places the onus on the prospective intervening lienor to take affirmative steps to ensure that the senior mortgagee is aware of its position. Examples, cited in the Statutory Note following § 2.1, include Alaska, Maine, Nebraska, North Dakota, Ohio, Rhode Island, Tennessee, Vermont, and West Virginia. Most of the statutes permit the delivery of notice by a junior lienor to act only as a subordination of optional advances, thus following the common-law approach; but several of them appear to subordinate all advances to an intervening lienor who gives notice; see Alaska, Maine, and Vermont.

(2) *Eliminating the mortgagor's default as a basis for deeming advances "optional."* In a number of the statutes, "obligatory" is redefined as "pursuant to commitment, ... whether or not a default ... has relieved or

may relieve [the mortgagee] from its obligation." The quoted language appears in Uniform Land Security Interest Act § 111(19) (1985), which takes this approach. It was originally drawn from U.C.C. § 9–105(1)(k). See the Illinois, North Carolina, and Rhode Island statutes cited in the Statutory Note.

This change is intended to permit the mortgagee to safely continue funding the loan despite the borrower's default under the mortgage, note, or loan agreement. Under the traditional "obligatory" concept, by comparison, a material default by the borrower would discharge the lender from the duty to make further advances, so that any advances actually made thereafter might be regarded as "optional" and subject to loss of priority. This could follow despite the fact that, from an economic viewpoint, continuing to supply funds (for example, to complete a construction project) was the only sensible course for the lender.

(3) *Eliminating the nonoccurrence of conditions as a basis for deeming advances "optional."* Under several of the statutes, an advance is regarded as being made "pursuant to commitment," "whether or not ... [an] event not within [the mortgagee's] control has relieved or may relieve it from its obligation." (See the source references in paragraph (2) above; Schalmo Builders, Inc. v. Malz, 629 N.E.2d 52 (Ohio.Ct.App.1993), construing Ohio Rev. Code § 5301.232(E)(4)). This approach is motivated by the fact that loan agreements, particularly for construction loans, are frequently hedged with multiple conditions. For example, the lender need not disburse funds unless the project is proceeding within budget, is constructed in conformity with approved plans and specifications, and the like. If some conditions are not met, and the lender continues (as a matter of good business judgment) to fund the loan, case law under the "optional/obligatory" distinction suggests that the further advances might lose priority. Under the reformulation found in these statutes, however, loss of priority would be a risk only if the lender had control of the conditions.

While these redefinitions of "notice" and "obligatory" are somewhat helpful in clarifying the optional/obligatory muddle, they are by no means an adequate solution. First, they fail to deal with the situation in which the mortgagee has simply reserved too much discretion, or has too much control of the relevant conditions, so that its advance cannot be regarded as "pursuant to commitment." Second, and more significantly, they lose sight of the original purpose of the optional/obligatory doctrine: to protect the mortgagor's right to use his or her unencumbered equity in the real estate as security for additional borrowing.

This is readily illustrated. Assume, under a statute containing the features described above, that ME1 makes a line-of-credit mortgage loan to MR for business purposes. ME1 promises to fund the loan up to a maximum of $100,000, but only upon certain conditions, one of which is that MR maintain a specific credit rating. After MR borrows $50,000 under this loan, MR's credit rating falls below the specified level and ME1 refuses to make further advances. The real estate's value is still well above $100,000, so MR approaches ME2 and attempts to arrange a second mortgage loan. ME2 is willing, and is plainly able to give ME1 actual notice that a second loan is about to be made. However, ME2 realizes that ME1 might in the future relax its position and make further advances to MR. If ME1 did so, those advances would quite plainly be "pursuant to commitment" as defined in the statutory language discussed above, despite the fact that, as a consequence of the credit condition's being unsatisfied, ME1 could not be compelled to make them. Hence, they would have priority over ME2. Since ME2 cannot be sure that such advances will not be made by ME1, ME2 will consider the real estate inadequate security and will refuse to make the second mortgage loan. Thus MR is in precisely the awkward and unfair position that the optional/obligatory doctrine was designed to avoid: He or she has plenty of unencumbered equity in the realty, but cannot get a loan from any source on its security.

Thus this statutory attempt to make the optional/obligatory doctrine more palatable to lenders has the effect of defeating the doctrine's objective. It would be simpler (and no less harmful to borrowers) merely to renounce the optional/obligatory distinction in all of its forms, and to declare that all future advances take the priority of the original mortgage. (Indeed, a number of statutes do precisely this, at least in some situations; see the references to Hawaii, Idaho, Kansas, Kentucky, Maryland, New Hampshire, New Jersey, New Mexico, New York, South Carolina, South Dakota, and Washington in the Statutory Note following § 2.1.)

But the latter result is unnecessarily harsh to borrowers. For this reason, this Restatement rejects the obligatory/optional distinction, recognizes the priority to all future advances, and adopts a different approach, described below, for protecting the interests of the mortgagor.

Mortgagor's notice to terminate or subordinate future advances, Comment b. About 15 statutes, as listed in the Statutory Note following § 2.1, attempt to deal with the problem of unavailability of junior financing to the mortgagor in a much more ingenious and effective way. They adopt the concept of a "cut-off notice": a notice which the borrower may issue to the lender and which, in effect, freezes advances at their current level. A borrower who has this power to freeze advances has no need of the optional/obligatory distinction. If the borrower needs additional financing, cannot get it on satisfactory terms from the existing mortgagee, and wishes to pursue borrowing opportunities with other lenders, he or she need merely issue a cut-off notice. The mortgagee is thus informed that no further advances will be secured by the mortgage; the future advance provisions of the loan are put at an end. Other lenders may then safely take junior mortgages on the property, knowing that further advances on the senior debt will not occur to exhaust the borrower's equity.

This does not mean that a junior lender can be absolutely certain of the amount to which it is subordinate. Under most of the statutes the junior lien is still subject to accrual of interest on the senior loan, to the senior's costs of enforcement and foreclosure, and to any advances the senior lender might make to protect the security. But these are risks which every junior lienholder must assume, whether the prior mortgage generally secures future advances or not.

The cut-off notice is a simple and effective solution to the dilemma of the borrower who needs additional financing. If the cut-off procedure is adopted, there is simply no need for the law to subordinate optional advances, for a properly advised junior lender will insist that a cut-off notice be given, and there will not be any further advances by the senior lender, optional or otherwise. Hence this Restatement adopts and recognizes a mortgagor's right to terminate further advances.

The statutory cut-off notice provisions vary in their effect. Most of them render advances made after receipt of the notice unsecured. See, in the Statutory Note following § 2.1, Alaska, Connecticut, Florida, Kentucky, Maine, Missouri, Nebraska, Nevada, North Carolina, Ohio, Pennsylvania, and Rhode Island statutes. Others merely subordinate the priority of further advances to any intervening liens. See Montana, Tennessee, and Virginia statutes. There seems to be no sound reason to restrict the mortgagor to one of these results rather than the other; this Restatement permits the mortgagor's notice to have either effect, according to its tenor.

Eliminating the optional/obligatory advance doctrine has one significant disadvantage. The doctrine has sometimes been used by the courts as a tool, albeit a somewhat blunt one, to prevent unfair hardship to junior mortgagees and mechanics' lienors in construction projects. If the senior construction lender employs sloppy loan disbursement practices that permit the borrower to divert funds from the project, thus increasing the balance on the construction loan without a commensurate increase in the value of improvements on the property, junior lienors are obviously unfairly disadvantaged. Courts have sometimes come to their aid by labeling the diverted disbursements "optional," thus giving the intervening lienors a priority they would not otherwise have had.

With the elimination of the optional/obligatory advance doctrine, this means of assisting victimized junior lienors is no longer available. However, other devices to assist them continue to exist. Perhaps the most effective, adopted by several courts, is the imposition of a duty of good faith and fair dealing on construction lenders, so that those who injure junior lienors by the use of negligent or lax disbursement procedures are held liable for the losses they cause. Elevation of the junior lienors' priority is an appropriate way to impose that liability. Cases imposing a duty of this sort on construction lenders include Security & Inv. Corp. v. Droege, 529 So.2d 799 (Fla.Dist.Ct. App.1988); Peoples Bank v. L & T Devel., Inc., 434 So.2d 699 (Miss. 1983), noted 53 Miss. L. Rev. 691 (1983); Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251 (Alaska 1975); Commercial Standard Ins. Co. v. Bank of America, 129 Cal.Rptr. 91 (Cal.Ct.App.1976); and Cambridge Acceptance Corp. v. Hockstein, 246 A.2d 138 (N.J. Super. Ct. 1968). See Kratovil, Mortgage Lender Liability—Construction Loans, 38 DePaul L. Rev. 43 (1989).

Cases in which there is no right to terminate or subordinate future advances, Comment c. Some of the existing statutes recognize situations in which a cut-off notice should be ineffective. For example, construction loans are not subject to a cut-off notice under the Missouri, Ohio, Pennsylvania, or Tennessee statutes. The Missouri and Connecticut statutes also exempt business and agricultural transactions in which the mortgage collateralizes a guaranty or an irrevocable letter of credit, and the Tennessee statute exempts obligatory advances made to third parties. This Restatement parallels and generalizes from these statutory provisions.

The right to terminate or subordinate future advances exists, under this Restatement, whether or not the borrower has a contractual duty to borrow additional funds. If such a duty exists, termination of future advances will breach it, rendering the mortgagor liable for contract damages. The case law uniformly rejects any right to specific performance by the mortgagee; see City Centre One Assoc. v. Teachers Ins. & Annuity Ass'n, 656 F.Supp. 658 (D.Utah 1987); Groot, Specific Performance of Contracts to Provide Permanent Financing, 60 Cornell L. Rev. 718, 727–36 (1975); 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.3 (3d ed. 1993).

Mortgage priority for other future expenditures, Comment d. A few of the statutes specifically exempt from the cut-off notice procedure the items mentioned in § 2.3(d), above. Such items include interest (Ohio and Tennessee) and advances for protection (Missouri, North Carolina, and Tennessee). It is likely that most of the other cut-off notice statutes would be similarly construed.

§ 2.4 Mortgages Securing Future Advances Not Specifically Described

A mortgage may secure future advances that are not made in connection with the transaction in which the mortgage is given, and that are not specifically described in the mortgage or other documents executed as part of that transaction, subject to the following limitations:

(a) The parties must have agreed that such future advances will be secured. Whether this agreement must be written and contained in the mortgage is governed by the principles of § 2.1(b) and (c).

(b) The advances must be made in a transaction similar in character to the mortgage transaction, unless

(1) the mortgage describes with reasonable specificity the additional type or types of transactions in which advances will be secured; or

(2) the parties specifically agree, at the time of the making of the advances, that the mortgage will secure them.

(c) If mortgaged real property is transferred, the mortgage will secure only advances made prior to the mortgagee's gaining actual knowledge of the transfer.

Cross-References:

Section 1.5, Description of the Mortgagee and the Mortgage Obligation; § 2.1, Future Advances; § 2.3, Priority of Future Advances.

Comment:

This section deals with what are usually termed dragnet clauses. A typical dragnet clause states that the mortgage will secure not only the debt incurred in the instant mortgage transaction, but in addition all other debts or obligations that are presently owed or may in the future be owed to the mortgagee by the mortgagor. The priority of advances or loans under a dragnet clause is governed by § 2.3.

Dragnet clauses are often described as disfavored by the courts. The reason is the probability that the mortgagor will not have noticed the clause in the mortgage or understood its significance. Hence dragnet clauses are construed narrowly against the mortgagee.

a. Necessity of mortgage clause. A mortgage will have a "dragnet" effect only if a specific agreement between the mortgagor and mortgagee so provides. Absent such an agreement, the mortgage will secure only advances made as part of the same transaction in which the mortgage is taken, or advances that have been made previously and are specifically identified in the mortgage.

However, the agreement need not be contemporaneous with the original mortgage. For example, the parties may later enter into a separate loan transaction and specifically agree that the preexisting mortgage will secure its repayment; see § 2.4(b)(2). Such an agreement will, in effect, act as a modification of the mortgage.

Sections 2.1(b) and 2.1(c) determine whether the agreement must be written or must appear in the mortgage. If the mortgage does not incorporate the agreement, and an interest in the subject real estate is transferred to a party without notice of it, the agreement becomes a nullity and the mortgage has no "dragnet" effect as against the transferee's interest. See Illustration 1.

The agreement may merely state the intention to secure advances in other transactions in general terms. A sufficient statement of this intention would be "This mortgage shall, in addition, secure all other indebtedness of the mortgagor to the mortgagee incurred while this mortgage is in effect." Except as provided in the other limitations stated in this section, it is unnecessary to define the nature of such "other indebtedness" in any greater detail.

Illustration:

1. Mortgagor obtains a $10,000 loan from Mortgagee and gives Mortgagee a mortgage on Mortgagor's real estate to secure

repayment. Mortgagor and Mortgagee separately agree that the mortgage will also secure any future indebtedness which Mortgagor may owe to Mortgagee. The mortgage is recorded but the agreement regarding future indebtedness is not. Mortgagor then borrows an additional $5,000 from Mortgagee in a separate transaction. Mortgagor subsequently sells the real estate to G, who has no notice of the agreement respecting future indebtedness. The mortgage does not secure repayment of the additional $5,000.

b. Inapplicability to preexisting debt. A dragnet clause can have only a prospective effect. Even if the clause refers in general terms to preexisting indebtedness, the mortgage will not secure that indebtedness. See Illustration 2. The reason for this limitation is that, if the parties wish to secure preexisting indebtedness, it is a simple matter for them to make specific reference to that debt in the mortgage or in a concurrent agreement. When this is not done, it is reasonable to assume that the parties did not focus their negotiations on the preexisting debt, and did not intend to make the mortgage secure it. On the other hand, a mortgage may secure preexisting indebtedness if it specifically identifies that debt. See Illustration 3; § 1.2(c).

Illustrations:

2. Mortgagor obtains a $5,000 unsecured loan from Mortgagee. Subsequently, Mortgagor borrows $10,000 from Mortgagee in a separate transaction, and gives Mortgagee a mortgage on Mortgagor's land to secure repayment of the $10,000. The mortgage contains a clause stating "All other debts, past, present, or future owed by Mortgagor to Mortgagee shall be secured by this mortgage." Notwithstanding this language, the mortgage does not secure the $5,000 debt.

3. The facts are the same as Illustration 2, except that the mortgage clause states "All other debts, past, present, or future owed by Mortgagor to Mortgagee, including Mortgagor's $5,000 loan of [date], shall be secured by this mortgage." The mortgage secures both the $5,000 and $10,000 debts.

c. Character of advances secured. Where a dragnet clause describes the other advances to be secured only in general terms (i.e., "all future debts Mortgagor may owe to Mortgagee"), the law imposes a further limitation: The mortgage will generally secure only advances made in transactions of a character similar to that in which the mortgage was taken.

The reason for this limitation is to mitigate the potential for unanticipated coverage of the clause. If an advance claimed by the mortgagee to be secured arises out of a transaction of a wholly different character from the original mortgage transaction, an inference arises that the parties did not intend to cover it, even though the language of the mortgage's dragnet clause is so broad that the advance literally falls within its terms. See Illustrations 4 and 5.

The "similar in character" test may be satisfied in several ways. The additional advance may be made to assist in financing of the same or a similar type of business venture. If the original transaction was a home purchase loan, a further loan to improve or repair the home will be regarded as "similar in character." If the original loan was to enable the borrower to purchase an automobile for personal use, a later loan to purchase another motor vehicle for similar use will be covered. See Illustrations 7 and 8.

If the mortgage clause describes with reasonable specificity other types of loans or advances that are not "similar in character," but that the parties intend to place within the scope of the dragnet clause, their intention will be honored. For example, a clause stating that "business loans" will be secured is sufficient to cover all sorts of business loans. It is not necessary to identify the particular business purpose for which such loans might be made. See Illustration 6.

Even if the future advances are not described with reasonable specificity and do not meet the "similar in character" test, such advances will be secured if, when they are made, the parties specifically identify them as being secured by the mortgage. See Illustration 9.

Illustrations:

4. Mortgagor obtains a $10,000 loan from Mortgagee and gives Mortgagee a mortgage on Mortgagor's land to secure repayment. The mortgage contains a clause stating "All other debts, past, present, or future, owed by Mortgagor to Mortgagee shall be secured by this mortgage." Subsequently Mortgagor injures Mortgagee in an automobile accident. Mortgagee files a personal injury action against Mortgagor and obtains a judgment. The judgment debt is not similar in character to the original mortgage loan, and is not secured by the mortgage.

5. Mortgagor obtains a $50,000 loan from Mortgagee to enable Mortgagor to purchase a house, and gives Mortgagee a mortgage on the house and lot to secure repayment. The mortgage contains a clause stating "All other debts, past, present, or future, owed by Mortgagor to Mortgagee shall be secured by this mortgage." Subsequently Mortgagor decides to start a restaurant

business, and borrows $10,000 from Mortgagee to purchase food preparation equipment. The $10,000 business loan is not similar in character to the original house purchase loan, and is not secured by the mortgage.

6. The facts are the same as Illustration 5, except that the mortgage clause is as follows: "All other debts, past, present, or future, owed by Mortgagor to Mortgagee, including loans for business purposes, shall be secured by this mortgage." The phrase "for business purposes" is a reasonably specific description of the $10,000 loan for the restaurant business, and it is secured by the mortgage.

7. Mortgagor obtains a $500,000 loan from Mortgagee to enable Mortgagor to construct an apartment building, and gives Mortgagee a mortgage on the building and associated land to secure repayment. The mortgage contains a clause stating "All other debts, past, present, or future, owed by Mortgagor to Mortgagee shall be secured by this mortgage." Mortgagor uses the entire $500,000 for construction, but because of unexpected cost increases it is insufficient to complete the building. Mortgagee advances an additional $25,000 to Mortgagor to permit completion. The $25,000 advance is similar in character to the mortgage transaction, and is secured by the mortgage.

8. Mortgagor starts a restaurant business and obtains a $10,000 loan from Mortgagee to purchase food preparation equipment. The loan is secured by a mortgage on Mortgagor's house, and contains a clause stating "All other debts, past, present, or future, owed by Mortgagor to Mortgagee shall be secured by this mortgage." Subsequently Mortgagor borrows an additional $5,000 from Mortgagee to purchase chairs and tables for the restaurant. The $5,000 loan is similar in character to the original mortgage loan, and is secured by the mortgage.

9. The facts are the same as Illustration 5, except that the promissory note signed by Mortgagor in connection with the $10,000 loan states "This loan shall be secured by the $50,000 mortgage of [date] previously given by Mortgagor to Mortgagee." The $10,000 loan is secured by the mortgage.

d. Limitations when real estate is transferred. When real estate is subjected to a mortgage containing a dragnet clause, and is subsequently transferred, the operation of the clause is limited in two particulars. First, indebtedness incurred by or advances made to the original mortgagor after the mortgagee gains actual knowledge of the transfer will not be secured by the mortgage. If this were not so, the purchaser of real estate would be placed in the intolerable position of having his or her land subjected to an encumbrance of uncontrollable dimensions. Absent very clear evidence that the transferee has expressly accepted such a burden, it is not permitted. This rule suggests that a person who purchases land subject to a mortgage containing a dragnet clause is well advised to inform the mortgagee of the purchase immediately.

Second, advances made to or indebtedness incurred by the transferee of the real estate, rather than to or by the original mortgagor, will not ordinarily be secured. The reason for this limitation is that the transferee (who, of course, did not execute the mortgage) is most unlikely to anticipate that his or her other debts will be secured by it. If the transferee does not specifically evince such an intent, the element of unfair surprise is too great. Again, clear evidence that the transferee intends to allow such advances to add to the mortgage balance should yield a contrary result.

REPORTERS' NOTE

On dragnet clauses, see generally 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.8 (3d ed. 1993); Meek, Mortgage Provisions Extending the Lien to Future Advances and Antecedent Indebtedness, 26 Ark. L. Rev. 485 (1973); Blackburn, Mortgages to Secure Future Advances, 21 Mo. L. Rev. 209 (1956); Note, Enforceability of "Dragnet Clauses" in Deeds of Trust: The Current State of the Law in Texas, 56 Tex. L. Rev. 733 (1978); Annotation, 3 A.L.R. 4th 690 (1980). By way of analogy, see Campbell, Contracts Jurisprudence and Article Nine of the Uniform Commercial Code: The Allowable Scope of Future Advance and All Obligations Clauses in Commercial Security Agreements, 37 Hast. L.J. 1007 (1986).

Necessity of mortgage clause, Comment a. See In re Bennett, 60 B.R. 48 (Bankr.N.D.Ala.1985) (future advances were not secured, where consideration clause but not defeasance clause mentioned such advances); In re Bonner, 43 B.R. 261 (Bankr.N.D. Ala. 1984) (similar); In re Chiodetti, 163 B.R. 6 (Bankr.D.Mass.1994) (future advances were not secured, where dragnet clause appeared in note but not in mortgage); In re Old Electralloy Corp., 132 B.R. 705 (Bankr. W.D. Pa. 1991) (same); In re Scranes, Inc., 67 B.R. 985 (Bankr. N.D.Ohio 1986) (same).

Illustration 1 is based on First Nat'l City Bank v. Tara Realty Corp., 399 N.E.2d 953 (N.Y. 1979), rev'g 410 N.Y.S.2d 71 (N.Y.App.Div.1978).

Inapplicability to preexisting debt, Comment b. Illustrations 2 and 3 are based on Nat'l Bank of Eastern Arkansas v. Blankenship, 177 F.Supp. 667 (E.D.Ark.1959); In re Shapiro, 109 B.R. 127 (Bankr.E.D.Pa.1990); Lundgren v. Nat'l Bank of Alaska, 756 P.2d 270 (Alaska 1987); In re Bass, 44 B.R. 113 (Bankr.D.N.M. 1984); United Nat'l Bank v. Tellam, 644 So.2d 97 (Fla.Dist.Ct.App.1994); and Kamaole Resort Twenty-One v. Ficke Hawaiian Invest., Inc., 591 P.2d

104 (Hawaii 1979) (preexisting debts are not covered by dragnet clause unless they are specifically identified or relate to the same transaction or series of transactions). See First Nat'l Bank v. Lygrisse, 647 P.2d 1268 (Kan.1982) (dragnet clause will cover antecedent debts only "if these are clearly identified in the mortgage").

Contra, see Bank of Brewton v. General Motors Acceptance Corp., 811 F.Supp. 648 (S.D.Ala.1992) (mortgage secured guaranties of the same date even though it did not specifically identify them); Ram Co. v. Estate of Kobbeman, 696 P.2d 936 (Kan. 1985) (preexisting debts are secured under dragnet clause where they are part of the same series of transactions as mortgage); Robert C. Roy Agency, Inc. v. Sun First Nat'l Bank, 468 So.2d 399 (Fla.Dist.Ct.App.1985) (preexisting debts are secured where dragnet clause clearly expresses intent to include them, even though they are not specifically identified); Iuka Guaranty Bank v. Beard, 658 So.2d 1367 (Miss.1995) (same, dicta); Clovis Nat'l Bank v. Harmon, 692 P.2d 1315 (N.M.1984); Schmitz v. Grudzinski, 416 N.W.2d 639 (Wis.Ct. App.1987) (same); Badger State Agri-Credit & Realty, Inc. v. Lubahn, 365 N.W.2d 616 (Wis.Ct.App. 1985) (same).

Character of advances secured, Comment c. Illustration 4 is based on Trapp v. Tidwell, 418 So.2d 786 (Miss. 1982). See also Ga. Code Ann. § 67–1316 (dragnet clauses are limited to debts arising ex contractu, not those arising ex delicto).

Illustration 5 is based on Sowers v. FDIC, 96 B.R. 897 (S.D.Iowa 1989) (home mortgage containing dragnet clause did not secure later farm loan); In re Ballarino, 180 B.R. 343 (D.Mass.1995) (home mortgage containing dragnet clause did not secure later business loan); and First Security Bank v. Shiew, 609 P.2d 952 (Utah 1980) (same). See also Paul Rochester Invest. Co. v. United States, 692 F.Supp. 704 (N.D.Tex.1988), rev'd without op., Prince v. Williams, 869 F.2d 1485 (5th Cir.1989) (commercial loan mortgage containing dragnet clause did not secure later personal loan); In re Swanson, 104 B.R. 1 (Bankr.C.D.Ill.1989) (dragnet clause in security agreement did not cause it to secure the maker's subsequent guaranty of their son's indebtedness to the same lender); In re Cox, 57 B.R. 290 (Bankr.E.D.Tenn.1986) (mortgage loan on wife's land to rebuild her residence did not secure subsequent business loan to husband); In re Grizaffi, 23 B.R. 137 (Bankr.D.Colo.1982) (dragnet clause in mortgage for business purposes did not cause it to secure later personal note); Lundgren v. Nat'l Bank of Alaska, 742 P.2d 227 (Alaska 1987) (dragnet clause will not secure new debts which are not of the same type or character as the original mortgage debt); Decorah State Bank v. Zidlicky, 426 N.W.2d 388 (Iowa 1988) (dragnet clause in farm operations loan mortgage did not cause it to secure subsequent residential purchase); Dalton v. First Nat'l Bank, 712 S.W.2d 954 (Ky.Ct.App.1986) (dragnet clause in security agreement for purchase of mobile home did not cause it to secure payment of an overdraft on bank account); Canal Nat'l Bank v. Becker, 431 A.2d 71 (Me.1981) (issue of fact existed as to whether later notes were sufficiently related to 1976 mortgage loan for acquisition of boat inventory, so that dragnet clause in mortgage would secure later notes); Merchants Nat'l Bank v. Stewart, 608 So.2d 1120 (Miss.1992) (dragnet clause in line-of-credit mortgage for crop production and irrigation did not cause it to secure loan to purchase other land, even though executed on the same day); Ruidoso State Bank v. Castle, 730 P.2d 461 (N.M.1986) (mortgagee did not meet burden of showing that purposes of mortgage loan and later loans were sufficiently related to cause mortgage to secure later loans); Mead Corp. v. Dixon Paper Co., 907 P.2d 1179 (Utah Ct. App. 1995) (where two business loans were made between the same parties on the same date, dragnet clause in one loan properly caused its collateral to secure other loan as well; the two loans "related to the same transaction").

Contra, see In re Willie, 157 B.R. 623 (Bankr.M.D.Tenn.1993) (under Tennessee law, dragnet clause in mortgage for personal purposes caused it to secure later loan for business purposes); Rogers v. First Tennessee Bank, 738 S.W.2d 635 (Tenn. Ct.App.1987) (dragnet clause in mortgage on nonresidential property for business purpose caused it to secure later loan on residential property); In re Stone, 49 B.R. 25 (Bankr.N.D.Tex. 1985) (dragnet clause covered second loan, where parties were identical and both loans were for similar business purpose.) Note that the Tennessee holdings above stem from the Tennessee legislature's overruling of the "same class of loan" doctrine; see Tenn. Code Ann. § 47–50–112(b).

See also In re Magers, 83 B.R. 685 (Bankr.W.D.Mo.1988) (dragnet clause in mortgage does not cause it to secure a later note which recites that it is "unsecured"). Cf. Johnson v. Midland Bank, 715 S.W.2d 607 (Tenn.Ct. App.1986) (dragnet clause causes mortgage to secure later notes despite the fact that they recited they were "unsecured"; court refused to consider whether later notes were for a purpose similar to that of the original loan).

In Union Nat'l Bank v. First State Bank, 697 S.W.2d 940 (Ark.Ct.App. 1985), a dragnet clause in a home loan stated that the mortgage covered future advances "whether or not such future advances may be for purposes related or unrelated to the purpose for which the original indebtedness secured hereby is loaned." The court held that this language was sufficient to make the mortgage secure subsequent automobile and business loans. This Restatement rejects that result, and requires that the clause contain a more specific description of the types of unrelated future loans to be secured, such as "business loans," "automobile loans," or the like; see Illustration 6.

Illustrations 7 and 8 are based on In re Continental Resources Corp., 799 F.2d 622 (10th Cir.1986) (where both debts were for working capital, dragnet clause in first mortgage covered second debt) and by L. B. Nelson Corp. v. Western American Fin. Corp., 722 P.2d 379 (Ariz.Ct.App. 1986) (dragnet clause in construction loan mortgage caused it to secure land acquisition and development loan on same project). See also In re Stone, 49 B.R. 25 (Bankr.N.D.Tex. 1985) (dragnet clause in mortgage for business purposes covered later loans for similar business purposes); Smith v. Union State Bank, 452 N.E.2d 1059 (Ind.Ct.App.1983) (dragnet clause covered later notes, where all loans related to debtors' farming operation); Garnett State Sav. Bank v. Tush, 657 P.2d 508 (Kan.1983) (same); Cabot, Cabot & Forbes Land Trust v. First Nat'l Bank, 369 So.2d 89 (Fla.Dist.Ct.App.1979).

Illustration 9 is based on Pearll v. Williams, 704 P.2d 1348 (Ariz.Ct.App. 1985) and Hawkeye Bank v. Michel, 373 N.W.2d 127 (Iowa 1985). See also Uransky v. First Fed. Sav. & Loan Ass'n, 684 F.2d 750 (11th Cir.1982); First Nat'l Bank v. Lygrisse, 647 P.2d 1268 (Kan.1982).

Limitations when real estate is transferred, Comment d. Note that Subsection (c) deals only with debts or advances incurred after the mortgagee learns of the transfer of the mortgaged property. There is no doubt that advances made before the mortgagee gains knowledge of the transfer, if they meet the other requirements stated in this section, will continue to be secured by the mortgage notwithstanding the transfer. See, e.g., State Bank of Albany v. Fioravanti, 417 N.E.2d 60 (N.Y. 1980).

Cases rejecting or questioning application of a dragnet clause to a later debt, incurred by the original mortgagor after a transfer of the mortgaged property, include Green v. Southtrust Bank, 519 So.2d 1289 (Ala.1987); Citizens Nat'l Bank v. Coates, 509 So.2d 103 (La.Ct.App.1987); Trapp v. Tidwell, 418 So.2d 786 (Miss.1982); Vaughan v. Crown Plumbing & Sewer Service, Inc., 523 S.W.2d 72 (Tex. Ct. Civ. App. 1975).

Compare Central Production Credit Ass'n v. Page, 231 S.E.2d 210 (S.C. 1977), in which the mortgagor obtained an additional advance after transferring the real estate to his wife. She indicated her express intention that the property would stand as security for the advance by contemporaneously executing a new mortgage on it, which for technical reasons was void. The court held that the dragnet clause in the original mortgage covered the advance, and that the mortgagee was not estopped to claim under the original mortgage because of its having obtained the new mortgage.

The rule of Subsection (c) is followed in Uniform Land Transactions Act § 3-205(d) (1975). See also Ga. Code Ann. § 67-1316 (dragnet clauses are limited to debts arising between the original parties to the security instrument).

The following cases deal with the question whether a later debt, incurred by the transferee after a transfer of the mortgaged property, is covered by the mortgage's dragnet clause: Uransky v. First Fed. Sav. & Loan Ass'n, 684 F.2d 750 (11th Cir. 1982) (where subsequent note executed by transferee specifically states that it is secured by prior dragnet mortgage, it is so secured); Walker v. Whitmore, 262 S.W. 678 (Ark.1924) (where dragnet clause refers to future debts "owing by grantor" of mortgage, debts incurred by transferee of property are not covered); Citizens Fed. Sav. & Loan Assoc. v. Andrews, 150 S.E.2d 301 (Ga.Ct.App. 1966) (under Ga. Code Ann. § 67-1316, dragnet clause applies only to debts between original parties to the mortgage).

CHAPTER 3

MORTGAGOR'S EQUITY OF REDEMPTION AND MORTGAGE SUBSTITUTES

Introductory Note: The core concept of this Chapter is the mortgagor's equity of redemption, the basic and historic right of a debtor to redeem the mortgage obligation after its due date, and ultimately to insist on foreclosure as the means of terminating the mortgagor's interest in the mortgaged real estate. This principle is articulated in § 3.1(a). The balance of § 3.1 delineates rules governing attempts by lenders to "clog" or limit the equity of redemption by specific language contained in the mortgage or in contemporaneous separate instruments. The remaining sections focus on a variety of mortgage substitutes.

Section 3.2 deals with the absolute deed as real estate security. Where the parties intend that such a device serve as security for an obligation, it will be treated as a mortgage. Section 3.3 considers absolute deed transactions in which there is a second written document which purports to give the grantor the option or the contractual obligation to purchase the real estate described in the absolute deed. Like its absolute deed counterpart, the conditional sale will be treated as a mortgage where the parties intend that it serve as security for an obligation.

Section 3.4 deals with the most frequently used purchase-money mortgage substitute, the contract for deed. While this controversial financing device has received varying treatment by courts and legislatures, § 3.4 treats it both procedurally and substantively as a mortgage. This approach is consistent with the Chapter's treatment of other mortgage substitutes in §§ 3.1–3.3.

Finally, § 3.5 considers the circumstances under which a promise by a debtor not to encumber or transfer real estate will be treated as a mortgage. The section adopts the position of the overwhelming majority of cases that, except in rare circumstances, such promises create neither an equitable lien nor a mortgage on real estate.

§ 3.1 The Mortgagor's Equity of Redemption and Agreements Limiting It

(a) From the time the full obligation secured by a mortgage becomes due and payable until the mortgage is foreclosed, a mortgagor has the right to redeem the real estate from the mortgage under the principles of § 6.4.

(b) Any agreement in or created contemporaneously with a mortgage that impairs the mortgagor's right described in Subsection (a) of this section is ineffective.

(c) An agreement in or created contemporaneously with a mortgage that confers on the mortgagee an interest in mortgagor's real estate does not violate this section unless its effectiveness is expressly dependent on mortgagor default.

Cross-References:

Section 3.2, The Absolute Deed Intended as Security; § 3.3, The Conditional Sale Intended as Security; § 6.1, Right of Mortgagor to Prepay in the Absence of Agreement Prohibiting Prepayment; § 6.2, Enforceability of Prohibitions and Restrictions on Prepayment; § 6.3, Limitation on Enforcement of Prepayment Fees in Connection with Casualty Insurance or Taking in Eminent Domain; § 6.4, Redemption from Mortgage by Performance or Tender; § 7.1, Effect of Mortgage Priority on Foreclosure.

Comment:

a. Historical note. As it developed in the 14th and 15th centuries, the English common-law mortgage evolved into a form of a fee-simple conveyance subject to a condition subsequent. For example, suppose lender loaned $10,000 to borrower to be repaid in three years, the loan to be secured by Blackacre, real estate owned by borrower. The borrower (as grantor) would convey Blackacre to lender and his heirs, but subject to the condition that if on the due date (called the "law day") borrower repaid the $10,000, borrower would have the right to reenter and terminate the lender's estate. Several important consequences flowed from this transaction. The lender obtained legal title to Blackacre, and with it the right to possession and to collect rents and profits. The latter right was especially important because at this stage of English legal history, the collection of any interest on indebtedness was deemed usurious. Access to the rents and profits thus proved to be an expedient economic substitute for interest. The consequences of payment default were especially harsh on the mortgagor. If for any reason the payment was not made on law day, the borrower forfeited all interest in Blackacre. This was virtually an absolute rule, and applied even if the borrower was unable to find the lender to make payment.

Eventually this harsh common-law mortgage yielded to the moderating influences of English Chancery. Tardy mortgagors began seeking redress from Chancery. Initially Chancery authorized the mortgagor to "pay late" or "redeem tardily" only if borrower was able to establish a significant excuse for the default, such as fraud, accident, misrepresentation, or duress. However, by the end of the 17th century, the mortgagor routinely was permitted, as a matter of right, to redeem the land by payment of the mortgage debt, so long as mortgagor tendered the principal and interest (by now the collection of interest was permitted) within a reasonable time after the law day. Specific grounds for equitable relief were no longer required. While the mortgagee did retain the right to take possession until the debt was paid, the mortgagee was required to account for any rents collected by crediting them to the mortgage debt. The foregoing right to "pay late" became known as the mortgagor's equity of redemption or, less frequently, the equity of tardy redemption. Eventually, this concept evolved from simply a late payment rule to connote, in addition, the mortgagor's ownership interest in the land prior to the satisfaction of the mortgage. The term "equity" became and is today the pervasively used term to describe this interest.

Mortgagees found the foregoing developments disturbing. Even though the mortgagor had defaulted, the mortgagee faced the prospect that mortgagor could sue to redeem in equity for an indefinite period. Because the mortgagee and potential purchasers of the mortgaged real estate could not reliably predict what a "reasonable" time for redemption might be, title to that land was frequently clouded and unmarketable. In response, Chancery created the remedy of foreclosure. After mortgagor default, Chancery, at the mortgagee's request, would fix a reasonable redemption period for the mortgagor. If the mortgagor failed to redeem within that period, the redemption right was forever barred and both legal and equitable title to the real estate vested in the mortgagee. This type of foreclosure was and is known as strict foreclosure.

While the foreclosure remedy was designed to aid mortgagees, they nevertheless found the prospect of extinguishing the equity of redemption exclusively through that method a less than satisfactory solution. Consequently, they attempted to craft mortgage language or extrinsic contemporaneous agreements by which mortgagors purported in a variety of ways to waive or limit their equity of redemption rights. An unsympathetic Chancery responded by creating the prohibition on clogging the mortgagor's equity of redemption. Under this rule, no agreement contained in the mortgage, or contemporaneous with it, could cut off a delinquent mortgagor's equity of redemption without resort to foreclosure by the mortgagee. Thus the equity courts refused to enforce attempts by a mortgagee, at the inception of the mortgage transaction, to have the mortgagor waive the right to insist on foreclosure in the event of a default.

The foregoing concepts as developed in English Chancery were adopted in this country relatively intact. American courts readily recognized the mortgagor's equity of redemption and most of its implications. The anti-clogging doctrine has found significant acceptance by American courts. On the other hand, strict foreclosure is routinely used only in two states, Vermont and Connecticut. Most foreclosure in this country is by public sale. Under this method, the real estate is auctioned to the highest bidder and the sale proceeds are applied to the mortgage debt. If the land sells for more than the mortgage debt, the surplus will be paid to mortgagor or others who derive their rights through the mortgagor; see § 7.4. If the sale yields less than the mortgage debt, the mortgagee generally can obtain a judgment for the deficiency against the mortgagor.

Courts sometimes use alternative characterizations of the clogging rule. "Once a mortgage, always a mortgage" is the most common alternative. It is also sometimes stated that "a mortgage cannot be made irredeemable." Whatever the language of the clogging concept, courts traditionally have been hostile to clauses and devices that purport to recognize the equity of redemption, but whose practical effect is to nullify or restrict its operation. This hostility is rooted in a judicial desire to protect "impecunious landowners." Equally important is a judicial inclination to protect the mortgagor against misplaced optimism and overconfidence concerning future ability to satisfy commitments.

b. Rationale. Subsection (a) is derived from centuries of English and American legal refinement and is accepted in every jurisdiction in this country. Until the late 1930s, mortgages typically were not evenly amortized; rather, installments of interest, and perhaps small amounts of principal, were paid over a relatively short time span, and all or substantially all of the principal automatically became due at a specified maturity date. While less common today, such "balloon" mortgages continue to be used in a variety of land financing contexts. Where this is so and the prior installments have been paid promptly, the "full obligation" becomes "due and payable" for purposes of this subsection on the "balloon" date specified in the mortgage.

However, the majority of contemporary mortgages are evenly amortized by regular payments, usually monthly. Moreover, they universally contain acceleration clauses which empower the mortgagee to declare the entire amount of the mortgage obligation due and payable in the event of mortgagor default. Such acceleration may be triggered not only by the mortgagor's failure to pay installments promptly, but also by such defaults as the failure to pay taxes or maintain insurance, the commission of waste, or the violation of a due-on-sale clause. See § 8.1, Accrual of the Right to Foreclose—Acceleration. In this setting the "full obligation" will almost always become "due and payable" upon exercise of the acceleration option by the mortgagee.

Subsection (b), while enjoying somewhat less than universal acceptance, follows as a necessary corollary of Subsection (a). If "clogging" were routinely permitted by agreement of the parties, there is a strong likelihood that foreclosure sales would disappear and debtors would lose the long-recognized right to have their real estate taken only after its value is tested by a public sale. Subsection (c) recognizes that it is appropriate to insulate loan transactions from the clogging rule where the mortgagee acquires an interest in mortgagor's real estate to enhance the return on its investment rather than to provide a remedy for mortgagor default.

Illustrations 1–5 represent classic applications of the anti-clogging concept. The escrow arrangement, as delineated in Illustration 5, is probably the most frequently used device for attempted circumvention of the rule.

Illustrations:

1. The following language is contained in a mortgage on Blackacre: "In the event Mortgagor defaults under this mortgage, Mortgagor waives any right to be foreclosed and agrees that title to the mortgaged real estate shall vest immediately and automatically in Mortgagee." Mortgagor fails to pay the debt promptly and Mortgagee declares a default. Three months later, Mortgagor tenders the full amount of the debt then due and owing. No foreclosure has occurred. The redemption is effective.

2. The following language is contained in a mortgage on Greenacre: "Mortgagor agrees that the right to redeem under this mortgage shall terminate four months after Mortgagee declares a default under this mortgage." Mortgagor goes into default and, six months thereafter, tenders to Mortgagee the full amount due and owing under the mortgage. No foreclosure has occurred. The redemption is effective.

3. The following language is contained in a mortgage on Whiteacre: "In the event of a default under this mortgage, Mortgagor agrees to deliver to Mortgagee an executed quitclaim deed to the mortgaged real estate." A default occurs and Mortgagor refuses to execute and deliver the foregoing deed. Mortgagor's promise is unenforceable.

4. In connection with the execution of a mortgage, Mortgagor delivers to Mortgagee a quitclaim deed to the mortgaged real estate. The parties agree that "in the event of default under the mortgage, Mortgagee shall have the right to record the deed and, upon so doing, Mortgagor's interest in the mortgaged real estate shall terminate immediately." Mortgagor defaults and Mortgagee promptly records the quitclaim deed. A month later, Mortgagor tenders the full amount due and owing on the mortgage debt. No foreclosure has occurred. The redemption is effective.

5. The facts are the same as in Illustration 4 except that the quitclaim deed is delivered to an escrow agent with instructions that "upon Mortgagee informing escrow agent that Mortgagor has defaulted under the mortgage, escrow agent shall record the deed and upon such recording, Mortgagor's interest in the mortgaged real estate shall terminate immediately." Mortgagor defaults and, upon being notified by Mortgagee, the escrow agent records the quitclaim deed. Three months later, Mortgagor tenders the full amount due and owing on the mortgage debt. No foreclosure has occurred. The redemption is effective.

c. Capitalizing interest and the clogging rule. Mortgage transactions increasingly involve the characteristic of capitalizing interest (and thus, of computing interest on interest). While it is occasionally argued that this characteristic runs afoul of the clogging doctrine, no case law supports the proposition that interest on interest is a clog. Nor do such mortgage provisions contradict the policy considerations that support the rule. The interest capitalization feature in such mortgages is increasingly used as a means of easing the mortgagor's monthly payment burden and of making real estate purchases more affordable. Its purpose clearly is not to penalize default or to create obstacles to redemption. These mortgage formats are socially useful and should not be impugned through the clogging doctrine. Moreover, in residential loans, the issue has largely been preempted by Congress in the Alternative Mortgage Transaction Parity Act of 1982, which not only authorizes such mortgage instruments, but also provides that state law yields to federal regulations governing them.

Illustrations:

6. Mortgagor executes a graduated payment mortgage on Blackacre, in which the payment schedule is fixed at the outset so that payments will increase each year, but in the early years are insufficient to cover accruing interest. The unpaid interest is added to the principal. This transaction does not violate this section.

7. Mortgagor executes an adjustable rate mortgage on Whiteacre, in which interest varies with an external index not under the control of Mortgagee and, during some time periods, may exceed the payments made by Mortgagor. This transaction does not violate this section.

8. Mortgagor executes a shared appreciation mortgage on Greenacre, under which Mortgagee charges both fixed interest and contingent interest. The contingent interest is computed as a percentage of the amount of price appreciation of the mortgaged real estate. The contingent interest is not paid until the real estate is sold or transferred by Mortgagor, or until the loan matures at a specified future date. The loan documents provide that, if real estate is not sold by the borrower, the interest thus computed will be added to principal. This transaction does not violate this section.

d. Option to purchase mortgaged real estate as a clog. Courts occasionally use the clogging concept to deny specific performance of an option to purchase the mortgaged real estate granted to a mortgagee incident to a mortgage transaction. Such an option can be viewed as a clog on the equity of redemption because it allows a mortgagee to acquire the real estate by means other than foreclosure. To the extent that the option is enforced it renders the land irredeemable.

An overly dogmatic approach to options granted to mortgagees in loan transactions will unduly discourage the flow of capital to a variety of socially useful projects. The prospect of being able to share in the success of the mortgagor may well induce the mortgagee to consider a variety of techniques that afford it the opportunity to acquire equity ownership in the mortgagor's real estate. For example, corporate mortgagors sometimes grant their mortgage lenders options or warrants to purchase their stock. An inflexible application of the clogging principle could render questionable the enforceability of such warrants because they enable the mortgagee to acquire indirectly an interest in corporate real estate without resort to foreclosure.

While this may represent an extreme application of the clogging concept, it is not difficult to envisage its application in a variety of other contexts where a lender is encouraged to provide capital by the prospect of sharing more directly in the success of the mortgagor. For example, a lender may be induced to provide long-term financing for several of a developer's shopping center projects and to grant interest rate concessions by the prospect of being able to acquire equity interests in one or more of them if they prove successful. Such use of options could be frustrated by the clogging rule even though the lender is motivated to share in the mortgagor's success rather than to avoid foreclosure if the venture fails.

In addition, the implications of an inflexible application of the clogging concept to such options create significant problems for title insurers. Lenders commonly seek endorsements to mortgagee title insurance policies that insure the enforceability of such options. However, title insurers are sometimes reluctant to insure unless the transaction contains an "unwind mechanism," enabling the mortgagor to repurchase the option for an additional fee and thereby to redeem the mortgaged real estate.

Thus it is preferable to reject the rigid position that all mortgagee attempts to enforce such options are invalid. This Restatement validates options and contract rights of acquisition by the mortgagee unless their enforcement is expressly dependent on mortgagor default. This approach continues to recognize that the essence of the equity of redemption is the right of a mortgagor in default to insist on being deprived of the mortgaged real estate only by a foreclosure process that tests its value at a public sale. Of course, it could be argued that Subsection (c) dilutes this right because it permits a mortgagee to exercise the option to avoid foreclosure in any mortgagor default situation where the option language does not expressly tie exercise to default. This result presumably could be avoided by treating any default-related exercise of the option as a clog irrespective of the language of the option. However, adoption of such an approach could also encourage a mortgagor to default intentionally in order to avoid the consequences of the option in any situation where market conditions make its exercise profitable for the mortgagee. To confer such discretion over the effectiveness of the option on the mortgagor might render its enforcement so unpredictable as to jeopardize its usefulness as a mortgage financing incentive.

Even where the option is otherwise enforceable under this section, it may, in rare instances, be desirable to protect residential and small business mortgagors, whether in default or not, from inequitable attempts by mortgagees to profit by acquiring appreciated and improved real estate by means of option exercise. Such mortgagors are apt to be unrepresented by counsel and to be less sophisticated negotiators than their large business counterparts. Consequently, close judicial scrutiny in such situations may be justified. However, rather than take an expansive view of the clogging concept, it is preferable for courts to deal with such situations by use of their inherent discretion to deny equitable relief under harsh and inequitable circumstances.

Illustrations:

9. The following language is contained in a mortgage on Blackacre or in an agreement executed contemporaneously with it: "Mortgagee shall have the option to purchase the mortgaged real estate at any time while this mortgage is effective on the terms and conditions set out herein." Ten years later, while the mortgage is still outstanding and not in default, Mortgagee exercises the foregoing option. Mortgagor refuses to perform and Mortgagee files suit for specific performance of the option. A judicial decree of specific performance is not barred by this section.

10. The facts are the same as Illustration 9, except that Mortgagee exercises the option while Mortgagor is in default and for the purpose of avoiding foreclosure of the mortgage. A judicial decree of specific performance is not barred by this section.

11. The following language is contained in a mortgage on Blackacre or in an agreement executed contemporaneously with it: "In the event that Mortgagor violates any of the terms and conditions of this mortgage, Mortgagee shall have the option to purchase the mortgaged real estate on the terms and conditions hereafter set out." Mortgagor defaults in the payment obligations under the mortgage. Mortgagee then exercises the option to purchase Blackacre. Mortgagor refuses to perform and Mortgagee files suit for specific performance of the option. Specific performance is barred under this section.

e. Contemporaneous conveyance of real estate incident to mortgage transaction not a clog. Occasionally, a mortgagor will not only deliver a mortgage on specific real estate, but will, as further consideration for the loan transaction, make an outright conveyance to mortgagee of some or all of the mortgagor's other real estate. Such conveyances represent the functional equivalent of the payment by mortgagor of "points" or prepaid interest and, as such, should not be called into question under the clogging concept. This type of conveyance does not run afoul of Subsection (b) because it does not impair the mortgagor's right to redeem the real estate described in the mortgage. Further shelter from a clogging attack is afforded by the express language of Subsection (c). One caveat, however, is appropriate. In rare circumstances a court could conclude that the contemporaneous conveyance was, itself, intended as further security and thus susceptible to being treated a mortgage under § 3.2.

Illustration:

12. Mortgagor executes a mortgage on Blackacre to secure the payment of a loan to Mortgagee. As further consideration for the loan, Mortgagor also delivers a deed conveying to Mortgagee fee simple title to Whiteacre. Mortgagor has no right or option to repurchase Whiteacre. Mortgagor will not be able to utilize this section to set aside the conveyance of Whiteacre.

f. Subsequent transactions. The prohibition against clogging the equity of redemption is inapplicable to fully executed transactions occurring after the creation of the mortgage. Consequently, a subsequent sale of the equity of redemption to the mortgagee will not run afoul of the clogging doctrine. The most common example of this sort of transaction is a mortgagor's deed to the mortgagee in lieu of foreclosure. The deed in lieu transaction clearly serves the public interest. It not only avoids the expense and delay of a foreclosure proceeding, but also reduces the pressure on scarce judicial resources. While the deed in lieu does not violate the anticlogging doctrine and is normally to be encouraged, it is closely scrutinized to ensure it is free from fraud or oppression on the part of the mortgagee and is supported by adequate consideration. Moreover, in rare instances it may itself be characterized as a mortgage transaction. See § 3.2. Finally, the deed in lieu can create significant priority problems where the mortgagor previously has created other liens on the real estate. See § 8.5, Comment *b.*

As Illustrations 14 and 15 indicate, subsequent executory agreements are not similarly shielded from the clogging doctrine. The policy supporting the rule against clogging in contemporaneous agreements also has force where a subsequent transaction provides for a future waiver of the mortgagor's redemption rights. The mortgagor can hardly be misled by sanguine overconfidence in his ability to meet future commitments where the sale of his equity of redemption is being fully consummated. However, the "mirage of hope" may well play a dominant role in any subsequent transaction where the mortgagor waives his future redemption and foreclosure rights.

Illustrations:

13. Several months after a mortgage on Blackacre is executed, Mortgagor goes into default. The parties agree that in lieu of Mortgagee foreclosing, Mortgagor will execute and deliver a deed to Blackacre to Mortgagee and the latter will release Mortgagor from the mortgage debt. Both the deed and release are executed and delivered. This transaction does not violate this section.

14. The facts are the same as Illustration 13, except that after Mortgagor defaults, the parties agree that, if the mortgage debt is not paid off within one year, Mortgagor will convey Blackacre to Mortgagee. The year expires without the mortgage debt being satisfied. Mortgagor refuses to deliver to Mortgagee a deed to Blackacre. Mortgagee will be unable to enforce Mortgagor's promise to convey Blackacre.

15. The facts are the same as Illustration 13, except that after Mortgagor's initial default under the mortgage, Mortgagor delivers to Mortgagee a quitclaim deed to Blackacre with the agreement that, if the mortgage is paid off within one year, the deed will be returned to Mortgagor, but if the debt is not satisfied within that period, the deed will be recorded. The year expires without Mortgagor satisfying the mortgage debt and Mortgagee records the deed to Blackacre. Three months thereafter, Mortgagor tenders the full amount of the mortgage debt to Mortgagee. The redemption is effective.

g. Concepts related to the clogging doctrine. The clogging rule has sometimes also been identified with the "collateral advantage" and "fettering" concepts. Under the first concept it is sometimes said that a person "shall not have interest for his money and a collateral advantage besides for the loan of it, or clog the redemption with any by-agreement." The latter concept has been described by English authority as meaning "that the mortgagee shall not make any stipulation which will prevent a mortgagor, who has paid principal, interest, and cost, from getting back his mortgaged property in the condition in which he parted with it."

Both the shared appreciation mortgage and mortgage provisions conferring options on the mortgagee to purchase some or all of the mortgaged real estate arguably could be viewed as running afoul of the collateral advantage concept. However, while these two concepts have been recognized in English law, they are not part of American law, are not adopted by this Restatement, and should not be permitted to pose obstacles to socially useful financing transactions.

REPORTERS' NOTE

The rule regarding the mortgagor's right to redeem prior to a valid foreclosure and the doctrine against clogging the mortgagor's equity of redemption are well supported by modern case law. 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.1 (3d ed. 1993). While protection from the clogging doctrine for contemporaneous options and a variety of other modern mortgage financing transactions is rarely discussed in the cases, it is well supported and encouraged as a solution to modern financing problems by many commentators. Licht, The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance, 60 St. John's L. Rev. 452 (1986); Preble & Cartwright, Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption, 20 Real Prop. Prob. & Tr. J. 821 (1985); Kane, Convertible Mortgages Serve as Financing Tools, 193 N.Y.L.J. 21 (March 13, 1985).

Historical note, Comment a. For theories on the development of the equity of redemption and the clogging doctrine, see generally Licht, The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance, 60 St. John's L. Rev. 452 (1986); Williams, Clogging the Equity of Redemption, 40 W. Va. L.Q. 31, 33 (1933); L. Jones, Mortgages §§ 7–9 (8th ed. 1928); Falconbridge, Legal Mortgages in Equity, 54 Can. L.J. N.S. 1 (1918); Coutts, Once a Mortgage Always a Mortgage—Stipulations in the Mortgage, 50 Cent. L.J. 464 (1900). For further consideration of the clogging doctrine or other aspects of it, see Preble and Cartwright, Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption, 20 Real Prop. Prob. & Tr. J. (1985); Fratcher, Restraints upon Alienation of Equitable Interests in Michigan Property, 51 Mich. L. Rev. 509, 542 (1953); Coughlin, Clogging the Redemption Rights in Illinois, 3 J. Marshall L.Q. 11 (1937); Wyman, The Clog on the Equity of Redemption, 21 Harv. L. Rev. 459 (1908).

For consideration of alternative characterizations of the clogging concept, see, e.g., G. Nelson & D. Whitman, Real Estate Finance Law § 3.1 at 30–32 (2nd ed. 1985); 3 Pomeroy, Equity Jurisprudence § 1193 at 2825 (4th ed. 1918); Licht, The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance, 60 St. John's L. Rev. 452 (1986); Preble & Cartwright, Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption, 20 Real Prop. Prob. & Tr. J. 821 (1985); Note, 20 Mich. L. Rev. 646, 647 (1922).

Rationale, Comment b. As Illustrations 1–5 suggest, mortgagees have used a variety of clauses and arrangements in an attempt to bypass a mortgagor's equity of redemption. However, courts have long been vigilant in invalidating them. See 1 G. Nelson & D. Whitman, Real Estate Finance Law 33–34 (3d ed. 1993).

Coursey v. Fairchild, 436 P.2d 35, 38 (Okla.1967): A 25-year deed to minerals given to mortgagee as additional consideration for extension of an existing mortgage was canceled upon mortgagor's payment in full of the debt and all interest due. The court stated that a right to redeem means "that upon discharge of the debt ... the mortgagor is entitled ... to have the mortgaged premises relieved from the lien and his entire estate restored to that extent which he would have had if the mortgage transaction had never taken place."

In Kawauchi v. Tabata, 413 P.2d 221 (Haw.1966), the court stated that a mortgagor has the right to redeem and may not renounce beforehand his privilege of redemption.

In Peugh v. Davis, 96 U.S. 332, 337 (1877), the Court stated that a mortgagor's right to redeem his property "cannot be waived or abandoned by any stipulation of the parties made at the time, even if embodied in the mortgage."

For examples of mortgagees' unsuccessful attempts to limit a mortgagor's time period for exercising his equity of redemption rights, see Frazer v. Couthy Land Co., 149 A. 428 (Del.Ch.1929) (three years); Bradbury v. Davenport, 46 P. 1062 (Cal.1896) (four months); Heirs of Stover v. Heirs of Bounds, 1 Ohio St. 107 (1853) (before a fixed date).

Support for Illustration 3 can be found in First Illinois National Bank v. Hans, 493 N.E.2d 1171 (Ill.Ct.App. 1986) ("[T]he stipulation ... obligating defendants upon default to execute a quitclaim deed of their interest ... effectively operates to destroy or cut off defendants' redemptive rights. In view of [prior case law] which establish[es] a *per se* rule that such terms are invalid, we find this provision ... to be null and void even though the evidence indicates that [it] was drafted by defendants' former attorney.")

Illustration 4 exemplifies a transaction where the attempted waiver of the equity of redemption takes the form of a quitclaim deed to the mortgaged premises delivered to the mortgagee contemporaneously with the mortgage. See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.1 (3d ed. 1993).

Oakland Hills Development Corp. v. Lueders Drainage District, 537 N.W.2d 258 (Mich.Ct.App.1995): Mortgage language provided that upon mortgagor default a deed to the mortgaged property was to be released to the mortgagee and that the latter would receive title without resort to foreclosure. The Michigan Court of Appeals held that this waiver of the right of redemption violated the clogging doctrine and was invalid.

Basile v. Erhal Holding Corp., 538 N.Y.S.2d 831 (N.Y.App.Div.1989): As part of a stipulation of settlement of litigation, mortgagor executed a mortgage and a "deed in lieu of foreclosure." The stipulation included the following language: "the mortgagor ... has simultaneously executed a deed in lieu of foreclosure which may be recorded by the mortgagee for any default herein." The court held that the deed "constituted ... the attempted waiver of the [mortgagor's] right of redemption in the property," and it was therefore "ineffective."

Kartheiser v. Hawkins, 645 P.2d 967 (Nev.1982): In a quiet title action by mortgagor's creditor who obtained a sheriff's deed to mortgagor's property, two quitclaim deeds given by mortgagor to mortgagee contemporaneously with the delivery of deeds of trust on the property involved were held to be only additional security for mortgagee's interest in the property. Judgment of quiet title was granted to the holder of the sheriff's deed subject to the deeds of trust.

Illustration 5 is similar to Illustration 4 except that the deed is placed in escrow at the time of the mortgage transaction rather than delivered to the mortgagee. As in the foregoing situation, the deed represents an ineffective attempt by the mortgagor to waive redemption rights.

In Marple v. Wyoming Prod. Credit Ass'n, 750 P.2d 1315 (Wyo.1988), the court held that a seller of property could not terminate the rights of redemption of a buyer, nor the security interests of holders of recorded junior liens, by recording a quitclaim deed which was held in escrow for seller to be reconveyed upon default of the buyer.

Pollak v. Millsap, 122 So. 16 (Ala. 1928), held plaintiff's right to redeem his land could not be abridged by a contemporaneous agreement by which plaintiff deposited in escrow a deed to be delivered to defendant's successor in interest in case of failure by plaintiff to repay a loan at maturity. Plaintiff had tendered the amount of the note to the escrow agent one day after maturity, but it was refused.

Plummer v. Ilse, 82 P. 1009 (Wash. 1905), held that a deed which was executed and placed in escrow in conjunction with a loan transaction, with instructions that, if plaintiff defaulted on the note, the deed would be delivered to defendant in full payment and satisfaction of the debt, created a mortgage. Regardless of the intention of the parties, the equity of redemption could not be waived by stipulation between the parties in the original transaction.

Questions have also been raised as to whether the clogging doctrine invalidates the commonly used due-on-sale clause. A due-on-sale clause affords a mortgagee the option of accelerating and foreclosing the mortgage debt if the mortgagor transfers an interest in the mortgaged real estate without the mortgagee's consent. Due-on-sale clauses are generally validated by § 341, Garn–St. Germain Depository Institutions Act of 1982, which preempts any conflicting state law. Hence, there is little room for operation of the clogging doctrine. One earlier commentator had suggested that such a clause violates the clogging rule because it makes transfer more difficult and thus impairs the equity of redemption. See Comment, Due-on-Sale Clauses and Clogging the Equity of Redemption, 36 Wash. Lee L. Rev. 1121 (1979). However, this argument fails because a due-on-sale clause does not require the mortgagor to waive the right to be foreclosed, which is the main concern of the clogging doctrine and this section.

Another argument that a due-on-sale clause creates a clog on the equity of redemption is presented in Lincoln Mortgage Investors v. Cook, 659 P.2d 925 (Okla.1982). The mortgagor argued that Coursey v. Fairchild, 436 P.2d 35 (Okla.1967) (summarized above) granted a mortgagor the right to make installment payments even after default. Since a due-on-sale clause prevents a mortgagor from making installment payments over the life of the loan, it arguably clogs the equity of redemption. The Oklahoma Supreme Court correctly rejected this argument and held that due-on-sale clauses do not clog the equity of redemption. If the mortgagor's argument were accepted, any acceleration clause which allowed the mortgagee to render the entire mortgage debt due and payable upon mortgagor default would be subject to possible invalidation. This would be so even though such clauses do not contain a waiver by the mortgagor of the right to be foreclosed. Moreover, the holding in this case is consistent with the historical context in which the clogging rule arose. Specifically, common-law mortgages required full payment of the debt on law day and rarely, if ever, provided for installment payments. Acceleration clauses, of which the due-on-sale clause is merely a specific form, are valid. See § 8.1. For further consideration of due-on-sale clauses and the clogging rule, see 1 G. Nelson & D. Whitman § 3.1 (3d ed. 1993); Preble & Cartwright, supra, 20 Real Prop. Prob. & Tr. J. 821, 860–866 (1985).

Capitalizing interest and the clogging rule, Comment c. For a general consideration of graduated payment mortgages, adjustable rate mortgages and shared appreciation mortgages, see 2 G. Nelson & D. Whitman, Real Estate Finance Law § 11.4. (3d ed. 1993). For specific discussion of the effect of the clogging doctrine on these mortgage financing arrangements, see Comment, The Shared Appreciation Mortgage: A Clog on the Equity of Redemption?, 15 J. Marshall L. Rev. 131 (1982).

The Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3801 et seq., took effect on October 15, 1982. It authorizes "all housing creditors to make, purchase, and enforce alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by Federal agencies."

Option to purchase mortgaged real estate as a clog, Comment d. An option granted by mortgagor to mortgagee contemporaneously with the mortgage transaction has sometimes been viewed as a clog on the equity of redemption. This is true even in situations where the transaction is otherwise fair and reasonable. Samuel v. Jarrah Timber, A.C. 323 (1904). However, with changes in the real estate market and the advent of more innovative real estate financing formats, many commentators have questioned the application of the anti-clogging rule to option provisions in mortgage transactions, especially where close judicial scrutiny reveals that all other elements of the transaction, including the agreement and the surrounding circumstances, are fair and equitable. 1 G. Nelson & D. Whitman, Real Estate Finance § 3.2 (3d ed. 1993); Cooper-Hill & Slama, The Convertible Mortgage: Can it be Separated from the Clogging Rule?, 27 S. Tex. L. Rev 407 (1986). Licht, The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance, 60 St. John's L. Rev. 452 (1986); Preble & Cartwright, Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption, 20 Real Prop., Prob. & Tr. J. 821 (1985); Kane, Convertible Mortgages Serve as Financing Tools, 193 N.Y.L.J. 21 (March 13, 1985).

Cases treating the option to purchase as a clog on the equity of redemption. In Humble Oil & Refining Co. v. Doerr, 303 A.2d 898 (Del.Ch.Super.1973), the court invalidated an option taken by Humble Oil to purchase an independent service station at any time for a fixed price. The option, taken as part of an extension of credit to the service station owners, was held to be void and unenforceable as against public policy. The court stated that an option which is part of an original loan transaction is absolutely void regardless of whether there was actual oppression.

In Lewis v. Frank Love, 1 All E.R. 446, 454 (1961), the parties to a mortgage recognized the clogging problem and attempted to eliminate it by executing the mortgage note and the option in separate documents. In exchange for the option the mortgagee also extended any payment of principal for two years. Notwithstanding these precautions, the court found the option constituted a clog because if exercised it would prevent the mortgagor from redeeming the land.

In Barr v. Granahan, 38 N.W.2d 705 (Wis.1949), in connection with a loan transaction for $8,500, mortgagor gave mortgagee an option to purchase mortgagor's property for $8,000. Exercise of the option was not tied to default. After significant payments and improvements were made by the mortgagor, mortgagee sought specific performance to exercise the option. Relying both on the anti-clogging doctrine and its own discretion to deny equitable relief under harsh and inequitable circumstances, the court denied specific performance.

Hopping v. Baldridge, 266 P. 469 (Okla.1928), held that upon payment of the entire mortgage debt a mortgagor is entitled to a full release of the property, including release from an option to purchase executed at the same time as the mortgage.

In Samuel v. Jarrah Timber, A.C. 323 (1904), an option to purchase property for a fixed sum taken by a mortgagee as part of the original mortgage transaction was held void as a clog on the equity of redemption regardless of fairness.

Cases holding that the option to purchase is not a clog on the equity of redemption. MacArthur v. North Palm Beach Utilities, Inc., 202 So.2d 181 (Fla.1967), held that the clogging doctrine was inapplicable where a seller-mortgagee who sold a large tract of land for subdivision and financed a water and sewage system for the subdivision, kept an option to purchase the system for construction cost. The court noted that the option was part of a complex business transaction between sophisticated parties, both of whom were represented by counsel. The option was held to be part of the sales transaction, not part of the mortgage transaction; therefore, it was sustained.

Cunningham v. Esso Std. Oil Co., 118 A.2d 611 (Del. Ch. 1955), involved facts similar to those in *Humble* above, but the court granted specific performance of the option to purchase. However, the clogging issue was not presented to or addressed by the court.

In Blackwell Ford, Inc. v. Calhoun, 555 N.W.2d 856 (Mich.Ct.App.1996), the Calhouns gave Blackwell, a sublessee on real estate owned by Blackwell, an option to purchase that real estate for $1,650,000. Blackwell paid $175,000 for the option but the parties agreed that, if the option was exercised and the Calhouns were unable to deliver marketable title, the Calhouns were obligated to return the option price. As security for the promise to return the option price, the Calhouns gave Blackwell a mortgage on the real estate. When Blackwell sought to exercise the option, the Calhouns refused to comply and offered to return the option price to Blackwell. When Blackwell sued for specific performance of the option agreement, the Calhouns asserted that the anti-clogging doctrine prohibited specific performance. The trial court agreed with the Calhouns and Blackwell appealed. The Michigan Court of Appeals reversed and held that the option was not a clog on the equity of redemption:

> [We] do not here have a case of a mortgage agreement with a lurking option to purchase, whereby the

mortgagee may swoop in and exercise the option following the commencement of foreclosure proceedings. If [Blackwell] exercises the option to purchase and [the Calhouns] are unable to deliver title, a financial obligation, secured by the mortgage, comes into being. On this mortgage [Blackwell] could foreclose, but plaintiff would be unable to then exercise the option, because the option was, necessarily, already exercised.

That being said, we would caution that this holding in no way diminishes Michigan's policy against clogging the equity of redemption....

Additionally, we would note that we are not troubled by the equities of this particular case. The doctrine against clogging is designed to protect the necessitous mortgagor from sacrificing his right of redemption as an incident of obtaining a loan.... Here, there was no loan; there was an option to purchase. This doctrine is not meant to protect landowners who, after selling an option to purchase their property, "elect" not to be bound by the option because of changing market conditions.

The Uniform Land Security Interest Act (ULSIA) reflects the approach expressed in this section because it appears to allow mortgagees to use the option as an alternative default remedy as long as the express language of the option is not tied to default. ULSIA § 211 (1983). In addition, some states have adopted legislation limiting the impact of the clogging rule in the option-mortgage context. New York legislation provides that an option to acquire an equity or other ownership interest in property granted to a mortgagee simultaneously, or in connection, with a mortgage is not unenforceable if the "power to exercise such option or right is not dependent upon the occurrence of a default" in the mortgage transaction. N.Y. Gen. Obligations Law § 5-334 (McKinney 1985). However, the applicability of this New York statute is limited to mortgages securing an indebtedness of $2,500,000 or more. California has similar legislation, but rather than using a monetary limitation, it applies only to property other than residential real property containing four or fewer units. Cal. Civil Code § 2906.

For cases illustrating the ability of courts to use their inherent discretion to invalidate options under harsh and inequitable circumstances, see Star Enterprise v. Thomas, 783 F.Supp. 1564 (D.R.I.1992) (enforcement of option against service station mortgagor deemed "manifestly unfair and inequitable"); Barr v. Granahan, 38 N.W.2d 705 (Wis.1949) (mortgagee's option to purchase mortgagor's tavern property held unenforceable as harsh and inequitable; alternative holding).

Subsequent transactions, Comment f. For further consideration of the "subsequent transaction" exception to the clogging rule, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.3 (3d ed. 1993); G. Osborne, Mortgages § 100 (1951); Coutts, Once a Mortgage Always a Mortgage—Stipulations in the Mortgage, 50 Cent. L.J. 464 (1900). Other aspects of subsequent transactions are considered in § 8.5, Comment *b*.

The cases are sharply divided on whether subsequent executory agreements violate the anti-clogging doctrine. For decisions treating such executory agreements as ineffective, see Cohn v. Bridgeport Plumbing Supply

Co., 115 A. 328 (Conn.1921) (mortgagor held entitled to redeem his property notwithstanding an executory contract made subsequent to the mortgage whereby mortgagor agreed to release his equity of redemption if the mortgage debt was not paid by a specified date); Holden Land & Live Stock Co. v. Interstate Trading Co., 123 P. 733 (Kan.1912), appeal dismissed, 233 U.S. 536 (1914) (deposit of a quitclaim deed in escrow, pursuant to an agreement subsequent to the mortgage, to be delivered to mortgagee if mortgagor fails to pay the debt by certain date, is ineffective); Batty v. Snook, 5 Mich. 231 (1858) (an executory agreement creating a forfeiture of defendant's equity of redemption upon failure to pay debt by specific date held void); Russo v. Wolbers, 323 N.W.2d 385 (Mich. Ct.App.1982) (a vendee's waiver of his statutory right of redemption is valid when given as consideration for vendor's postponement of any further foreclosure action).

For cases holding that such agreements are valid, see Bradbury v. Davenport, 52 P. 301 (Cal.1898) (deposit of deed in escrow, pursuant to an agreement subsequent to mortgage, to be delivered if mortgagor failed to pay the debt on a renegotiated due date, is effective and not a clog); Ringling Joint Venture II v. Huntington National Bank, 595 So.2d 180 (Fla.Dist.Ct.App.1992) (subsequent transaction involving placing warranty deed in escrow held not a clog; however, the court stressed that the "agreements used in this case could easily result in abuse or inequity in another case under other facts. Such arrangements should be carefully scrutinized to assure that they do not violate the favored right of redemption.").

In addition, two recent decisions uphold post-default executory transactions. See Guam Hakubotan, Inc. v. Furusawa Investment Corp., 947 F.2d 398 (9th Cir.1991), cert. denied, 504 U.S. 930 (1992); Wensel v. Flatte, 764 S.W.2d 627 (Ark.Ct.App.1989). Each of the latter cases involved a post-default extension agreement under which the mortgagor delivered a deed to the mortgagee with the understanding that it was to be recorded if the mortgagor failed to satisfy the terms of the extension. Each mortgagor asserted that the deed delivered to the mortgagee should be characterized as an equitable mortgage under the principles enunciated in §§ 3.2 and 3.3 of this Restatement. In each case the court concluded that there was insufficient evidence that a mortgage transaction was intended. In *Wensel*, the argument that the subsequent executory transaction violated the clogging principle was neither advanced by the mortgagor nor considered by the court. In *Guam Hakubotan* there is some language to suggest that the clogging principle was argued, but the court did not confront the issue directly. Instead, it seemed to deal with the issue largely in the context of whether the parties intended a mortgage transaction.

The subsequent executory agreement represents a close question under the clogging principle. Arguably not only should one be able to contract to sell what could be disposed of at once, the deed in escrow and related post-default executory agreements are often a crucial part of work-out transactions and the latter are to be encouraged over foreclosure or bankruptcy. On the other hand, significant policy concerns support the position taken by this section:

The serious concerns that support the application of the anti-clogging principle at the time of the original mortgage transaction are equally compelling in the subsequent executory setting. These concerns are: (1) the necessity of the mortgagor; and (2) an optimistic overconfidence in his or her capacity to surmount future difficulties. The two combine to lead to over-sanguine commitments. Both are present at the time the mortgage is entered into originally. However, when the transaction is subsequent to the mortgage and is consummated immediately, neither exerts any influence.

All hope is lost. The mortgagor has simply given up. However, if it is a subsequent agreement for *future* forfeiture, the "mirage of hope" is sufficiently strong to bring it under the general ban against forfeitures due to "misreliance upon airy hope." In the latter setting "hope springs eternal." Finally, if anything, the mortgagor is in a weaker bargaining position in the work-out setting than at the time of the original loan transaction. In the latter situation, after all, a mortgagor who does not like the terms being proposed by the mortgagee presumably can shop elsewhere for a different lender. On the other hand, in most work-out contexts, the mortgagor clearly cannot choose a different lender and, consequently, is in a weaker position concerning terms being demanded by the mortgagee.

1 G. Nelson & D. Whitman, Real Estate Finance Law 43 (3d ed. 1993).

Concepts related to the clogging doctrine, Comment g. See, e.g., 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.1 (3d ed. 1985); G. Osborne, Mortgages §§ 98–99 (1951).

§ 3.2 The Absolute Deed Intended as Security

(a) Parol evidence is admissible to establish that a deed purporting to be an absolute conveyance of real estate was intended to serve as security for an obligation, and should therefore be deemed a mortgage. The obligation may have been created prior to or contemporaneous with the conveyance and need not be the personal liability of any person.

(b) Intent that the deed serve as security must be proved by clear and convincing evidence. Such intent may be inferred from the totality of the circumstances, including the following factors:

(1) statements of the parties;

(2) the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance;

(3) the fact that the grantor retained possession of the real estate;

(4) the fact that the grantor continued to pay real estate taxes;

(5) the fact that grantor made post-conveyance improvements to the real estate; and

(6) the nature of the parties and their relationship prior to and after the conveyance.

(c) Where, in addition to the deed referred to in Subsection (a) of this section, a separate writing exists indicating that the deed was intended to serve as security for an obligation, parol evidence is admissible to establish that the writings constitute a single security transaction.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 3.3, The Conditional Sale Intended as Security; § 6.4, Redemption from Mortgage by Performance or Tender.

Comment:

a. Introductory note. Many lenders view mortgage law generally as "pro-mortgagor." This perception derives from modern judicial interpretation of the mortgagor's "equity of redemption" and the prohibition on "clogging" that equity. In addition, statutes often reinforce mortgagor rights by limiting the mortgagee's pre-foreclosure right to accelerate the mortgage debt and by establishing statutory periods for post-foreclosure redemption. In many states foreclosure by judicial action is the sole foreclosure method, and is frequently time-consuming and costly. See § 7.1, Comment *a.*

Because of these and certain other considerations, lenders sometimes use land-financing substitutes in the hope of avoiding these restrictions. However, courts frequently counter these attempts by characterizing such devices as "equitable mortgages." The absolute deed and its variants commonly evoke this judicial response. Under this approach, lenders utilize as a security device an absolute deed from the borrower to the lender containing no defeasance language. The deed is often accompanied by an agreement, oral or in writing, by the lender-grantee to reconvey to the borrower-grantor if the debt is paid according to its terms. The impetus for using an absolute deed transaction may on rare occasions come from the borrower-grantor rather than the lender. For example, the borrower-grantor may look upon such a transaction as an effective method of concealing his or her real estate ownership from other creditors. Consequently, a recorded absolute deed may satisfy the lender's requirement for security while creating the false impression that the lender rather than the borrower is the actual owner of the mortgaged real estate.

However, the format of most loan transactions is dictated by the lender. Consequently, just as an explicit attempt by a mortgagor to waive the equity of redemption will be treated as an unenforceable "clog" on that equity, so too will a covert scheme for accomplishing the same purpose. Parol evidence is therefore admissible to establish that an absolute deed was intended as security.

Note that the issue is not whether the parties intended to create a mortgage; if that had been their intent, they would presumably have used an explicit mortgage. Rather, the question is whether they intended for the deed to serve as security for some obligation; if they did, the courts will convert the transaction into a mortgage by operation of law.

b. Burden of proof. Although a few jurisdictions suggest that a deed may be shown to be a mortgage by a mere preponderance of the evidence, the overwhelming majority apply a "clear and convincing" standard. This heavier burden of proof is warranted. Public policy favors the stability of written real estate transactions and the discouragement of false swearing by a grantor, who may simply regret having sold the real estate and may seek to avoid the consequences of the sale by attempting to recast it as a mortgage transaction. Moreover, the "clear and convincing" standard may discourage borrowers who wish to conceal their ownership of real estate from creditors by putting title in the lender's name.

c. Parol evidence rule. The parol evidence rule normally bars extrinsic evidence that would vary the terms of a written instrument executed with the intention that it be the complete expression or embodiment of the parties' agreement. The rule is usually deemed inapplicable in the present context on the theory that the absolute deed was not intended to embody the complete agreement of the parties. Thus the oral agreement merely supplements the deed concerning a matter with which the latter did not purport to deal. Alternatively, the frequency of absolute deed transactions and concern for protection of the borrower's redemption right may simply lead courts implicitly to recognize the use of extrinsic evidence as a substantive exception to the parol evidence rule. The "clear and convincing evidence" requirement may allay concern over the use of parol evidence.

d. Statute of Frauds. The Statute of Frauds requires that the creation and transfer of interests in land be in writing. It therefore could be argued that the Statute is violated when a grantor seeks to establish by extrinsic evidence an agreement by the grantee to reconvey to the grantor. Various justifications have been used to avoid the Statute. Courts frequently stress protection of the grantor against fraud and unjust enrichment. Sometimes courts articulate a concern for the redemption interest as a basis for avoidance of the Statute. The best explanation for the Statute's inapplicability is simply that it is not violated by a judicial determination that an absolute deed is a mortgage. Such a finding does not create in or transfer to the grantor an interest in land; rather, the parol evidence simply establishes that the grantor never parted with ownership in the land. On its face, the Statute of Frauds merely requires a writing; it does not preclude oral testimony to explain or supplement the writing.

e. Factors evidencing intent of the parties. As the following Illustrations indicate, no single factor is controlling in determining whether an absolute deed disguises a mortgage transaction. Sometimes, as indicated by Illustrations 1 and 2, the grantor may actually have delivered a promissory note to the grantee. Where this is the case, there is exceptionally strong evidence that security was intended. As these Illustrations also establish, the indebtedness may have been created either prior to or contemporaneously with the conveyance. However, as Illustrations 3 and 5 indicate, it is unnecessary to establish either the existence of a promissory note or similar written evidence of the debt or that the grantor is personally liable to repay it. Rather a court may impute the existence of the debt where the totality of the facts indicate that a security transaction was intended.

A substantial disparity between the value received by the grantor and the fair market value of the land at the time of the conveyance is strong evidence that security was intended, as in Illustrations 3 and 5. Normally rational people, other than in gift transactions, do not transfer land without receiving a purchase price that approximates its fair market value. On the other hand, as in Illustration 4, if the disparity between the amount advanced and the fair market value of the land is relatively small, it indicates a sale and not a mortgage transaction.

Other factors can also be significant indicators of intent. Retention of possession by the grantor is usually evidence that the conveyance is a mortgage unless, for example, the grantee is able to establish that grantee thereafter became grantor's lessor. On the other hand, a lease does not necessarily negate mortgage treatment. A grantor's continuing to pay the real estate taxes is indicative of a mortgage and not a sale. However, if the grantee can show that the grantor and grantee had a landlord-tenant relationship, the payment of real estate taxes may be of less importance because, under lease arrangements, it is not uncommon for the lessee to pay the real estate taxes. So, too, as in Illustration 5, in the absence of a concurrent long-term lease, parties do not normally make substantial improvements to land in which they do not have a beneficial interest. Consequently, such improvements would be significant evidence that the conveyance was intended as security. Finally, grantee's occupation can also be important. For example, if the grantee is in the business of making mortgage loans, this fact would point to a mortgage rather than a sale transaction.

Illustrations:

1. Grantor conveys Blackacre to grantee by a deed that contains no language of defeasance. At the same time Grantor receives $25,000 from Grantee and delivers a promissory note payable to Grantee. Grantor retains possession of Blackacre. Grantor's delivery of the promissory note to Grantee together with Grantor's retention of possession justifies the conclusion that the parties intended a security transaction.

2. The facts are the same as Illustration 1, except that Grantor delivers the promissory note to Grantee a year before executing and delivering the deed. The fair market value of Blackacre at the time of the conveyance is $50,000. Even though the note is not delivered contemporaneously with the deed, the facts justify the conclusion that the parties intended a security transaction.

3. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $25,000 in cash, but Grantor does not deliver a promissory note to grantee. Grantor testifies that Grantee promised orally to reconvey Blackacre to grantor upon the latter's payment of $35,000 to Grantee two years thereafter. Grantee denies making such an oral promise and contends that the transaction constitutes a sale of Blackacre to Grantee. Grantor has retained possession and has continued to pay real estate taxes on Blackacre. At the time of the conveyance the fair market value of Blackacre was $50,000. The facts justify the conclusion that the parties intended a security transaction.

4. The facts are the same as Illustration 3, except that Grantee takes possession of Blackacre and its fair market value at the time of the conveyance is in the range of $25,000 to $30,000. The facts justify the conclusion that the parties intended a sale transaction rather than security.

5. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $25,000 in cash, but Grantor does not deliver a promissory note to Grantee. Grantor retains possession, pays the real estato taxes

and builds a garage on the premises. The fair market value of Blackacre at the time of the conveyance is $50,000. Grantor dies a year after the conveyance and, other than Grantee, no one else can testify as to what was said at the time the deed was delivered. Grantee testifies that the parties intended an absolute sale of Blackacre. Nevertheless, the facts justify the conclusion that the parties intended a security transaction.

f. Absolute deed with collateral written evidence of security intent. Illustrations 6 and 7 show that parol evidence can be used to establish that the two writings (an absolute deed and a separate document showing that the deed was intended to serve as security for an obligation) really constituted one transaction. The parol evidence rule does not bar its admission because the evidence does not contradict or vary the writings, but rather establishes that the documents were part of a single mortgage transaction. Indeed, since courts accept extrinsic non-written evidence to establish that an absolute deed is a mortgage, it follows *a fortiori* that written evidence should be admissible for such a purpose.

As Illustration 7 indicates, the two writings need not be executed simultaneously. The fact that the written agreement of defeasance is executed after the absolute deed does not bar mortgage treatment so long as the parties actually agreed to the defeasance at the time the grantor delivered the deed.

Illustrations:

6. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance and receives $25,000 from Grantee. At the same time, in a letter to Grantor, Grantee acknowledges that "if you pay off the $25,000 debt with 10 percent interest by the end of next year, I will reconvey the land to you." The facts justify the conclusion that the two writings were part of the same agreement and that the parties intended a security transaction.

7. The facts are the same as Illustration 6, except that Grantee delivers the letter to Grantor six months after the conveyance. The facts justify the conclusion that the two writings were part of the same agreement and that the parties intended a security transaction.

g. Rights of bona fide purchasers from grantee. A grantor's right to redeem the land from an absolute deed that was intended as security can be defeated by a bona fide purchaser from the grantee.

Thus, a purchaser from the grantee who pays value and takes without either actual or constructive notice that the land has been conveyed as security will take free of any equity in the grantor to redeem. This result rests either upon state recording acts or the maxim that a bona fide purchaser of legal title terminates equitable rights. However, even where a bona fide purchase deprives the grantor of access to the land itself, the grantor may recover from the grantee the difference between the value of the land and the amount of the obligation.

REPORTERS' NOTE

Introductory note, Comment a. This section is consistent with the rule against clogging a mortgagor's equity of redemption. See § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It. It deals with attempts by lenders to circumvent mortgage law, specifically the pro-mortgagor protections incident to the equity of redemption, the right to a valid foreclosure and statutory redemption, by disguising the mortgage transaction in the form of an absolute deed with a contemporaneous side agreement. This section represents the majority view that the intent of the parties, and not the form of the transaction, controls.

Smith v. Player, 601 So.2d 946 (Ala. 1992) ("a deed of conveyance of land absolute and unconditional on its face, but intended and understood by the parties to be merely a security for the payment of a debt, will be treated in equity as a mortgage.").

Davis v. Davis, 890 S.W.2d 280 (Ark.Ct.App.1995) (Although "the law presumes that a deed absolute on its face is what it appears to be, * * * any evidence, written or oral, tending to show the real nature of the transaction is admissible.").

Boyarsky v. Froccaro, 479 N.Y.S.2d 606 (N.Y.Sup.Ct.1984) ("As a general rule, the form of the transaction is not conclusive and any agreement in writing made by the owner of the land, upon a valid consideration, by which an intention is clearly shown that the land shall be security for an obligation, creates an equitable mortgage upon the land." It is the substance rather than the form of a transaction which controls, and the basic issue is one of intent.).

Brenneman Mechanical & Electrical, Inc. v. First National Bank Of Logansport, 495 N.E.2d 233 (Ind.Ct. App.1986) (Whether an absolute deed is in fact a mortgage is determined by the intent of the parties rather than by the form or name of the instrument.).

Markell v. Hilpert, 192 So. 392 (Fla.1939) (In a suit to have a conveyance by absolute deed declared a mortgage, a court looks at substance rather than form, makes inquiry and hears evidence beyond the terms of the instrument to the very heart of the transaction so as to determine the intent of the parties, and all admissible evidence bearing upon the issue is received by the court, whether written or oral.).

Several states have enacted legislation dealing with this unique problem. See Statutory Note to this section. For further background on the use of absolute deeds as mortgages, see 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 3.5, 3.9 (3d ed. 1993);

Cunningham & Tischler, Disguised Real Estate Security Transactions As Mortgages In Substance, 26 Rutgers L. Rev. 1, 1–4, 13 (1972).

As an alternative to treating absolute deed transactions as mortgages, courts occasionally set them aside on unconscionability grounds. See, e.g., Ryan v. Weiner, 610 A.2d 1377 (Del. Ch. Ct. 1992) ("sale" of equity by grantor for approximately 15% of fair market value set aside as "shockingly unconscionable"); Howard v. Diolosa, 574 A.2d 995 (N.J. Super. Ct. 1990) (sale transaction in which grantors, who owed past-due real estate taxes and were being pressed by other creditors, deeded their home to grantee for less than ⅓ of its fair market value in exchange for a five-year lease deemed unconscionable and unenforceable).

Burden of proof, Comment b. Because of the high potential for undermining legitimate land transfers by claims that "we intended it as security," the overwhelming majority of jurisdictions hold the challenger to a stringent standard of proof. In most cases, courts require clear, satisfactory, and convincing evidence, although there are a few notable exceptions.

Davis v. Davis, 890 S.W.2d 280 (Ark.Ct.App.1995) ("In order to establish that a deed absolute on its face is in fact a mortgage, the evidence must be clear, unequivocal and convincing.").

Beelman v. Beelman, 460 N.E.2d 55 (Ill. App. Ct. 1984) (Evidence "must provide clear, satisfactory and convincing proof that the deed absolute in form was intended as a mortgage.").

Stava v. Stava, 383 N.W.2d 765 (Neb.1986) (The party asserting that an absolute conveyance of real estate is in fact a mortgage has the burden of proving that fact by clear and convincing evidence.).

Neal v. Sparks, 773 S.W.2d 481 (Mo.Ct.App.1989) (Burden imposed upon party seeking to have conveyance that is absolute on its face declared an equitable mortgage is "proof beyond a reasonable doubt by clear, cogent, and convincing evidence.").

Peerless Construction Company, Inc. v. Mancini, 466 N.Y.S.2d 497 (N.Y.App.Div.1983) ("The burden of establishing an oral defeasance to such a deed is an onerous one resting on whoever alleges it, and its existence and also its precise terms, must be established by clear and conclusive evidence, otherw.se the strong presumption that the deed expresses the entire contract between the parties to it is not overcome.").

Jensen v. Friedman, 179 P.2d 855 (Cal.Ct.App.1947) (To convert an absolute deed into a mortgage, the evidence must be so clear as to leave no substantial doubt that the real intention of the parties was to execute a mortgage and not an absolute transfer of land.).

A few courts that apply a clear and convincing standard of proof qualify it by mandating that any doubt as to the parties' intent be resolved in favor of a finding of mortgage intent. These courts seem to be applying a preponderance of the evidence standard in effect, if not in form.

Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987) ("If a deed is to be construed as a security instrument, the supportive evidence must be clear, satisfactory, and convincing. If it is unclear whether mortgage or absolute deed was intended by an instrument, doubt is resolved in favor of equitable mortgage.").

McGill v. Biggs, 434 N.E.2d 772 (Ill. App. Ct. 1982) ("In order to convert an absolute deed on its face into a mortgage, proof must be clear, satisfactory, and convincing and can come from almost every conceivable fact that could legitimately aid that determination. If there is doubt as to intent of conveyance, it should be resolved in favor of mortgage.").

In contrast, see Cavanaugh v. High, 6 Cal.Rptr. 525 (Cal.Ct.App. 1960) (There is a presumption that a deed absolute in form is what it purports to be and is not a mere mortgage. The burden of proof rests upon the party who contends that the deed is a mortgage, and proof by clear and convincing evidence is required.).

There is Florida case law that sets the burden of proof at only a preponderance of the evidence standard, and in addition resolves doubtful cases in favor of a mortgage interpretation. See Matter of F & M Enterprises, Inc., 58 B.R. 436 (Bankr.M.D.Fla. 1986) (Under Florida law, the party contending that an absolute conveyance should be deemed a mortgage has the burden of establishing the intent of the parties by a preponderance of the evidence); Marcus v. Hull, 195 So. 170 (Fla.1939) ("Only a preponderance of evidence is required to establish that an absolute deed is a mortgage, and in cases of doubt as to whether the parties intended the transaction to be an absolute conveyance or a mortgage, the instrument will be held a mortgage."). See also Stovall v. Stokes, 115 So. 828 (Fla. 1928).

For further consideration of the burden of proof required to show a deed absolute on its face to be a mortgage, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.7 (3d ed. 1993); Cunningham & Tischler, Disguised Real Estate Security Transactions As Mortgages In Substance, 26 Rutgers L. Rev. 1, 22–23 (1972); Updike, Mortgages, in 1956 Annual Survey of American Law, 32 N.Y.U. L. Rev. 789 (1957).

Parol evidence rule, Comment c. Under one theory or another, nearly all jurisdictions hold that the parol evidence rule does not bar the admission of extrinsic evidence to show that an absolute deed was intended to operate only as a security device. Some courts claim that a genuine exception to the parol evidence rule exists in this situation, while others seem to eschew serious consideration of the rule in order to avoid the harsh consequences of its application.

Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987) (In determining the intent of the parties with respect to a conversion of an absolute deed into a mortgage or other security agreement, parol evidence may be considered, and courts may look behind the form of the instrument to ascertain the actual relationship between the parties.).

Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987) ("Even when the instrument appears on its face to be a deed absolute, parol evidence is admissible to show that the parties actually intended the instrument as a mortgage.").

Silas v. Robinson, 477 N.E.2d 4 (Ill. App. Ct. 1985) ("An equitable mortgage can be found on the basis of parol evidence.... For purposes of determining the existence of an equitable mortgage, all the circumstances surrounding the transaction are relevant to the parties' intent, including parol evidence.").

Brown v. Cole, 768 S.W.2d 549 (Ark.Ct.App.1989) (Any written or oral evidence tending to show the true nature of a transaction involving an alleged mortgage in the form of a deed is admissible, since the equity upon which a court acts arises from the real character of the transaction.). See also Davis v. Davis, 890 S.W.2d 280 (Ark.Ct.App.1995).

Pierce v. Robinson, 13 Cal. 116 (1859) ("Parol evidence is admissible to show that a deed absolute on its face was intended as a mortgage, and the evidence is not restricted to cases of fraud, accident, or mistake in the creation of the instrument. Evidence of the circumstances under which the deed was made, and of the relations existing between the parties, is admitted, not to contradict or vary written instruments, is directed to the language employed by the parties, and does not exclude an inquiry into the objects and purposes of the parties in executing the instruments.").

Grable v. Nunez, 64 So.2d 154 (Fla. 1953) ("Admission of parol testimony to establish a conveyance absolute in form to be in fact a mortgage is an exception to the general rule.").

For additional information on the exception to the parol evidence rule in the context of absolute deeds as mortgages, see Annot., 111 A.L.R. 448.

More generally, see 1 G. Nelson & D. Whitman, Real Estate Finance Law, §§ 3.6, 3.15 (3d ed. 1993); Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance, 26 Rutgers L. Rev. 1, 9 (1972). See also Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 302 (1963); Smedley and Blunk, Oral Understandings at Variance with Absolute Deeds, 34 Ill. L. Rev. 189, 198 (1939); Stone, Resulting Trusts and the Statute of Frauds, 6 Col. L. Rev. 326, 339 (1906).

Statute of Frauds, Comment d. As in the case of the parol evidence rule, courts have similarly refused to apply the Statute of Frauds to bar admission of oral evidence showing an absolute deed to be a mortgage. Various justifications have been offered, ranging from the purpose of the Statute of Frauds to its very letter, for finding the statute inapplicable in this context.

Webb v. Harrington, 504 S.W.2d 252 (Mo.Ct.App.1973) (Parol evidence is admissible to prove that a deed absolute on its face is really an equitable mortgage, notwithstanding the Statute of Frauds.).

Schultz v. Schultz, 324 N.W.2d 48 (Mich.Ct.App.1982) ("Notwithstanding the direct language of the statute of frauds, a court may declare a deed absolute on its face to be an equitable mortgage.... The demand for writing in the statute of frauds was intended for persons dealing with each other at arm's length and on an equal footing.... The other instance in which equitable mortgages may properly be declared occurs when a creditor abuses the 'power of coercion' which he may have, by the force of circumstances, over the debtor. Courts sitting in equity interfere between the creditor and debtor to prevent oppression. Otherwise, the statute of frauds would become a shield for the protection of oppression and fraud.").

Kulik v. Kapusta, 135 N.E. 402 (Ill. 1922) ("The statute of frauds was intended to prevent fraud, and not to protect and facilitate it, and does not exclude parol evidence to show that a deed absolute in form was intended as a security only, and was therefore in equity a mortgage.").

Duncan v. Essary, 392 P.2d 877 (Kan.1964) ("The statute of frauds was not intended to affect the power which courts of equity had always exercised to declare absolute deeds to be mortgages to secure a debt."). O'Neill v. Capelle, 62 Mo. 202 (1876) ("The admission of parol evidence to show that a deed absolute in form was given in trust as a mortgage is not in contravention of the statute of frauds, since a fraud would be perpetrated in excluding the evidence, and in such cases equity gives relief irrespective of the statute.").

60 Columbia St. v. Leofreed Realty Corp., 110 N.Y.S.2d 417 (N.Y.Sup.Ct. 1952) ("Statute of frauds did not preclude grantor from proving by parol evidence that deed absolute upon its face was intended as a mortgage ... the defense of the Statute of Frauds is unavailing to the defendants since it is trite law that a party may prove by parol evidence that a deed absolute upon its face was intended as a mortgage and in so doing is not granting, creating or declaring any interest or estate in lands.").

Bell v. Bell, 718 S.W.2d 863 (Tex. Ct. App. 1986) ("When a deed absolute on its face is declared to be mortgage, it is not a grant of title but is instead, from its inception, a mere lien.").

But in contrast to the above cases, see Walters v. Patterson, 531 So.2d 581 (Miss.1988) (reformation of a deed in order to establish an equitable mortgage was precluded by Statute of Frauds); Robison v. Moorefield, 107 N.E.2d 278 (Ill. App. Ct. 1952) (an oral agreement giving plaintiff who has conveyed property by an absolute deed an option to repurchase premises does not constitute a mortgage, and is unenforceable as being in violation of Statute of Frauds).

For further discussions on the Statute of Frauds and its relation to the admissibility of parol evidence to show an absolute deed to be a mortgage, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.15 (3d ed. 1993); Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance, 26 Rutgers L. Rev. 1, 10 (1972); Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 303 (1963); Smedley and Blunk, Understandings at Variance with Absolute Deeds, 34 Ill. L. Rev. 189, 198 (1940); Stone, Resulting Trusts and the Statute of Frauds, 6 Col. L. Rev. 326, 339 (1906).

Factors evidencing intent of the parties, Comment e. As the Comment indicates, the interpretation of an absolute deed as a mortgage is to be made based on the totality of the circumstances surrounding the transaction. Although no one factor is determinative, most jurisdictions hold that as a base requirement for a mortgage determination, there must be an obligation owed to the grantee, and the conveyance must have been intended to secure that obligation. Where, of course, the grantee actually receives a promissory note from the grantor, there is a strong case for finding a security transaction. See, e.g., Flack v. McClure, 565 N.E.2d 131 (Ill. App. Ct. 1990) ("[Grantor] signed a note which the grantees retained. Where the grantor is indebted to the grantee at the time of the conveyance, and the grantee retains the note ... then the indebtedness was not satisfied by the conveyance, and, until the contrary is shown, it will be presumed that a mortgage was intended.").

In most situations, however, the evidence of the obligation is much less obvious. Moreover, the cases are hardly uniform in how they articulate the nature of that obligation or debt. In particular, a conflict exists as to whether the grantor must be personally liable for its payment. Many courts specify that "a definite debt" must be due "from mortgagor to mortgagee" or that "there must be a right of the grantee to demand and enforce his debt and the obligation of the grantor to pay." See Hall v. Livesay, 473 So.2d 493 (Ala.1985); Toulouse v. Chilili Cooperative Association, 770 P.2d 542 (N.M.Ct.App.1989). The foregoing language strongly suggests that not only is "debt" or "obligation" necessary for a mortgage finding, but personal liability of the grantor must exist as well.

For other courts, however, the terms "debt" or "obligation" do not necessarily refer to a formal personal obligation on the grantor's part to repay the consideration received, but merely an expectation or assumption by the parties that a repayment will occur. In these jurisdictions, the existence of an obligation and the intent to secure it may be imputed from the intention of the parties to make a loan, as well as from the presence of several other aggregating factors suggesting a mortgagor-mortgagee relationship. See Davis v. Davis, 890 S.W.2d 280 (Ark.Ct.App.1995) (although "there was no writing evidencing such a debt, ... [t]here was evidence, however, that the parties' parents had borrowed money every spring on their crops and paid the money back later that year. There was also evidence that [grantee] owned a lot of property and loaned money."). See Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987).

This section incorporates the latter approach. To require not only an obligation but grantor personal liability as well would impose in the equitable mortgage context a requirement that is inapplicable to formal or "legal" mortgages. In the latter setting, "non-recourse" obligations are clearly mortgageable. See § 1.1, The Mortgage Concept; No Personal Liability Required.

Brenneman Mechanical & Electrical, Inc. v. First Nat'l Bank, 495 N.E.2d 233 (Ind.Ct.App.1986) ("Whether a deed absolute on its face is in fact an equitable mortgage is determined on a case-by-case basis.... A court must consider all the circumstances, the parties' positions at the time, their conduct, declarations and attitude and any other facts tending to show the true nature of the transaction.").

Bell v. Bell, 718 S.W.2d 863 (Tex. Ct. App. 1986) (In determining whether a deed absolute on its face is a mortgage, courts look to the intent of the parties as manifested by all the facts surrounding the transaction. The controlling issue is whether there exists an indebtedness for which the conveyance is security, because without a debt there can be no mortgage.).

Abberton v. Stephens, 747 S.W.2d 334 (Mo.Ct.App.1988) (An indispensable fact to holding that an absolute deed is an equitable mortgage is that the deed was given as security for a debt owed by the grantor to the grantee; and in determining whether a debt exists, courts look to the parties' intent at the time of the conveyance.).

Basile v. Erhal Holding Corp., 538 N.Y.S.2d 831 (N.Y. App. Div. 1989) ("A deed conveying real property, although absolute on its face, will be considered to be a mortgage when the instrument is executed as security for debt.").

Neal v. Sparks, 773 S.W.2d 481 (Mo.Ct.App.1989) (Whether a conveyance is a deed or an equitable mortgage is determined by the intent of the parties.).

Hall v. Livesay, 473 So.2d 493 (Ala. 1985) ("To prove an equitable mortgage, it must be shown that: (1) the mortgagor has a mortgageable interest in property sought to be charged as security; (2) that a definite debt is due from mortgagor to mortgagee, and (3) that the intent of the parties is to secure the debt by a mortgage, lien, or charge on property.").

Toulouse v. Chilili Cooperative Association, 770 P.2d 542 (N.M.Ct.App. 1989) ("The great weight of authority supports the position that the existence of an indebtedness running from the grantor to the grantee is essential to a conclusion that a deed be construed as a mortgage. Not only must there be the indebtedness, but the rights and remedies of the parties must be mutual, that is, there must be the right of the grantee to demand and enforce his debt and the obligation of the grantor to pay," quoting Bell v. Ware, 69 N.M. 308, 366 P.2d 706 (1961).).

Wensel v. Flatte, 764 S.W.2d 627 (Ark.App. 1989) (If a debt exists, and the conveyance was intended by the parties to secure its payment, equity will regard and treat the absolute deed as a mortgage. The party claiming that deed was a mortgage has the burden of proving that the deed was in fact a mortgage, that there was indebtedness, and that the deed was intended to secure the debt.).

Webb v. Harrington, 504 S.W.2d 252 (Mo.Ct.App.1973) ("Where a deed absolute on its face is given in consideration of a previous debt owed by the grantor to the grantee, and the debt remains enforceable by the grantee against the grantor, the conveyance will be construed as an equitable mortgage.").

Besides the six specifically enumerated factors to be considered in determining the existence of a debt and the parties' intent (see infra), another factor which some courts emphasize in their consideration of the totality of the circumstances surrounding the transaction is the financial condition of the grantor at the time of the conveyance. See, e.g., Schultz v. Schultz, 324 N.W.2d 48 (Mich.Ct.App. 1982) ("Thus, an adverse financial condition of the grantor coupled with an inadequate purchase price for the property is sufficient to establish a deed absolute on its face to be an equitable mortgage."). See also Smith v. Player, 601 So.2d 946 (Ala.1992).

For general overview of this section and further discussions on the factors evidencing the existence of a debt and the intent of the parties to secure that debt by means of the absolute conveyance, see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.8 (3d ed. 1993); Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 305–306 (1963); When Is an Absolute Conveyance a Mortgage?, 8 U. Fla. L. Rev. 132 (1955).

The six specifically enumerated factors merely represent a few of the most readily discernible means of arriving at the parties' intention. The weight allocated to the presence or absence of each factor need not be equal. Different courts place different amounts of emphasis on one factor or another, some even demanding the existence of one particular factor as a threshold to inquiry.

W. M. Barnes Co. v. Sohio Natural Resources Company, 627 P.2d 56 (1981) ("A court ... [in interpreting a deed] must consider such facts surrounding the transaction as the intention of the parties and the purpose to be accomplished; the existence of a continuing obligation on the grantor's part to pay the debt allegedly secured by the deed; the adequacy of the consideration compared to the value of the property; the compliance and subsequent acts of the parties; the party responsible for taxes and improvements; and the form of the written documentation of the transaction.").

Kidings v. Marengo Savings Bank of Marengo, 125 N.W. 200 (Iowa 1910) ("In determining whether a deed absolute in form is a mortgage, the most important questions are First, whether there was a continuing obligation by the grantor to pay a debt which it is claimed the deed was made to secure; second, the value of the land as compared with the debt which was to be secured; third, how have the parties treated the conveyance; fourth, in what form are the written evidences of the transaction; and, fifth, what sort of testimony is relied on to show that the deed was accepted as security for a debt?").

Statements of the parties, factor 1. Oral testimony concerning the nature of the transaction is generally admissible to show that an absolute deed was given as security. See Reporters' Note to Comment *c*, supra. Although a highly significant factor, statements of the parties alone will usually be insufficient to overcome the onerous burden of proof requirement of clear and convincing evidence, absent some other corroborating factors. This stems from both the notion that people usually evidence their intentions accurately in a writing, and the basic untrustworthiness of oral statements contradicting a writing where much time has transpired since the writing was created and the parties are clearly not disinterested. Nevertheless, there are occasions where parol testimony can be quite persuasive on the issue.

Smith v. Player, 601 So.2d 946 (Ala. 1992) (court emphasized that "at no time has [grantee] refuted [grantor's] testimony that this 'outright sale,' as it was referred to by his attorney, was actually intended by him and [grantee] to be a sort of conditional sale conditioned upon [grantor's] failure to repay").

Stava v. Stava, 383 N.W.2d 765 (Neb.1986) (Whether a deed absolute in form is a mortgage depends upon the intentions of both of the parties, and that intention may be evidenced not only by the documents in question, but also by the declarations and conduct of the parties.).

Corey v. Roberts, 25 P.2d 940 (Utah 1933) ("In determining whether a deed, absolute in its terms, is intended as a mortgage, elements to be considered are whether there was continuing obligation on part of grantor to pay debt which it is claimed deed was made to secure, question of relative values, contemporaneous and subsequent acts, declarations and admissions of parties, form of written evidences of transactions, nature and character of testimony relied upon, various business, social, or other relationships of parties, and apparent aims and purposes to be accomplished.").

Brandt v. Manson, 207 S.W.2d 846 (Mo.Ct.App.1948) ("Mere verbal declarations of the parties is generally insufficient to establish that a deed absolute on its face is a mortgage, in absence of corroborating facts.").

But see Say v. Crocker First National Bank, 277 P. 146 (Cal.Ct.App. 1929) (Grantor's testimony that deed was intended as security was sufficient evidence that it was so intended.).

See also Laney v. Hogan, 1986 WL 7591 (Ark.Ct.App.1986) (The court found an absolute deed to be a mortgage where the grantor "emphatically denied that she had ever intended to give Helen an ownership interest in the property, and testified that the only reason we had given Helen a deed, rather than a mortgage, was because Helen had demanded it." Grantee, on the other hand, "also admitted that she had intended for the property to be her mother's home, and that it was not her intention that any ownership be transferred to her before her mother's death.").

Sweet v. Luster, 513 So.2d 1240 (Miss.1987) (The court found the deed to be a mortgage where an employee of the grantee "testified that Walter said he was going to endorse the note, and (the deed) would be his security." Luster added that he would hold the deed until the note was paid.).

For criticisms of finding an absolute deed to be a mortgage on the basis of the parties' testimony, see McGill v. Lester, 700 P.2d 964 (Idaho.Ct.App.1985) (Walters, C.J., dissenting).

Disparity in price, factor 2. Where a substantial disparity exists between the amount of money received by the grantor and the fair market value at the time of the conveyance, a mortgage transaction rather than an outright conveyance is implicated. Of course, the presence of such a disparity alone should not necessarily be dispositive, since rational sellers sometimes make bad business deals.

Illustration 3 exemplifies a situation where a substantial discrepancy between "sale price" and fair market value at time of conveyance indicates that security and not an absolute sale was intended. In contrast, Illustration 4 demonstrates a weak case for such an interpretation. Since the disparity in this example is not very significant, substantially more corroborative evidence would be needed to justify treatment of the conveyance as a mortgage in contravention of the terms of the written deed.

Smith v. Player, 601 So.2d 946 (Ala. 1992) ("[Grantor] did not receive any proceeds from the transaction, and the evidence indicates that the amount [grantee] paid on the credit union loan was anywhere from $700 to $24,000 less than the fair market value of the property.").

Reynolds v. Hook, 292 P. 1000 (Cal. Ct.App.1930) ("Great inequity between value of property and price allegedly paid is one of the circumstances indicating that deed, absolute in form, is mortgage.").

Webb v. Harrington, 504 S.W.2d 252 (Mo.Ct.App.1973) ("Substantial disparity between the alleged consideration and the fair market value of real property conveyed by a deed absolute on its face, where the grantor contends the conveyance is an equitable mortgage, is indicative, but not conclusive, of an equitable mortgage.").

Flack v. McClure, 565 N.E.2d 131 (Ill. App. Ct. 1990) ("Where consideration is grossly inadequate, a mortgage is strongly indicated.... Here, grantees signed an $80,000 contract on the home at the same time they gave grantor $9,000.").

Davis v. Wilson, 21 N.W.2d 553 (Iowa 1946) (The fact that the value of the property is substantially more than the consideration for the deed is a strong circumstance indicating that the deed was intended to serve as security.).

See also Swanbeck v. Sheaves, 1986 WL 2957 (Ohio.Ct.App.1986) (The court construed an absolute deed as an equitable mortgage. The conveyance was made in consideration of $2,000 although the fair market value of the land at that time was $4,000, and subsequently rose to $8,000 by time of trial.).

See also Schultz v. Schultz, 324 N.W.2d 48 (Mich.Ct.App.1982), under Reporters' Note to Comment *e*, supra.

For further discussion of price disparity as an important factor in showing an absolute deed to be a mortgage, see Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 307 (1963).

Retained possession, factor 3. As pointed out in the Comment, retention of possession by the grantor can be an important factor in favor of a mortgage interpretation, absent evidence that subsequent to the conveyance grantee and grantor entered into a lessor-lessee relationship.

Illustrations 1 and 2 demonstrate the significance of retained possession by the grantor following the conveyance. Coupled with the existence of an obligation, retained possession clearly establishes the intent of the parties to use the deed, and hence the land, as security for the debt.

Smith v. Player, 601 So.2d 946 (Ala. 1992) ("We note also, that until a disagreement later arose between [grantee] and [grantor], * * * [grantor] continued to live on the property without objection by [grantee].").

Sims v. Sims, 502 So.2d 722 (Ala. 1987) ("Finding that warranty deed was intended to be mortgage was supported by evidence that ... grantor continued to live on property ...").

Flack v. McClure, 565 N.E.2d 131 (Ill. App. Ct. 1990) (In affirming the finding of a mortgage, court found it significant that grantor "stayed in the home for a year after she gave the defendants the quitclaim deed.").

Sweet v. Luster, 513 So.2d 1240 (Miss.1987) ("Parol evidence that grantor of warranty deed retained and exercised same control over land both before and after deed's execution was admissible to show that parties intended deed as debt-securing mortgage, not conveyance.").

Toulouse v. Chilili Cooperative Association, 770 P.2d 542 (N.M.Ct.App. 1989) ("Among the circumstances held to be evidence that they intended to convey the title instead of a mortgage are the following: That the grantor relinquished possession; that he allowed a long period of time to elapse without asserting a claim to the land or exercising any act of ownership over it; that he paid no taxes or encumbrances; that grantee took possession and exercised dominion over the land as owner; that he paid taxes; that he put valuable improvements on the land; that he contracted to sell and convey the land as owner.").

As noted earlier, a few jurisdictions seem to suggest that retention of possession by the grantor is a condition precedent to the admission of further evidence of mortgage intent. Mississippi and Georgia in particular emphasize the importance of this factor in their analyses.

Walters v. Patterson, 531 So.2d 581 (Miss.1988) ("Person claiming ownership of property and challenging warranty deed absolute on its face must first establish retention of possession of property after conveyance by clear, unequivocal, and convincing evidence.").

Askew v. Thompson, 58 S.E. 854 (Ga.1907) ("Under this section (Ga. Code Ann. § 44-14-32), a deed absolute on its face may be shown by parol evidence to have been intended to convey title only for the purpose of securing a debt, where the grantee has not taken possession of the property.").

Harris v. Kemp, 451 So.2d 1362 (Miss.1984) (Notwithstanding the provisions of Miss. Code Ann. § 89-1-47, parol evidence could be introduced to prove that an absolute deed was intended as security, where the grantor retained possession of the property.).

For further discussion of the significance of grantor possession in these types of cases, see Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 308 (1963).

Real estate taxes, factor 4. If the grantor continues to pay real estate taxes on the property following the conveyance, this indicates that the transaction was intended as security rather than as an absolute conveyance of title. If, however, the evidence clearly indicates that this was part of a bargained-for arrangement, there would be no such inference from this fact. For example, the property may have been leased back to the grantor under a "net" lease, under which lessee payment of real estate taxes is a common arrangement.

Illustration 5 demonstrates the significance of combining several favorable factors indicating a mortgage rather than an absolute conveyance, among these being the payment of real estate taxes by the grantor, improvements made by the grantor (see infra), and retained possession by the grantor (see supra), all following the conveyance.

Smith v. Player, 601 So. 2d 946 (Ala. 1992) ("Similarly, the evidence indicates that [grantor] continued paying taxes on the property until long after this controversy arose.").

Abberton v. Stephens, 747 S.W.2d 334 (Mo.Ct.App.1988) ("Facts indicative of deed absolute and not equitable mortgage are that property is conveyed subject to prior lien, grantee of deed pays taxes levied against property, grantee of deed pays for insurance on property, and conveyance emanates from amicable avoidance of foreclosure.").

Laney v. Hogan, 1986 WL 7591 (Ark.Ct.App.1986) (Trial court was justified in finding an equitable mortgage where grantor "paid no rent to [grantees], had paid the taxes and insurance on the property, and had made substantial repairs and improvements to the property.").

Silas v. Robinson, 477 N.E.2d 4 (Ill. App. Ct. 1985) ("Evidence in partition action, including that plaintiff sister contributed virtually nothing in repairs, maintenance or taxes and did not attempt to occupy or take advantage of the benefits of ownership of the property and that defendant sister managed and rehabilitated the property by paying for repairs, real estate taxes and insurance and by occupying a portion of the premises and renting out the remainder, established that recorded deed which named them as joint tenants was equitable mortgage serving as security for plaintiff sister's loan to defendant sister.").

See also Toulouse v. Chilili Cooperative Association, 770 P.2d 542 (N.M.App. 1989), under Retained Possession, Factor 3, supra.

For more information concerning the payment of real estate taxes by the grantor, see Karesh, Security Transactions, in Survey of South Carolina Law, 10 S.C.L.Q. 114, 115 (1957).

Improvements, factor 5. Like the paying of real estate taxes, the making of improvements upon the land by the grantor following the conveyance is a strong indication that the transaction was intended to be only a security device for an existing debt, and not an absolute conveyance.

Webb v. Harrington, 504 S.W.2d 252 (Mo.Ct.App.1973) (Where the grantor of an absolute deed makes improvements on the conveyed property after the conveyance, it is indicative, but not conclusive, of an equitable mortgage.).

See Laney v. Hogan, 1986 WL 7591 (Ark.Ct.App.1986); Silas v. Robinson, 477 N.E.2d 4 (Ill.Ct.App.1985), under Real Estate Taxes, Factor 4, supra.

See also Toulouse v. Chilili Cooperative Association, 770 P.2d 542 (N.M.Ct.App.1989), under Retained Possession, Factor 3, supra.

In addition, see discussion of Illustration 5, under Real Estate Taxes, factor 4, supra.

Relationship of the parties prior to and after the conveyance, factor 6. The final illustrative factor is the relationship between the parties, both before and after the conveyance. If the parties were in a creditor-debtor relationship prior to the conveyance, and that relationship continues in full force and effect following the conveyance, this is highly indicative that the conveyance was intended as security for enforcement of the debt. So, too, if the grantor makes post-conveyance payments to the grantee, this suggests a mortgage transaction. Similarly, if the grantee is in the business of making loans and is not accustomed to purchasing property outright, then this too is a factor which will operate in favor of a mortgage interpretation.

Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987) (A telltale sign that an absolute deed amounts only to an equitable mortgage is that the transaction of which the deed is a part operates to create or continue as between the parties the relationship of obligor and obligee.).

Stava v. Stava, 383 N.W.2d 765 (Neb.1986) (When it is contended that conveyance of real estate is a mortgage, the test is whether the relation of the parties to each other as debtor and creditor continues after the conveyance. If it does, the transaction will be treated as a mortgage, otherwise not.).

Abberton v. Stephens, 747 S.W.2d 334 (Mo.Ct.App.1988) (In order to prove the existence of an equitable mortgage, the grantor of the absolute deed must prove a binding obligation on his part continuing after conveyance, and the grantor must recognize the continued existence of the debt; however, if the grantor is at liberty to pay or not to pay at his whim or caprice, then there is no mortgage.).

Thompson v. Mansfield, 258 P. 702 (Cal.Ct.App.1927) (Where the facts and circumstances show a continuation of a debtor-creditor relationship, a deed absolute in form may be held to be a mortgage.).

Jensen v. Friedman, 179 P.2d 855 (Cal. Ct. App. 1947) (The fact that the relationship of debtor and creditor continued to exist between the defendant and the plaintiff after execution of the absolute deed was proof that the deed was intended to serve as security.).

For further discussion of the relationship between the parties as a factor for interpreting an absolute deed as a mortgage instrument, see Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance, 26 Rutgers L. Rev. 1, 15 (1972).

The absolute deed with collateral written evidence of security intent, Comment f. As the Comment points out, when there is a separate writing indicating that the conveyance was intended as security, it is much easier to establish that an absolute deed was intended to operate as security. Courts will often declare that two or more writings, when taken together, constitute a mortgage transaction in substance. Obviously there is no Statute of Frauds problem since the agreement to reconvey is embodied in a writing. Furthermore, parol evidence is admissible to explain what was fully intended by the absolute conveyance. Most courts justify this by stating that the absolute deed was never intended to embody the entire agreement and therefore requires parol evidence to tie the two documents together, establishing that they relate to the same transaction.

Marple v. Wyoming Production Credit Association, 750 P.2d 1315 (Wyo.1988) (Concurrently executed land sales transaction documents should be considered together.).

Scott v. Mewhirter, 49 Iowa 487 (1878) ("It is a general rule that a deed made for the purpose of securing a debt, and accompanied by a contemporaneous agreement for reconveyance of the property on payment of debt and interest, is in legal effect a mortgage.").

Gay v. Hamilton, 33 Cal. 686 (1867) ("Where a deed absolute is given, and at the same time a defeasance is executed, parol evidence is admissible to show that they were parts of the same transaction, and that the whole amounted to and was intended to be a mortgage.").

Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987) (Written agreement gave grantors the right to demand reconveyance upon payment of amounts due grantor).

Rockwell International Corp. v. Commonwealth of Pa., 512 A.2d 1332 (Pa.Cmwlth.1986) ("A deed absolute on its face may be transformed into a mortgage by a defeasance which is in writing, signed and delivered by the grantee in the deed to the grantor.").

Barkwell v. Swan, 13 So. 809 (Miss. 1892) ("An unrecorded contemporaneous writing showing a recorded deed absolute in form to be a mortgage is not void. The conveyance being of record, the failure to record the writing showing its real character will not affect the validity of the mortgage.").

Brown v. Hermance, 10 N.W.2d 66 (Iowa 1943) ("Where an absolute deed is accompanied by a contract to reconvey on specified conditions, and, under evidence, a doubt exists as to whether conveyance was intended to be absolute or as security for debt, contract will be construed to be a 'mortgage' rather than a 'privilege to repurchase' or a 'conditional sale.'").

See Illustrations 6 and 7 for examples of how the deed absolute on its face and separate written defeasance will be construed together as a mortgage instrument.

For further discussion of the admissibility of collateral written defeasance agreements to show an absolute deed to be a mortgage in reality, see Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance, 26 Rutgers L. Rev. 1, 13, 15–19 (1972).

Rights of bona fide purchasers from grantee, Comment g. For further commentary and case consideration of the bona fide purchase rule, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.11 (3d ed. 1993).

STATUTORY NOTE

Arizona: Ariz. Rev. Stat. Ann. § 33–702(A) (1990). Mortgage defined; admissibility of proof that transfer is a mortgage.

> Every transfer of an interest in real property, other than in trust ... made only as a security for the performance of another act, is a mortgage. The fact that a transfer was made subject to defeasance on a condition may, for the purpose of showing that the transfer is a mortgage, be proved except against a subsequent purchaser or encumbrancer for value without notice, notwithstanding that the fact does not appear by the terms of the instrument.

California: West's Cal. Civ. Code § 2924 (1974). Transfer as security deemed mortgage or pledge.

> Every transfer of an interest in property, other than in trust, made only as a security for the performance of another act, is to be deemed a mortgage.

West's Cal. Civ. Code § 2925 (1974). Transfer subject to defeasance on a condition; proof.

> The fact that a transfer was made subject to defeasance on a condition, may, for the purpose of showing such transfer to be a mortgage, be proved (except as against a subsequent purchaser or encumbrancer for value and without notice), though the fact does not appear by the terms of the instrument.

West's Cal. Civ. Code § 2950 (1974). Instrument of defeasance affecting grant in absolute form; necessity of recording.

> When a grant of real property purports to be an absolute conveyance, but is intended to be defeasible on the performance of certain conditions, such grant is not defeated or affected as against any person other than the grantee or his heirs or devisees, or persons having actual notice, unless an instrument of defeasance, duly executed and acknowledged, shall have been recorded in the office of the County Recorder of the county where the property is situated.

Florida: Fla. Stat. Ann. § 697.01 (1969). Instruments deemed mortgages.

(1) All conveyances ... or other instruments of writing conveying or selling property, either real or personal, for the purpose or with the intention of securing the payment of money, whether such instrument be from the debtor to the creditor or from the debtor to some third person in trust for the creditor, shall be deemed and held mortgages.

(2) Provided, however, that no such conveyance shall be deemed or held to be a mortgage, as against a bona fide purchaser or mortgagee, for value without notice, holding under the grantee.

Georgia: Ga. Code Ann. § 44-14-32 (1982). Use of parol evidence to prove apparent deed a mortgage.

A deed or bill of sale which is absolute on its face and which is accompanied with possession of the property shall not be proved, at the instance of the parties, by parol evidence to be a mortgage only unless fraud in its procurement is the issue to be tried.

Idaho: Idaho Code § 45-904 (1977). Transfers deemed mortgages.

Every transfer of an interest in property other than in trust to secure the performance of any obligation of the trustor or other person named in the trust instrument, made only as a security for the performance of another act, is to be deemed a mortgage.

Idaho Code § 45-905 (1977). Defeasance may be shown by parol.

The fact that a transfer was made subject to defeasance on a condition may, for the purpose of showing such transfer to be a mortgage, be proved (except as against a trustee under any trust deed or transfer in trust, or a subsequent purchaser or encumbrancer for value and without notice), though the fact does not appear by the terms of the instrument.

Illinois: Ill. Ann. Stat. ch. 95, para. 55 (1987). Constructive mortgage.

Every deed conveying real estate, which shall appear to have been intended only as a security in the nature of a mortgage, though it be an absolute conveyance in terms, shall be considered as a mortgage.

Maine: Me. Rev. Stat. Ann. tit. 33, § 33 (1978). Forms.

Mortgages of real estate include those made in the usual form, in which the condition is set forth in the deed, and those made by a conveyance appearing on its face to be absolute, with a separate instrument of defeasance executed at the same time or as part of the same transaction.

Me. Rev. Stat. Ann. tit. 33, § 202 (1978). Failure to record, effect of. A deed purporting to convey an absolute estate in land cannot be defeated by an instrument intended as a defeasance, as against any other person than the maker, his heirs and devisees, unless such instrument is recorded in the registry where the deed is recorded.

Maryland: Md. Real Prop. Code Ann. § 7-101 (1981). When deed absolute in terms to be considered a mortgage; assignment of mortgages as security.

(a) When deed absolute in terms to be considered a mortgage.—Every deed which by any other writing appears to have been intended only as security for payment of an indebtedness or performance of an obligation, though expressed as an absolute grant is considered a mortgage. The person for whose benefit the deed is made may not have any benefit or advantage from the recording of the deed, unless every other writing operating as a defeasance of it, or explanatory of its being intended to have the effect only of a mortgage, also is recorded in the same records at the same time.

Mississippi: Miss. Code Ann. § 89-1-47 (1972). Deed not shown to be mortgage by parol evidence.

A conveyance or other writing absolute on its face, where the maker parts with the possession of the property conveyed by it, shall not be proved, at the instance of any of the parties, by parol evidence, to be a mortgage only, unless fraud in this procurement be the issue to be tried.

New York: N.Y. Real Prop. Law § 320 (McKinney 1989). Certain deeds deemed mortgages.

A deed conveying real property, which, by any other written instrument, appears to be intended only as a security in the nature of a mortgage, although an absolute conveyance in terms, must be considered a mortgage; and the person for whose benefit such deed is made, derives no advantage from the recording thereof, unless every writing, operating as a defeasance of the same, or explanatory of its being desired to have the effect only of a mortgage, or conditional deed, is also recorded therewith, and at the same time.

Oklahoma: Okla. Stat. Ann. tit. 46 (1983). 1. Absolute deed as mortgage.

Every instrument purporting to be an absolute or qualified conveyance of real estate or any interest therein, but intended to be defeasible or as security for the payment of money, shall be deemed a mortgage and must be recorded and foreclosed as such.

Pennsylvania: Pa. Stat. 21 P.S. § 951. Defeasances; requisites.

No defeasance to any deed for real estate, regular and absolute upon its face, made after the passage of this act, shall have the effect of reducing it to a mortgage, unless the said defeasance is in writing, signed and delivered by the grantee in the deed to the grantor; and, in so far as it may effect any subsequent grantee or mortgagee of such real estate, for value, unless it is also acknowledged and recorded in the office for the recording of deeds and mortgages in the county wherein the said real estate is situated, before the execution and delivery of such subsequent grant or mortgage; and such defeasances shall be recorded and indexed as mortgages by the recorder.

Utah: Utah Code Ann. § 70-40-8 (1984). Mortgage not deemed a conveyance—Foreclosure necessary.

A mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of real property without a foreclosure and sale.

Wyoming: Wyo. Stat. § 34-1-127 (1977). Effect on purported absolute conveyance of unrecorded deed of defeasance.

When a deed or mortgage purports to be an absolute conveyance in terms, but is made or intended to be made defeasible by force of defeasance, or other instrument for that purpose, the original conveyance shall not be thereby defeated or affected as against any person other than the maker of the defeasance, or his heirs or devisees, or persons having actual notice thereof, unless the instrument of defeasance shall have been recorded in the office of the register of deeds (county clerk) of the county where the lands lie.

§ 3.3 The Conditional Sale Intended as Security

(a) Parol evidence is admissible to establish that a deed purporting to be an absolute conveyance of real estate accompanied by a written agreement conferring on the grantor a right to purchase the real estate, was intended to serve as a security for an obligation, and should therefore be deemed a mortgage. The obligation may have been created prior to or contemporaneous with the conveyance and need not be the personal liability of any person.

(b) Intent that the deed serve as security must be proved by clear and convincing evidence. Such intent may be inferred from the totality of the circumstances, including the following factors:

(1) statements of the parties;

(2) the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance;

(3) the terms on which the grantor may purchase the real estate;

(4) the fact that the grantor retained possession of the real estate;

(5) the fact that the grantor continued to pay real estate taxes;

(6) the fact that the grantor made post-conveyance improvements to the real estate; and

(7) the nature of the parties and their relationship prior to and after the conveyance.

(c) The presence of language in any of the written documents that expressly negates the intent to enter into a mortgage transaction is relevant to the issue of the parties' intent, but does not preclude a determination that the parties intended a mortgage transaction.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 3.2, The Absolute Deed Intended as Security; § 6.4, Redemption from Mortgage by Performance or Tender.

Comment:

a. Introductory note. Section 3.2 deals with situations in which parol evidence is used to establish that an absolute deed was intended as security for an obligation, or in which the security intent is reflected in a separate writing. The present section deals with absolute deed transactions in which there is a second written document that purports to confer on the grantor either the option (Illustrations 1–3 and 5–6) or the contractual obligation (Illustration 4) to purchase the property described in the deed. This type of transaction is often referred to as a conditional sale.

As in the case of the absolute deed situation, the conditional sale often reflects a lender-grantee desire to avoid the consequences of the borrower-grantor's equity of redemption and other substantive mortgage rules favoring debtors. However, there can be other reasons for using this device. One such reason can be found in state usury law. For example, a lender may seek to characterize the difference between the "sale" price and the repurchase amount as simply being part of the repurchase price and not as the usurious interest that it actually is. The conditional sale has also sometimes been motivated by federal income tax law considerations. Under federal income tax law, ordinary income traditionally has been taxed at a higher rate than capital gain. Since profit from the sale of land is usually treated as capital gain, a lender may sometimes seek to mask the difference between the sale price and the repurchase price as a capital gain rather than ordinary interest income. Such a characterization would, of course, be impossible in a normal mortgage transaction. Income tax considerations may also be important in "sale and leaseback" conditional sale transactions. If the borrower-grantor's periodic payments to the lender-grantee are treated as lease rental payments, they often will be completely deductible by the grantor as a business expense. On the other hand, if the payments are viewed as mortgage amortization, only the interest portion will be deductible.

b. Burden of proof. While courts usually follow a "clear and convincing" standard in absolute deed transactions, the acceptance of this burden of proof has been less pervasive in the conditional sale context. For some courts, it is sufficient to establish mortgage intent in the latter situation by a preponderance of the evidence. This approach emphasizes that the only controversy in the conditional sale setting is whether the grantor's written right to reacquire the property derives from the language of the repurchase agreement or grantor's status as a mortgagor. In a sense, permitting grantor to establish that the transaction is a mortgage does not contradict the written documentation in the same degree as in the absolute deed setting. The grantee's expectations arguably are disturbed to a much lesser extent where a formal agreement expressly provides for grantor's reacquisition of the real estate than where grantee is compelled to part with a title that he or she may well have assumed to be indefeasible.

On balance, however, the heavier standard of proof is justified. In the conditional sale setting, extrinsic evidence establishing that the parties intended a security transaction not only contravenes the deed to the grantee, it is also incompatible with a second written document. If anything, it is more difficult to justify the use of parol evidence in the latter context than where it simply supplies a part of the transaction that the parties did not spell out in the absolute deed. Moreover, the principle of stability of written real estate transactions and the discouraging of false swearing are equally applicable in both situations.

c. Factors evidencing intent of the parties. As in the absolute deed setting considered in § 3.2 of this Chapter, no single factor is necessarily determinative of whether a conditional sale in reality represents a security transaction. As Illustrations 1 and 2 indicate, the delivery to grantee of grantor's promissory note represents extremely persuasive evidence of mortgage intent. However, as Illustrations 3, 5, and 6 indicate, the existence of a promissory note or other written evidence of the debt is not a prerequisite to finding a security transaction. As in the absolute deed setting, a court may infer the existence of the obligation where the totality of the facts indicate that the parties intended the deed to serve as security. Moreover, personal liability on the obligation is not required. See § 3.2, Comment *c* and Reporters' Note.

Perhaps the single most important indication of mortgage intent is the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance. It is axiomatic that a rational owner of real estate normally will not sell it without receiving a purchase price that at least roughly approximates its fair market value. Illustrations 3, 4, and 6 exemplify this principle. On the other hand, attempting to determine market value with precision is often an illusory exercise. Moreover, personal exigencies can force some sellers to take less for their property than their otherwise rational counterparts would be willing to accept. Consequently, as Illustration 5 indicates, a conveyance by the grantor for 75 to 80 percent of fair market value may reflect an arm's-length sale rather than a mortgage transaction.

It is sometimes important to focus on the purchase price that must be paid by the grantor to reacquire the real estate. For example, where the difference between the amount the grantor received for the conveyance and the purchase price reflects a normal investment return, this suggests the parties intended a security transaction. See Illustration 3.

Most of the factors utilized in § 3.2 to determine mortgage intent in the absolute deed context are also important in the conditional sale setting. Yet some of those factors may be of minimal importance in certain conditional sale transactions. For example, if there has been a sale and lease-back, the retention of possession by the grantor may not be indicative of a mortgage transaction because it is consistent with the grantor's status as a lessee. Moreover, in such a situation the significance of the grantor's payment of real estate taxes is neutralized if the lease requires such payment by the grantor. On the other hand, if the term of the lease is relatively short, a rational lessee normally will not make major improvements to the premises. Consequently, such improvements in a conditional sale setting can be significant evidence of a concealed mortgage transaction. Finally, the nature and relationship of the parties can be as significant in the conditional sale situation as in the absolute deed setting. For example, the fact that the grantee's usual business is the lending of money rather than the buying and selling of real estate tends to point to a mortgage transaction in both contexts.

It is axiomatic that once there is a judicial determination that a conditional sale is in reality a mortgage transaction, the redemption amount should be the mortgage obligation with interest at the statutory rate, and not the option price. In Illustrations 1–2, the mortgage obligation is readily ascertainable by looking to the promissory note delivered to the grantee. In the more usual case where no promissory note exists, the conditional sale is often structured so that the option price in fact equals or approximates the amount (with interest) that grantee "loaned" to the grantor. To use the option price as the redemption amount in such situations thus seems appropriate. This is the situation in Illustrations 3–4. In Illustration 6, however, the option price ($30,000) grossly exceeds the amount ($5,000) grantee actually has advanced to grantor or for his benefit. Thus, the "debt" or "obligation" to be redeemed should be the latter rather than the former amount. To use the option price under such circumstances would not only afford the grantee a substantial windfall, but would be grossly unfair to the grantor-mortgagor and would do violence to the traditional protection afforded to mortgagors by the equity of redemption.

Illustrations:

1. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. At the same time Grantor receives $50,000 from Grantee and delivers to Grantee a $60,000 promissory note payable to his order bearing no interest. Grantee delivers to Grantor a written option to purchase Blackacre for $60,000 exercisable two years later. Grantor retains possession of Blackacre and continues to pay real estate taxes on it. Grantor fails to exercise the option in a timely fashion. The facts justify the conclusion that the parties intended a security transaction. Grantor will be permitted to redeem by paying to Grantee the amount due on the promissory note or to compel Grantee to foreclose on Blackacre for that amount.

2. The facts are the same as Illustration 1 except that Grantor receives the $50,000 from Grantee and delivers the promissory note to Grantee a year before executing and delivering the deed and accepting the option to purchase. Grantor fails to exercise the option in a timely fashion. The facts justify the conclusion that the parties intended a security transaction. Grantor will be permitted to redeem by paying to Grantee the amount due on the promissory note or to compel Grantee to foreclose on Blackacre for that amount.

3. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $50,000 in cash, but receives no promissory note from Grantor. Grantee delivers to Grantor a two-year written lease on Blackacre with rent payable at $300 monthly. The lease also confers on Grantor the right at the end of that two-year period to purchase Blackacre for $60,000. Grantor retains possession of Blackacre and continues to pay real estate taxes on it. At the time of the conveyance, the fair market value of Blackacre is $125,000. Grantor fails to exercise the option in a timely fashion. The facts justify the conclusion that the parties intended a security transaction. Grantor will be permitted to redeem by paying to Grantee $60,000 less a credit for the rent paid or to compel Grantee to foreclose on Blackacre for that amount.

4. The facts are the same as Illustration 3 except that, in lieu of executing a lease and option, the parties enter into a written contract obligating Grantor to purchase Blackacre for $60,000 at the end of the two-year period. Grantor fails to comply with the contract obligations in a timely fashion. The facts justify the conclusion that the parties intended a security transaction.

Grantor will be permitted to redeem by paying $60,000 to Grantee or to compel Grantee to foreclose on Blackacre for that amount.

5. The facts are the same as Illustration 3 except that the fair market value of Blackacre at the time of the conveyance is in the $60,000 to $65,000 range. The facts justify the conclusion that the parties intended a sale and lease-option of Blackacre and not a security transaction.

6. Both a mortgage with a balance of $30,000 and real estate taxes on Blackacre are seriously delinquent. Grantor, the owner of Blackacre, seeks assistance from Grantee. Pursuant to Grantee's instructions, Grantor conveys Blackacre to Grantee subject to the existing mortgage. Grantee then delivers to Grantor a three-year lease on Blackacre with rent payable at $300 monthly. The lease also contains an option to purchase exercisable at the end of the lease term for $30,000, with Grantor agreeing to take subject to the existing mortgage. Grantee expends a total of $5,000 to satisfy the mortgage arrearages and delinquent real estate taxes. At the time of the foregoing transaction, the fair market value of Blackacre, free and clear of liens, is $60,000. During the ensuing three years, Grantor promptly pays the rental payments under the lease and Grantee makes the mortgage payments. During this period, the total rental payments approximate the amount paid on the mortgage. Grantor fails to exercise the option in a timely fashion. The facts justify the conclusion that the parties intended a security transaction. Grantor will be permitted to redeem by paying to Grantee $5,000 (the net amount expended by Grantee on this transaction) plus interest at the statutory rate. Alternatively, Grantor will be permitted to compel Grantee to foreclose on Blackacre for that amount.

d. Language negating mortgage intent. Because grantee-lenders frequently use specific mortgage-negating language in conditional sale transactions, giving dispositive effect to such provisions would, as a practical matter, deprive this section of much of its effectiveness for grantor-mortgagors. Illustration 7 reflects the position of Subsection (c) of this section that such provisions are evidence of the parties' intent, but will not normally be deemed dispositive on that issue. This is especially the case where the fair market value of the real estate at the time of the conveyance greatly exceeds the amount the grantor receives for it, a situation that is present in the Illustration. Under these circumstances, such language should not be permitted to override the presumption that a rational person will not normally sell real estate for substantially less than it is worth. Nevertheless, some weight may be given to such language and, in close cases, it may tip the balance against a determination that the parties intended a security transaction. Greater weight should be accorded such provisions in commercial conditional sale transactions involving sophisticated parties who are represented by counsel. In the latter context, predictability and stability in real estate transactions are especially important concerns.

Most attempts to establish that a conditional sale is a security transaction will be by the grantor. However, this need not always be the case. For example, suppose the value of the conveyed real estate has dropped substantially and the grantor has other substantial assets to satisfy any personal liability on the mortgage debt to the grantee. The latter may well desire to establish that what appears to be a sale was actually intended to be a loan transaction. If the grantee was the party who insisted on insertion of the mortgage-negating language, the grantee probably should be estopped from attacking his or her own prior attempt to negate mortgage intent. This may represent one situation where such mortgage intent-negating provisions should be given preclusive effect.

Illustration:

7. The facts are the same as Illustration 3 except that the following language is contained in one of the written documents: "Nothing herein contained shall be construed to involve a loan from Grantee to Grantor or to create the relationship of mortgagor and mortgagee between the parties hereto, it being understood and agreed between Grantee and Grantor that the transaction provided for a sale and a conveyance of real property and option for a valuable consideration to purchase real property under specified conditions and terms." While the foregoing language provides some evidence of the parties' intent, the facts nevertheless justify the conclusion that they intended a security transaction.

e. The commercial sale and leaseback. The sale and leaseback is an effective and commonly used method of financing commercial real estate. Although this transaction often involves complex multi-party arrangements, in its basic form an owner sells real estate to an investor who leases it back to the seller on a long-term lease. Frequently, the buyer-lessor also grants the seller-lessee an option to repurchase the real estate at the end of the lease term.

Such transactions are attractive to each of the participants. For the buyer-lessor, the rent payments represent a current return on investment and the retention of the reversion affords a potential gain from long-term appreciation in the value of the real estate. Pension funds, insurance companies, charities, and other institutional lenders often view such transactions as an alternative to investing in mortgages or long-term bonds. For individual investors and syndicated partnerships, the sale and leaseback frequently provides an attractive tax shelter. For the seller-lessee, the transaction can afford the opportunity to raise capital in a larger amount than would be available on a first mortgage loan and without the higher interest rate that second mortgage financing would command. As noted in Comment *a*, income tax advantages can also accrue to the seller-lessee. For example, lease payments may be fully deductible business expenses, while only the interest portion of mortgage loan payments usually qualifies for such treatment.

However, when the sale and leaseback fails or otherwise encounters economic distress, the seller-lessee may sometimes attempt to use the principles of this section to persuade a court to recharacterize it as an equitable mortgage. Success in such an attempt can mean that the buyer-lessor will be required to use foreclosure rather than lease remedies to terminate the seller-lessee's interest. Moreover, if the seller-lessee seeks bankruptcy protection and the court treats the sale and leaseback as a mortgage transaction, Bankruptcy Code treatment of mortgagees is usually substantially less favorable than that accorded lessors.

In applying this section, courts should exercise restraint in characterizing as mortgage transactions substantial commercial sale and leaseback arrangements involving sophisticated parties who are represented by legal counsel. For institutional and other large investors, predictability as to the legal effect of such transactions is especially important. Moreover, policy concerns aimed at discouraging overreaching and protecting necessitous and overly sanguine borrowers are far less compelling when asserted by those who have the expertise and opportunity to make a reasoned business judgment on the risks and benefits of a proposed commercial transaction.

REPORTERS' NOTE

Introductory note, Comment a. This section establishes that an absolute deed, coupled with a right to repurchase in the grantor, can be shown by parol evidence to have been intended to operate as a mortgage. The grantor of the deed will typically attack this conditional sale after failing to exercise the option to repurchase in a timely manner, by claiming that a security transaction was intended by the parties despite the plain language of the documents in question. Courts, exercising their equitable powers, will allow the admission of parol evidence to show that the conditional sale was intended to serve as security. See, e.g., Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987); Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986). Once security intention is established, the grantor will be given all of the rights of an ordinary mortgagor, including an equity of redemption, the right to a valid foreclosure, and statutory redemption rights should they exist.

For general background on the conditional sale transaction and typical forms such transactions take, see 1 G. Nelson & D. Whitman, Real Estate Finance Law, § 3.17 (3d ed. 1993). For an example of the use of the conditional sale to avoid the application of state usury law, see Hembree v. Bradley, 528 So.2d 116 (Fla. Dist.Ct.App.1988).

For a historical view of the borrower/mortgagor-motivated conditional sale (as opposed to the lender/mortgagee-motivated conditional sale), see Wigmore, The Pledge–Idea, 10 Harv. L. Rev. 389, 393 (1887).

For collections of conditional sale cases, see Annots., 79 A.L.R. 937 (1932); 155 A.L.R. 1104 (1945).

See also Campbell, Cases on Mortgages (2d ed.) at 97 n.1; Note, When Is an Absolute Conveyance a Mortgage?, 8 U. of Fla. L. Rev. 132 (1955).

As an alternative to security intent analysis, courts occasionally apply an unconscionability approach to conditional sale transactions. See, e.g., Jones v. Johnson, 761 P.2d 37 (Utah Ct. App. 1988) (transaction in which grantor conveyed to grantee her home worth $40,000 for a $17,000 "purchase price" and received an option to repurchase during the next 13 months for $21,700 was not unconscionable).

Burden of proof, Comment b. There is no clear consensus as to the standard of proof to be applied in conditional sale transactions. Both the "clear and convincing" and "preponderance of the evidence" standards have significant support in the case law.

Duvall v. Laws, Swain, & Murdoch, 797 S.W.2d 474 (Ark.Ct.App.1990) (The burden of proving that an absolute deed coupled with an option in the grantor to repurchase is a mortgage transaction may be met "only by clear and convincing evidence.").

Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App.1970) ("However, this extrinsic evidence must be clear and convincing in order to show that a deed absolute and a separate option to repurchase together constitute a mortgage," citing Merryweather v. Pendleton, 367 P.2d 251 (Ariz.1961)).

Cowles v. Zlaket, 334 P.2d 55 (Cal. Ct.App.1959) ("In cases ... where a conveyance is absolute in form with an option to repurchase, the one asserting that it is a loan must establish that fact by evidence which is clear and convincing.").

Christensen v. Nelson, 873 P.2d 917 (Idaho.Ct.App.1994) ("The district court was required to apply a clear and convincing standard to its finding of fact.").

Robinson v. Builders Supply & Lumber Co., 586 N.E.2d 316 (Ill. App. Ct. 1991) ("To convert an absolute deed into a mortgage, the proof must be clear, satisfactory and convincing").

Baker v. Taggart, 628 P.2d 1283 (Utah 1981) ("The burden of proof was upon the plaintiff to show by clear and convincing evidence that the conveyance was intended as a mortgage. In the absence of such clear and convincing evidence, the presumption is that the instrument of conveyance is what it purports to be. The reason for this presumption is clear: to enhance the security of real estate transactions.").

Fry v. D.H. Overmyer Co. Inc., 525 P.2d 140 (Or.1974) ("Clear and convincing evidence standard is applicable to both absolute deed and conditional sale transactions.").

Fox v. Peck Iron and Metal Company, Inc., 25 B.R. 674 (Bankr. S.D.Cal.1982) ("In dealing with a conveyance absolute in form with an option to repurchase, the one asserting that it is a loan must establish that fact by evidence which is clear and convincing.").

In re OMNE Partners II, 67 B.R. 793 (Bankr.D.N.H.1986) ("This power [to recharacterize] should be exercised only upon a showing of clear and convincing evidence by the debtor that the transaction should be deemed a disguised financing transaction.").

Westberg v. Wilson, 241 N.W. 315 (Minn.1932) (Preponderance of the evidence is sufficient to show a conditional sale to have been intended as security.).

Matter of F & M Enterprises, Inc., 58 B.R. 436 (Bankr.M.D.Fla.1986) (The requisite burden of proof upon the grantor is a preponderance of the evidence).

Some courts that adhere to a preponderance of the evidence standard further enhance the likelihood of a mortgage finding by resolving all doubts in favor of mortgage intent.

Matter of Kassuba, 562 F.2d 511 (7th Cir.1977) ("Where the transaction involves both a conveyance and a contract for repurchase and where the surrounding circumstances leave the intent of the parties in doubt, a court of equity will generally treat the transaction as a mortgage.").

James v. Ragin, 432 F.Supp. 887 (W.D.N.C.1977) ("Doubts as to whether the transaction is a sale or mortgage are to be construed in favor of a mortgage.").

Matthews v. Sheehan, 69 N.Y. 585 (1877) ("In all doubtful cases a contract will be construed to be a mortgage rather than a conditional sale, because in the case of a mortgage the mortgagor, although he has not strictly complied with the terms of the mortgage, still has his right of redemption; while in the case of a conditional sale, without strict compliance, the rights of the conditional purchaser are forfeited.").

Rice v. Wood, 346 S.E.2d 205 (N.C. Ct. App. 1986) ("When evidence leaves the status of the transaction in doubt, courts generally hold a deed with an accompanying provision for reconveyance to be a mortgage rather than a conditional sale.").

Earp v. Boothe, 24 Gratt. 368 (Va. 1874) ("It may be premised that where upon the face of the transaction it is doubtful whether the parties intended to make a mortgage or conditional sale, courts of equity will always incline to consider it a mortgage, because by means of conditional sales oppression is frequently exercised over the needy, and they are too often made the vehicle of extortion.").

See also Fogelman, The Deed Absolute as a Mortgage in New York, 32 Fordham L. Rev. 299, 307 (1963).

For a consideration and evaluation of the conflicting views as to burden of proof, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.18 (3d ed. 1993).

On the admissibility of parol evidence to show a conditional sale to be a mortgage, see Cunningham & Tischler, Disguised Real Estate Security Transactions as Mortgages in Substance, 26 Rutgers L. Rev. 1, 13 (1972).

For further cases on the quantum of proof required, see Updike, Mortgages, in 1953 Annual Survey of American Law, 29 N.Y.U. L. Rev. 829, 830 (1954).

Factors evidencing intent of the parties, Comment c. As in the absolute deed as a mortgage situation, the interpretation of a conditional sale as a security transaction is to be made on a case-by-case basis, based on the totality of the circumstances surrounding the transaction. No one factor is determinative, although as a prerequisite for interpretation as a mortgage there must at least be an obligation owed to the grantee, and the conveyance must have been intended to secure it. However, as in § 3.2, the obligation need not be the personal obligation of the grantor and its existence and the intent to secure it may be inferred from the presence of several other aggregating factors suggesting a security transaction between the parties. See § 3.2, Comment *e*. Moreover, as in the absolute deed situation, the obligation may have been created prior to or contemporaneous with the conveyance which is intended to secure it. See Illustrations 1 and 2.

Duvall v. Laws, Swain, & Murdoch, 797 S.W.2d 474 (Ark.Ct.App.1990) ("One test that may be helpful in determining whether a transaction is a mortgage or conditional sale is to decide whether the grantee has the right to compel the grantor to pay the consideration named in the stipulation for reconveyance.").

Robinson v. Builders Supply & Lumber Co., 586 N.E.2d 316 (Ill. App. Ct. 1991) ("While a debt relationship is essential to a mortgage, direct evidence is not necessary ... and, in fact, no particular type of evidence is required. Although [grantor] never executed a note or other document which demonstrates the existence of a debt, a number of factors here might suggest a debt relationship. [Grantor] signed the deeds after she told [grantee] that she needed a loan, and [grantee] responded that [grantee] could assist her. Moreover, [grantor] stated that she never intended to sell her property and believed at all times that the transaction constituted a loan. [Grantee's attorney] acknowledged that she initially came to [grantee] to save her property. Although the documents do not appear to create indebtedness between the parties, the record suggests that the parties' primary intent was to effect a security agreement, rather than an outright sale of the properties.").

O'Briant v. Lee, 200 S.E. 865 (N.C. 1939) ("If there was a debt, either antecedent or presently created, the instrument must be construed to constitute a mortgage, unless a contrary intent clearly appears upon the face of the instrument.").

Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986) ("The law of this State is well settled that where land is conveyed by a deed absolute and at the same time an agreement is executed that the grantee will reconvey the property if the grantor pays a sum certain at or before a specified time, the two documents, taken together, may either be a sale with a contract to repurchase or a mortgage.... Whether a particular transaction constitutes a mortgage or a sale with a contract to repurchase depends on the particular facts and circumstances involved, but in all cases, the decision finally turns on the real intention of the parties as disclosed by the writings or extrinsic evidence.... 'A general criterion, however, has been established by an overwhelming consensus [sic] of authorities, which furnishes a sufficient test in the great majority of cases.... This criterion is the continued existence of a debt or liability between the parties, so that the conveyance is in reality intended as a security for the debt.' (quoting O'Briant v. Lee, 214 N.C. 723, 725-26, 200 S.E. 865, 867 (1939), supra) ... The debt may exist prior to the conveyance or may arise from a loan made at the time of the conveyance.... In any event, the debt must not be discharged or satisfied by the conveyance; the grantor should remain bound to pay at some future time.... It is not merely the existence of the deed and an agreement to reconvey that constitutes the mortgage. 'On the contrary, it is absolutely essential that at the inception of the transaction the deed be intended to operate by way of security.' (quoting O'Briant v. Lee, supra, at 727, 200 S.E. at 867)").

Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987) ("The question of whether an instrument written as a deed is actually a deed or is in fact a mortgage is a question of fact.... The true nature of the instrument is resolved by ascertaining the intent of the parties as disclosed by the contract or attending circumstances or both.... Even when the instrument appears on its face to be a deed absolute, parol evidence is admissible to show that the parties actually intended the instrument as a mortgage.... When there is a fact finding that the parties intended the transaction to be a loan, and that finding is supported by probative evidence, the law will impute the existence of a debt.").

Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App.1970) (The presence of a subsisting obligation is of primary importance.).

See also 20 Ill. L. Rev. 732, 733 (1926); 2 Idaho L.J. 151 (1932).

For good summaries of the relevant factors in determining whether a conditional sale was intended to operate as security, see:

Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App.1970), citing, Merryweather v. Pendleton, 367 P.2d 251, 264 (Ariz.1961) ("(1) the prior negotiations of the parties, to discern if such negotiations contemplated a mere security for a debt; (2) the distress of the maker; (3) the fact that the amount advanced was about the amount that the 'grantor' needed to pay an existing indebtedness; (4) the amount of the consideration paid in comparison to the actual value of the property in question; (5) a contemporaneous agreement to repurchase; and (6) the acts of the parties in relation to each other, i.e., whether their acts are ordinarily indicative of a vendor-purchaser relationship or that of a mortgagor and mortgagee.").

Patterson v. Grace, 661 N.E.2d 580 (Ind.Ct.App.1996) ("Indiana courts have looked to various factors in ascertaining the intent to create an equitable mortgage, including: (1) the existence of a debt prior to the transaction or one created as part of the transaction, (2) documents that provide the grantor can redeem the property by performing certain conditions within a certain time, (3) the grantee gave inadequate consideration for the conveyance of the real property, (4) the grantor paid interest to the grantee, (5) the grantor retained possession, control, and use of the property, particularly when no rent was paid, (6) the grantor made improvements that a tenant would not likely make, (7) the grantee did not exercise ownership or control over the property, and (8) the parties did not extinguish a debt.").

James v. Ragin, 432 F.Supp. 887 (W.D.N.C.1977) ("Whether there was a debtor-creditor relationship created at the time of the transaction ...; whether the transaction originated out of a loan ...; and whether the purported sale price is less than the worth of the property.").

Corey v. Roberts, 25 P.2d 940 (Utah 1933) ("The declarations and admissions of the parties; ... the nature and character of the testimony relied upon; the various, social and other relationships of the parties; and the apparent aims and purposes to be accomplished.").

Republic Financial Corp. v. Mize, 682 P.2d 207 (Okla.1983) ("The instruments involved indicate on their face that the debtor/creditor relationship continued after the deed was given, making it readily apparent that the relation of mortgagor and mortgagee still remains. The price was inadequate when compared to the appraised fair market value of the land, and raises a strong presumption that there exists a right to redeem and that the transaction was really a mortgage. The fact that Mize, the grantor, remained in possession is another circumstance that tends to show that the transaction was not really a sale, but a mortgage, for such continuing possession, if not inconsistent with a sale, is unusual. Notwithstanding the deed, Mize remained liable to Republic on the debt, and the contemporaneous agreement giving Mize the right to repurchase also points to the deed being a security for the debt rather than an absolute conveyance. These, as well as other factors discussed, infra lead to the irresistible conclusion that the transaction here was security for payment of money, and in equity a mortgage ...").

Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986) ("There was substantial evidence, which established that the transaction began out of negotiations for a loan and not a sale, that the consideration paid was less than half the fair market value of the property and that the grantors remained in possession of the property following the conveyance and paid rent to grantee in an amount equal to the monthly mortgage payments, sufficient to support grantors' prima facie case that the conveyance and option to repurchase constituted a mortgage.").

See also 20 Ill. L. Rev. 732 (1926); 26 Mich. L. Rev. 821 (1928); 19 N.C. L. Rev. 416, 418 (1938).

For a general discussion of the factors establishing a conditional sale as a mortgage, see 1 G. Nelson & D. Whitman, Real Estate Finance Law, § 3.19 (3d ed. 1993).

Statements of the parties, factor 1. In certain circumstances, oral testimony can help establish that a conditional sale was really intended to serve as security. In the absence of other probative evidence, however, oral testimony alone will often not be enough to overcome the presumption that a written deed and contract to repurchase are what they purport to be.

Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986) ("Where deed and option to repurchase do not affirmatively show that parties intended a mortgage and where such intent cannot reasonably be inferred from the documents, grantor in the deed may prove intent to create a mortgage by proving facts and circumstances dehors the deed inconsistent with an absolute conveyance; however, mere declarations of the grantor will not be enough to show that the parties intended a mortgage.").

Disparity in price, factor 2. One of the most important and revealing factors for interpreting a conditional sale as security is the presence of a substantial disparity between the price allegedly paid for the land and the fair market value of the land at the time of the conveyance. Although a slight disparity in price can be attributed to the difficult task of valuing the property, shrewd bargaining or the financial distress of the grantor, a substantial disparity in price, in contrast, strongly suggests a mortgage transaction.

Orlando v. Berns, 316 P.2d 705 (Cal.Ct.App.1957) (The fair market value of the land greatly exceeded both the amount received by the grantor and the repurchase price.).

Christensen v. Nelson, 873 P.2d 917 (Idaho.Ct.App.1994) ("Assuming that $60,000 was the value of the property for a quick sale, a $46,595.99 sale price is not so inadequate as to require recharacterization of the transaction.").

Koenig v. Van Reken, 279 N.W.2d 590 (Mich.Ct.App.1979) ("Under Michigan law, it is well settled that the adverse financial condition of the grantor, coupled with the inadequacy of the purchase price for the property (mortgagor conveyed over $30,000 in equity and received less than $4,000), is sufficient to establish a deed absolute on its face to be a mortgage.").

Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987) ("The evidence was that the repurchase price was exactly 10% more than the original price; the land was worth almost twice as much as the original sale price; the lease price equaled exactly 9% interest on the balance of the note to Johnson's ex-wife assumed by Cherry and 18% interest on the alleged purchase price; Johnson was indebted to other creditors for approximately $119,000 of the $120,000 he received from Cherry; Johnson was within one week of losing the land entirely; and Johnson had told a real estate agent he was not interested in listing his property for sale.").

Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986) ("The fair market value of the property was approximately $46,000.... The purchase price was $21,000 ... [and] was arrived at by adding up the Rices' debts and the costs of the transactions, i.e. mortgage assumption, foreclosure costs, attorneys fees, brokerage fees and deed preparation.").

Republic Financial Corp. v. Mize, 682 P.2d 207 (Okla.1983) ("The price was inadequate when compared to the appraised fair market value of the land, and raises a strong presumption that there exists a right to redeem and that the transaction was really a mortgage.").

In re Corey, 892 F.2d 829 (9th Cir.1989) (finding that security was not intended was upheld where there was no discussion of grantees making a loan and "they paid a fair market price").

See also 155 A.L.R. 1104, 1109 (1945); 90 A.L.R. 953 (1934); 11 Wis. L. Rev. 118 (1938), for additional authorities.

See Illustrations 3, 4, and 5 for a comparative analysis.

Purchase terms, factor 3. For cases focusing on the reacquisition price in determining security intent, see Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987) (fact that option price was exactly 10% more than the amount grantor originally received was indicative of mortgage intent); Orlando v. Berns, 316 P.2d 705 (Cal.Ct.App. 1957) (fact that the value of the realty greatly exceeded both the amount received by the grantor and the repurchase price deemed indicative of mortgage intent); Osipowicz v. Furland, 260 N.W. 482 (Wis.1935) (court was strongly influenced to find a security transaction where the value of the property greatly exceeded both the amount received by the grantor and the repurchase price). See generally, 1 G. Nelson and D. Whitman, Real Estate Finance Law § 3.19 (3d ed. 1993).

Retained possession, factor 4. As the Comment indicates, retention of possession by the grantor can be an important factor in favor of a mortgage interpretation, absent evidence that the grantee and grantor entered into a bona fide sale and lease-back arrangement. Illustrations 1 and 2 demonstrate the role that retained possession can play absent a lease-back arrangement. In contrast, Illustration 5 is typical of a true sale and lease-back arrangement.

See Patterson v. Grace, 661 N.E.2d 580 (Ind.Ct.App.1996); Robinson v. Builders Supply & Lumber Co., 586 N.E.2d 316 (Ill.Ct.App.1991); Republic Financial Corp. v. Mize, 682 P.2d 207 (Okla.1983); Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986), under Reporters' Note to Comment *c*, supra.

Real estate taxes, factor 5. The payment of real estate taxes by the grantor may be of importance in establishing security intent. However, payment of taxes by a grantor-lessee may simply indicate that the parties intended a sale and "net" lease. On the other hand, simply because the grantee has paid the real estate taxes does not automatically negate a mortgage transaction. If the transaction is deemed to be a mortgage, the grantee who has paid real estate taxes on the property will undoubtedly be entitled to reimbursement by the grantor/mortgagor.

See Republic Financial Corp. v. Mize, 682 P.2d 207 (Okla.1983) (The contract for sale provided that Mize (grantor) would pay the taxes and insurance in return for immediate possession.).

See also Booth v. Landau, 477 N.Y.S.2d 195 (N.Y.App.Div.1984) ("Grantees of deed which was deemed mortgage were entitled to reimbursement for real estate taxes paid on premises which were occupied by grantor, rent free, after execution of deed.").

Improvements, factor 6. As Comment *c* indicates, the fact that the grantor made significant post-conveyance improvements to the land is indicative that the conditional sale was intended to serve as security. This can be true even in the lease-back situation, for even lessees, except perhaps in long-term lease situations, will not ordinarily expend large amounts of money for substantial improvements on land which they do not own. See, e.g., Patterson v. Grace, 661 N.E.2d 580 (Ind.Ct.App.1996) ("Finally, [grantors] made numerous improvements to the property that a tenant would not likely make.").

The nature of the parties and their relationship prior to and after the conveyance, factor 7. The nature of the parties and their relationship prior to and after the conveyance is highly relevant in determining security intent. If the grantee is in the business of loaning money and not accustomed to buying property, then this fact will lend weight to a mortgage interpretation. Similarly, if the grantor was in severe financial distress and in danger of losing the property to foreclosure immediately before the conveyance took place, this too may indicate that the transaction was intended as security, especially when the "sale price" approximates the grantor's indebtedness.

Robinson v. Builders Supply & Lumber Co., 586 N.E.2d 316 (Ill. App. Ct. 1991) ("Relevant here are [grantor's] desperate circumstances and her relative lack of sophistication. [Grantee] claims that [he] was twenty years older than [grantor], and, like [grantor] never completed high school. We decline, however, to equate [grantee's] level of sophistication and business experience with that of [grantor], given that [grantee] for sixty years was in the business of buying and rehabilitating distressed properties. Moreover, [an attorney represented grantee] throughout the transaction while [grantor] did not have an attorney prior to or at the time she conveyed the deeds.").

Republic Financial Corp. v. Mize, 682 P.2d 207 (Okla.1983) (parties originally were mortgagor and mortgagee before the conveyance).

Rice v. Wood, 346 S.E.2d 205 (N.C.Ct.App.1986) ("Parties' conduct before, at and after the transaction, was relevant in determining parties' intent as to whether deed and option to repurchase, taken together, constituted a mortgage." "The sales price was not arrived at by determining fair market value but by adding up the costs of the transaction, i.e. mortgage assumption, foreclosure costs, attorney fees, deed preparation and realtor's commission plus an additional $743.00 to the plaintiffs to cover outstanding debts ... There was substantial evidence, which established that the transaction began out of negotiations for a loan and not a sale ... the conduct of the parties before, at and after the conveyance reveal that the plaintiffs were in financial distress when they sought the help of Mr. Fagerberg (agent for mortgagee).").

Matter of F & M Enterprises, Inc., 58 B.R. 436 (Bankr.M.D.Fla.1986) ("The [mortgagee] obtained deeds in the same fashion on two other occasions.").

Johnson v. Cherry, 726 S.W.2d 4 (Tex.1987) ("The landowner was indebted to other creditors and was within one week of losing his land entirely.").

Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App.1970), citing Merryweather v. Pendleton, 367 P.2d 251, 264 (Ariz.1961): ("(1) the prior negotiations of the parties, to discern if such negotiations contemplated a mere security for a debt; (2) the distress of the maker; (3) the fact that the amount advanced was about the amount that the 'grantor' needed to pay an existing indebtedness . . .; and (6) the acts of the parties in relation to each other, i.e., whether their acts are ordinarily indicative of a vendor-purchaser relationship or that of a mortgagor and mortgagee.").

See also Koenig v. Van Reken, 279 N.W.2d 590 (Mich.Ct.App.1979), under Disparity in Price, Factor 2, supra, for severe financial distress of the grantor at the time of the conveyance.

Amount of the mortgage debt once conditional sale is deemed a mortgage. Once a grantor (or in rare cases a grantee) succeeds in showing a conditional sale to be a mortgage, the primary inquiry is "what is the amount of the mortgage debt secured?" When a specific debt is evidenced by a promissory note or other such separate writing, as in Illustrations 1 and 2, then the amount of the debt secured by the mortgage is clear. In most cases, however, there is no such separate writing. One possibility is that the amount secured by the mortgage should be the option price set forth in the repurchase agreement. As the Comment points out, in most cases this will approximate the amount the grantee has advanced to the mortgagor or on the mortgagor's behalf. In Illustration 3, the option price was $60,000 which is approximately the amount which mortgagor received ($50,000) plus a suitable rate of interest. It should be noted, however, that the mortgagor should be credited for any payments he made to the mortgagee in the guise of rent following the conveyance (see Illustration 3), unless such payments were used by the mortgagee to pay off another existing mortgage or lien on the land which mortgagor was obligated to pay (see Illustration 6).

On the other hand, if the option price does not accurately reflect the mortgage debt, because it would bring a windfall to the mortgagee, then the actual amount advanced by the mortgagee (plus an appropriate rate of interest) should be used as the mortgage debt, as in Illustration 6.

Language negating mortgage intent, Comment d. Courts disagree on the effect of specific provisions negating mortgage intent. Some suggest that such language is conclusive. See O'Briant v. Lee, 195 S.E. 15 (N.C. 1938) (dictum); McMurry v. Mercer, 73 S.W.2d 1087 (Tex. Civ. App. 1934) (dictum). Others hold that such provisions constitute only evidence of the parties' intent and do not preclude a finding that they intended a security transaction. See Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App.1970); Beeler v. American Trust Co., 147 P.2d 583 (Cal.1944).

Illustration 7 is based on Downs v. Ziegler, 477 P.2d 261 (Ariz.Ct.App. 1970) ("Although there is case authority in other jurisdictions that if an agreement for reconveyance expressly recites that the transaction is not a mortgage such recital is conclusive of the matter, it has also been held that such a recital is not conclusive, and that a deed intended as security for a debt will be found a mortgage *no matter how strong* the language of the deed or of any accompanying instrument.") (emphasis in original).

In *Downs*, supra, it was the grantees/mortgagees (rather than the grantor) who were attacking the conditional sale as a mortgage because they wanted to avoid liability for a deficiency judgment on a foreclosing senior mortgage they had assumed. (Under Arizona law, assuming purchasers are normally liable on the assumed mortgage, but assuming junior mortgagees are not.) Moreover, the grantees had drafted the clause in the conditional sale agreement specifically negating mortgage intent. Nevertheless, contrary to the Comment's suggestion, the court did not estop the grantees from attacking their own anti-mortgage provision, and allowed them to show that the conditional sale was intended as security. The court did, however, hold the grantees to a higher standard of proof, requiring clear and convincing evidence. (See Reporters' Note to Comment *b*, supra).

See Reporters' Note to Comment *d*, supra, in conjunction with Illustration 7.

The commercial sale and leaseback, Comment e. For an extensive analysis of the consequences of characterizing the commercial sale and leaseback as a mortgage, see Hornburger and Andre, Real Estate Sale and Leaseback and the Risk of Recharacterization in Bankruptcy Proceedings, 24 Real Prop. Prob. & Tr. J. 95 (1989).

A defaulting seller-lessee who chooses bankruptcy usually will find it much more advantageous to be a mortgagor than a lessee. This is because a lessee who files a bankruptcy petition must either assume or reject the lease within a short period of time or the lease will be deemed rejected. In the latter situation, the lessee will be required to surrender the property immediately to the lessor. On the other hand, if the transaction is characterized as a mortgage, the seller-mortgagor often will be able to retain possession of the real estate and restructure the mortgage obligation as part of a bankruptcy reorganization plan.

1 G. Nelson & D. Whitman, Real Estate Finance Law 81–82 (3d ed. 1993). See In re Opelika Manufacturing Corp., 67 B.R. 169 (Bankr.N.D.Ill. 1986); In re Independence Village, Inc., 52 B.R. 715 (Bankr.E.D.Mich. 1985); In re Seatrain Lines, Inc., 20 B.R. 577 (Bankr.S.D.N.Y.1982). Occasionally, the lessor-purchaser rather than the lessee-seller will seek to recharacterize the transaction as a mortgage. See In re PCH Associates, 949 F.2d 585 (2d Cir.1991) (lessor-purchaser was successful in obtaining a mortgage recharacterization in order to avoid being labeled a joint venturer and to achieve the status of a secured creditor to enhance its claim to the proceeds from a bankruptcy sale of the real estate).

§ 3.4 A Contract for Deed Creates a Mortgage

(a) A contract for deed is a contract for the purchase and sale of real estate under which the purchaser acquires the immediate right to possession of the real estate and the vendor defers delivery of a deed until a later time to secure all or part of the purchase price.

(b) A contract for deed creates a mortgage.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 3.2, The Absolute Deed Intended as Security; § 3.3, The Conditional Sale Intended as Security.

Comment:

a. Introductory note. The contract for deed is the most commonly used mortgage substitute. It is also frequently called an "installment land contract," a "long-term land contract," an "installment sale contract," "bond for deed," and a "land sale contract." The contract for deed and the purchase money mortgage serve an identical economic function; in both the vendor is financing the balance of the purchase price in a real estate sale transaction. The purchaser normally takes possession upon execution of the contract for deed and makes installment payments of principal and interest until the contract balance is fully satisfied. While the purchaser obtains equitable title upon execution of the contract, legal title is retained by the vendor until the final payment is made. At that point, the vendor delivers a deed to the purchaser conveying legal title to the real estate.

Such contracts may be paid over periods as short as a year or two or as long as 25 years or more. Often they are evenly amortized, but frequently they may call for "balloon" payments. During the contract period the purchaser is typically obligated to pay taxes, maintain casualty insurance, and keep the premises in good repair.

The contract for deed must be distinguished from the ordinary executory contract for the sale of land, which is variously referred to as an "earnest money contract," a "binder," or a "marketing contract." The latter device is clearly not a mortgage. While the contract for deed is a long-term vendor financing device, the earnest money contract governs the rights and liabilities of the parties during the short period between the date of the bargain and the date of closing, usually a period of a few months. At the closing of the earnest money contract, the purchaser either tenders the full purchase price or deals with any balance by delivering a purchase money mortgage to the seller or some third party. Indeed, where the transaction contemplates seller financing, the closing of the earnest money contract may involve the execution by the purchaser of a contract for deed rather than a purchase-money mortgage. Courts should not readily convert an earnest money contract into a contract for deed. For example, a purchaser under an earnest money contract occasionally will go into possession of the real estate for a short period prior to the closing. Where this occurs, the parties will be governed by landlord-tenant law and a contract for deed relationship will not be created.

Like the absolute deed and the conditional sale, the contract for deed has traditionally been used as a mortgage substitute in those states where the substantive law of mortgages and the procedural aspects of foreclosure are considered to be heavily pro-mortgagor. It tends to be most popular in those states, about half of the jurisdictions in the nation, where a judicial proceeding is the only method of mortgage foreclosure. This procedure requires a full court proceeding in which all interested persons must be made parties, and is often time-consuming and costly.

The primary attraction of the contract for deed for the vendor is the forfeiture clause. Under this provision, "time is of the essence" and when the purchaser fails to pay promptly or otherwise defaults under the contract, the vendor ostensibly has the right to declare the contract terminated, to regain possession of the real estate, and to retain all of the purchaser's prior payments as liquidated damages. Thus, when the contract for deed is enforced as written, the vendor is able to avoid the equity of redemption, foreclosure, and other traditional debtor protections that are part and parcel of mortgage law.

While lender use of the absolute deed and conditional sale as mortgage substitutes has received an unsympathetic judicial reception (see §§ 3.2, 3.3), the same cannot be said for the courts' traditional treatment of the contract for deed. Indeed, in most states there was a time when forfeiture provisions were routinely enforced in favor of the vendor. Enforcement presumably was rooted in a desire to effectuate the parties' intent, even though forfeiture often caused a substantial loss to the purchaser and afforded a windfall gain to the vendor. Such enforcement proved especially harmful to purchasers who were nearing the completion of their contract payments and whose financial equity in the real estate was substantial. Nevertheless, courts tended to de-emphasize the mortgage-like character of the contract for deed and to treat it instead as an executory contract for the sale of land.

More recently, however, courts and legislatures have increasingly used mortgage law analogies in scrutinizing the contract for deed and its forfeiture clause. As one court emphasized, "if the absolute deed kind of forfeiture may not be enforced by the grantee according to the express terms of the agreement, why then, should a forfeiture under a land sale contract be so enforced?" Braunstein v. Trottier, 635 P.2d 1379, 1382 (Or.App.1981). This heightened judicial and legislative attention, however, has produced neither analytical nor practical consensus. Predictability in this area is noticeably lacking, although there is no jurisdiction today in which a vendor can safely assume that the forfeiture clause will always be enforced as written.

b. Judicial restrictions on forfeiture. Numerous courts during the past several decades have refused to enforce forfeiture clauses that they deemed unreasonable or inequitable. They have employed a variety of approaches. Some courts, for example, have either explicitly or implicitly conferred on the tardy purchaser a mortgagor's equity of redemption, permitting the purchaser to tender the remainder of the purchase price in a suit or counterclaim for specific performance of the contract. These courts, however, generally have not yet recognized that a purchaser who is unable or unwilling to redeem has a right to have the contract foreclosed as a mortgage.

Even where forfeiture is upheld, courts frequently have extended to the defaulting purchaser a restitution remedy—the right to recoup the contract payments to the extent that they exceed the damages caused to the vendor by the purchaser's default.

Finally, some courts and legislatures have opted simply to treat the contract for deed as a mortgage, with the purchaser having both a mortgagor's equity of redemption and the right to insist on foreclosure as the sole method for terminating it. That is the position of this section. The following headings consider more closely the various approaches being used to mitigate the impact of forfeiture on the purchaser.

(1) *Recognition of an equity of redemption.* A significant number of jurisdictions have held that the purchaser in default is entitled to a final opportunity to tender the contract balance prior to forfeiture of the land to the vendor. Some view this right as an unconditional and the equivalent of the mortgagor's equity of redemption, while others condition the right on the purchaser's prior payments having been sufficient to create a substantial equity in the property. Occasionally the purchaser's ability to redeem will depend upon whether the payments already made exceed the fair rental value of the real estate. A few cases suggest that the purchaser who is guilty of gross negligence or bad faith will be barred from redemption.

(2) *Restitution to the purchaser.* In some jurisdictions that do not yet recognize the purchaser's equity of redemption, or where the purchaser is either unwilling or unable to redeem, a court may grant forfeiture but ameliorate it by applying restitution concepts. Thus, in return for forfeiture, the vendor will be required to refund the contract payments made by the purchaser to the extent that they exceed vendor's actual damages. These damages normally consist either of the loss of bargain value or the fair rental value of the premises during purchaser's possession, plus such incidental damages as repairs and the costs of resale.

(3) *Treatment as a mortgage.* A growing number of states hold that the contract for deed should be treated as a mortgage, at least in those cases where the purchaser's payments have been more than nominal. This approach affords the purchaser greater rights than the decisions that simply recognize a purchaser's equity of redemption. The latter cases generally give the purchaser in default the right to redeem by paying off the contract balance. However, if redemption does not occur, the land will be forfeited to the vendor. By comparison, under mortgage treatment the purchaser not only has the right to tardy redemption, but in addition, if no redemption occurs, the right in most jurisdictions to have the value of the land tested at a public foreclosure sale. If the property sells for more than the contract price, the purchaser has the right to the surplus. If the sale yields less than the contract debt the vendor, unless prohibited by statute, is entitled to a deficiency judgment.

c. Legislative regulation of the contract for deed. More than a dozen states have statutes governing contracts for deed. Some simply deal with non-substantive issues such as recording. At the other extreme, a few mandate that some or all contracts for deed be treated as mortgages. Most impose "grace periods" during which the purchaser can avoid forfeiture by payment of contract arrearages.

Some of these statutes also delineate non-judicial procedures by which the vendor can effect a termination of the purchaser's contract rights. They usually require service of notice of intent to forfeit on the purchaser and, less commonly, on others who have junior interests in the real estate. Notice by publication is also commonly required. If the purchaser cures the default within the statutory period, the contract is reinstated. Otherwise, the land and all prior payments are forfeited to the vendor.

Such arrearages statutes are a double-edged sword. On the one hand, they temper the harshness of forfeiture. On the other, they tend to put a legislative imprimatur on the forfeiture concept. Courts in such jurisdictions seem inclined to limit their intervention to ensuring that the technical requirements of the statute are satisfied. This preoccupation with procedure, while understandable, tends to discourage further judicial inroads on the forfeiture remedy or attempts at recharacterization of the contract for deed as a mortgage.

d. Rationale of this section. This section treats the contract for deed as a mortgage. Not only is the contract for deed governed procedurally and substantively by the law of mortgages, but the parties are permitted to vary that result by agreement only to the extent that parties to a normal mortgage transaction are so empowered. Several reasons support this position. First, to the extent that a discernable judicial trend in this area exists, it favors mortgage characterization. Recent decisions in several states, including Indiana, New York, and Kentucky have adopted this approach. Florida, in most situations, can also be included in this category. California decisions stop just short of this result. Several other states have accomplished total or partial mortgage treatment by statute.

In addition, in the states (probably a majority) that have chosen neither outright mortgage treatment nor statutory institutionalization of forfeiture, case law often affords insufficient guidance or predictability as to when forfeiture will be enforced. Consequently, title problems abound with contracts for deed. Indeed, in many jurisdictions the contract for deed affords the vendor a satisfactory method for reacquiring the real estate only if the purchaser fails utterly to assert his or her rights. Thus, only if the purchaser surrenders possession without having recorded the contract will the vendor be able to resell the real estate to a person who would qualify as a bona fide purchaser. On the other hand, a purchaser who records the contract poses a significant problem for the vendor. Even if the purchaser vacates the premises, and even assuming there is a strong probability a court would uphold forfeiture, the recording of a self-serving affidavit that forfeiture has occurred will probably not suffice to establish marketable title in the vendor. Instead, the vendor often faces the prospect of bringing a quiet title action or similar judicial proceeding to accomplish that result.

Numerous other perplexing substantive problems are obviated by treating the contract for deed as a mortgage. The use of vendor's and purchaser's interests for security purposes will be facilitated. Currently, for example, substantial controversy exists as to how a lender can perfect a security interest in a vendor's interest. To a lesser extent, similar problems exist for the lender who seeks to extend credit on the security of a contract purchaser's interest. Treatment of the contract for deed as a mortgage will clarify that Article 9 of the Uniform Commercial Code governs the acquisition and perfection of a security interest in a vendor's position. This will eliminate the uncertainty and risk currently associated with secured lending to a vendor. Moreover, taking a security interest in the purchaser's position will be no different than taking any other junior mortgage on a borrower's equity of redemption. In addition, the rights of judgment creditors against vendor or purchaser will be rendered more predictable and secure.

Finally, mortgage treatment will eliminate a difficult problem that arises during a purchaser bankruptcy. If a contract for deed is deemed an "executory contract" for purposes of § 365(a) of the Bankruptcy Code, the vendor may compel the purchaser-debtor to assume or reject the contract. If the purchaser assumes the contract, § 365(b) requires the purchaser to cure the default, compensate the vendor for any damages caused by it, and provide adequate assurance of future performance of the contract obligations. If the bankruptcy estate is unable to satisfy these requirements, the contract will be deemed rejected and the purchaser will lose the land. To the extent that the land is worth more than the contract balance, the surplus will inure to the vendor's benefit. On the other hand, if the contract for deed is treated as a mortgage, the foregoing Bankruptcy Code sections may not be invoked by the vendor, who will be treated just as any other mortgagee in the bankruptcy proceeding. Thus, the vendor will be entitled only to the contract balance and not the land itself.

One alternative to an outright mortgage approach is to condition mortgage treatment on the purchaser's having made substantial contract payments. This approach, however, is unsatisfactory. Predictability would be sacrificed in each case to the need for a court to make a determination of whether the purchaser's financial stake in the property is sufficient to justify mortgage treatment. Moreover, because some contracts would continue to be subject to forfeiture and the application of non-mortgage law, courts would be confronted with the unfortunate need to maintain two separate and distinct bodies of law governing security interests in real estate.

Widespread adoption of this section will undoubtedly eliminate the contract for deed's *raison d'etre.* Some may assert that the contract for deed affords an inexpensive and efficient method for a secured lender to terminate a borrower's interest upon default. The availability of forfeiture, it may be argued, encourages the extension of credit to those whose marginal creditworthiness would militate against the use of the mortgage or deed of trust. There is, however, a fundamental flaw in this reasoning. The answer to the credit problem lies not in perpetuating an unpredictable and problematic financing device that often falls far short of being efficient and inexpensive. The answer, instead, lies in bringing all real estate security transactions within the purview of mortgage law and in making mortgage foreclosure less time-consuming and costly. This goal has largely been accomplished in the substantial number of states where legislation accords the mortgagee the option of utilizing "power of sale" and other nonjudicial foreclosure methods as an alternative to the traditional judicial foreclosure proceeding.

This section is inapplicable to a lease with an option to purchase. Because an option does not impose an obligation on the optionee, it does not constitute a "contract for the purchase and sale of real estate" as contemplated by this section. On the other hand, to the extent that such a lease-option agreement accompanies an absolute conveyance and the parties intend the arrangement to serve as security for an obligation, mortgage treatment of the transaction under § 3.3 will be appropriate.

As noted in Comment *c* to this section, statutes in several states recognize and regulate the contract for deed as a distinct mortgage substitute and authorize forfeiture as a remedy for purchaser breach. To the extent that this section conflicts with such a statutory scheme, it will have no effect on the rights and remedies of the parties to a contract for deed transaction.

Concerns about the impact of a change in the law on existing contracts for deed need not pose a significant obstacle to the adoption of this section. To the extent that a court concludes that a retroactive application of this section would impose an undue hardship, it is appropriate to apply it prospectively only.

Illustrations:

1. Vendor and Purchaser enter into a contract to sell Blackacre for $50,000. Purchaser makes a down payment of $5,000 and agrees to pay the balance in five equal annual installments of $9,000 plus interest at 10 percent. Upon satisfactory completion of this obligation, the contract calls for delivery by Vendor to Purchaser of a deed to the premises. If Purchaser defaults, the contract gives Vendor the right to terminate the contract and to retain prior payments by Purchaser as liquidated damages. Purchaser has the right to possession during the pre-conveyance period. Purchaser defaults on the first annual installment and Vendor declares a termination of the contract. Two months later, Purchaser tenders to the Vendor $45,000, the contract balance, together with accrued interest. Vendor does not foreclose the contract as a mortgage. Forfeiture is unenforceable. The redemption is effective and Vendor will be required to deliver to Purchaser a deed to the premises.

2. The facts are the same as Illustration 1, except that after Vendor's declaration of contract termination, Purchaser is either unable or unwilling to tender the balance of the contract price. Forfeiture is unenforceable. Purchaser has the right to have the contract foreclosed as a mortgage.

3. The facts are the same as Illustration 1, except that Purchaser has no right to possession until after full payment of the contract has been completed. The contract is not a contract for deed and is not governed by this section.

4. The facts are the same as Illustration 2, except that a foreclosure of the real estate actually occurs and the foreclosure sale price exceeds the balance owing on the contract. The excess

should be paid to whoever is entitled to foreclosure sale surplus under § 7.4

5. The facts are the same as Illustration 4, except that the foreclosure sale yields less than the contract balance. To the extent that deficiency judgments are permissible under mortgage law in the jurisdiction, Vendor is entitled to a judgment for the difference between the foreclosure sale price and the contract balance.

e. Effect on other vendor remedies. Notwithstanding a traditional reliance on the forfeiture remedy, vendors under contracts for deed sometimes utilize other contract remedies. The primary alternative to forfeiture has been a vendor's suit for *specific performance for the price.* Under this approach, vendor tenders title to the real estate and the purchaser is ordered to pay the remainder of the contract purchase price. Some courts have conditioned this remedy on the presence in the contract of an acceleration clause, allowing the vendor to declare the entire price due and payable upon the purchaser's breach. Normally a vendor will be attracted to this remedy where the value of the land has dropped below the contract price and the purchaser has the financial ability to satisfy a judgment.

While it is often a less satisfactory alternative, vendors may sometimes sue for *damages,* measured by the difference between the contract price and the fair market value of the land as of the date of the purchaser's breach. This remedy is probably only realistic where the purchaser has abandoned possession of the land. This is so because where the use of the forfeiture remedy is necessary to regain possession, a subsequent action for damages might be barred by the election of remedies doctrine. In addition, the vendor faces the difficult task of convincing a fact-finder (usually a jury) that the land, as of the date of the breach, is worth less than the contract price. If the purchaser is capable of satisfying a judgment, the vendor is nearly always better advised to sue for specific performance for the price.

Because this section characterizes the contract for deed as a mortgage for all purposes, the foregoing contract remedies, as such, will be unavailable to the vendor. Nonetheless, mortgage law affords the vendor functionally equivalent remedies. For example, just as the mortgagee normally has the right to defer or forego foreclosure in favor of a suit on the obligation, the contract vendor will be able to do likewise for an amount equal to the contract price. Even where the absence of an acceleration clause would otherwise cast doubt on this remedy, the mere presence of a forfeiture clause should be a sufficient basis for a court to treat purchaser's default as an anticipatory repudiation of the whole contract. The net effect is that the vendor *qua* mortgagee will be entitled to a remedy that differs in name only from specific performance for the price. Moreover, to the extent that a deficiency judgment is available to a mortgagee where the foreclosure sale yields less than the mortgage obligation, so too will such a judgment be granted to the contract vendor after a foreclosure sale produces similar results. This mortgage remedy not only affords the vendor a practical substitute for a contract action for damages, but also gives the vendor the advantage of not having to prove the fair market value of the real estate, as would be required in an action for damages.

f. Mortgageability of the purchaser's interest. As the purchaser makes payments on the contract for deed, and especially if the land is increasing in value, the purchaser's interest becomes increasingly valuable. Thus, a purchaser will frequently seek to borrow money by using the real estate as security for the loan. A mortgage on the purchaser's interest is the economic and functional equivalent of a second mortgage, while the contract vendor's interest is analogous to a first purchase-money mortgage.

The overwhelming majority of cases take the position that the purchaser's interest is mortgageable. However, because lenders are often unclear about the nature of the purchaser's interest, there is little consensus about the proper method of taking a mortgage on it. While some lenders use traditional forms such as a mortgage or a deed of trust to effectuate a security interest in the purchaser's interest, others employ problematic devices such as an "assignment of purchaser's interest for security purposes" or other nonstandard arrangements.

Moreover, the cases have been less than uniform in affording the purchaser's mortgagee procedural protection when the vendor attempts to declare a forfeiture. For example, the majority of cases hold that a vendor cannot effect a forfeiture without first providing the purchaser's mortgagee (who has recorded) with notice of intention to enforce forfeiture and an opportunity to protect itself. On the other hand, a minority of decisions impose this duty to notify only where the vendor has actual knowledge of the interest of the purchaser's mortgagee. Consequently, in the latter situation, a traditional reliance on the recording system affords inadequate protection to those who have advanced secured credit to the purchaser.

By treating the contract for deed as a mortgage, this section eliminates the foregoing problems, and should encourage secured lending to contract purchasers. One who takes security in a purchaser's interest will become a junior mortgagee, with all the rights and responsibilities that mortgage law allocates to such mortgagees. Forfeiture will be just as ineffective against the junior mortgagee as it is against the purchaser. Only foreclosure of the contract for deed will be effective to eliminate the junior mortgagee, and recordation of the junior mortgage will ensure the junior's right to notice of a foreclosure of the prior contract.

Illustrations:

6. Purchaser and Vendor enter into a contract for deed for the sale of Blackacre for $50,000. The contract for deed contains a forfeiture clause. Vendor makes an initial payment of $10,000 and agrees to pay the balance at 12 percent interest in equal monthly payments over a 10-year period. Three years later, debt amortization has reduced the contract balance to $35,000 and the fair market value of Blackacre has increased to $75,000. Purchaser's equity of redemption at that point is worth $40,000. Purchaser then gives a mortgage on Blackacre to Bank to secure a $20,000 "home equity" loan. Purchaser holds title to Blackacre subject to a $35,000 first mortgage in favor of Vendor and a $20,000 second mortgage in favor of Bank.

7. The facts are the same as Illustration 6, except that shortly after Bank takes its second mortgage, Purchaser defaults under the contract for deed. Vendor will not be permitted to invoke forfeiture. If Vendor chooses to rely on its security interest in Blackacre, it must foreclose its contract for deed as a mortgage and Bank will be entitled to the procedural and substantive rights afforded to a junior mortgagee under applicable mortgage law. A purchaser at the foreclosure sale will acquire title to Blackacre free and clear of liens.

8. The facts are the same as Illustration 7, except that the Bank's mortgage, rather than the contract for deed, is defaulted upon. Bank then forecloses its mortgage. A purchaser at the foreclosure sale will acquire title to Blackacre subject to a first mortgage in favor of Vendor in an amount equal to its then current balance.

g. Clogging the purchaser's equity of redemption. Vendors frequently seek to obviate the uncertainty of the forfeiture remedy, and title problems associated with the purchaser's recording of a contract for deed, by requiring the purchaser to execute and deliver a quitclaim deed to the premises contemporaneously with the execution of the contract. Often the purchaser is required at the time of contract execution to deliver an executed quitclaim deed to an escrow agent. If the vendor notifies the escrow agent that the purchaser has defaulted and that the vendor elects to terminate the contract for deed, the escrow agent is authorized to record the deed. In an abbreviated version of this approach, the vendor, rather than an escrow agent, will hold the quitclaim deed and record it after the purchaser's default. As § 3.1(b) of this Restatement indicates, if, in a traditional mortgage transaction, a mortgagor delivers a deed to the mortgaged real estate to an escrow agent or to the mortgagee, contemporaneous with the execution of the mortgage, that deed will be deemed an invalid clog on the mortgagor's equity of redemption. Because this section treats the contract for deed as a mortgage and the purchaser as owning the equity of redemption, the use of a contemporaneous deed in the contract for deed setting should likewise be ineffective.

Illustrations:

9. In connection with the execution of a contract for deed, Purchaser delivers to Vendor a quitclaim deed to the real estate. The parties agree that "in the event of a default under the contract, Vendor shall have the right to record the deed, and upon so doing, Purchaser's interest in the real estate shall terminate immediately." Purchaser defaults, Vendor declares a termination of the contract and promptly records the quitclaim deed. A month later Purchaser tenders the full amount due and owing on the contract for deed. No foreclosure has occurred. The redemption is effective and the Vendor will be required to deliver to Purchaser a deed to the premises.

10. The facts are the same as Illustration 9, except that the quitclaim is delivered to an escrow agent with instructions that "upon Vendor informing escrow agent that Purchaser has defaulted under the contract, escrow agent shall record the deed and, upon such recording, Purchaser's interest in the real estate shall terminate immediately." Purchaser defaults and, upon being notified by Vendor, the escrow agent records the quitclaim deed. Three months later Purchaser tenders the full amount due and owing on the contract for deed. No foreclosure has occurred. The redemption is effective and Vendor will be required to deliver to Purchaser a deed to the premises.

REPORTERS' NOTE

Introductory note, Comment a. For a national and comparative perspective on the contract for deed, see Freyfogle, Vagueness and the Rule of Law: Reconsidering Installment Land Contract Forfeiture, 1988 Duke L.J. 609 (1988); Nelson and Whitman, Installment Land Contracts: The National Scene Revisited, 1985 B.Y.U. L. Rev. 1 (1985); Comment, Forfeiture: The Anomaly of the Land Sale Contract, 41 Albany L. Rev. 71 (1977). Treatises considering the contract for deed include 7 Powell, The Law of Real Property ch. 84D (Freyfogle Revision 1991); 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 3.26–3.37, 8.18 (3d ed. 1993). For more state-specific treatment, see Durham, Forfeiture of Residential Land Contracts in Ohio: The Need for Further Reform of a Reform Statute, 16 Akron L. Rev. 397 (1983); Mixon, Installment Land Contracts: A Study of Low Income Transactions, With Proposals for Reform and a New Program to Provide Home Ownership in the Inner City, 7 Houston L. Rev. 523 (1970); Warren, California Installment Land Sales Contracts: A Time for Reform, 9 U.C.L.A. L. Rev. 608 (1962); Comment, Remedying Inequities of Forfeiture in Land Installment Contracts, 64 Iowa L. Rev. 158 (1978); Comment, Florida Installment Land Contracts: A Time for Reform, 28 U. Fla. L. Rev. 156 (1975); Comment, Reforming the Vendor's Remedies for Breach of Installment Land Sales Contracts, 47 So. Cal. L. Rev. 191 (1973); Note, Forfeiture and the Iowa Installment Land Contract, 46 Iowa L. Rev. 786 (1961).

For decisions enforcing contract for deed forfeiture clauses, see Smith v. MRCC Partnership, 792 S.W.2d 301 (Ark.1990) (forfeiture upheld after five-year default where purchaser had paid slightly more than 10% of the contract price); Grombone v. Krekel, 754 P.2d 777 (Colo.Ct.App. 1988) (forfeiture enforced where purchaser defaulted repeatedly and equity in real estate was approximately 10% of its fair market value); Long v. Smith, 776 S.W.2d 409 (Mo.Ct.App. 1989) (forfeiture enforced where purchaser's payments on contract were proportionate to the rental value of the property); Burgess v. Shiplet, 750 P.2d 460 (Mont.1988) (trial court erred in treating contract for deed as mortgage and in failing to enforce forfeiture provision even though purchaser had paid almost 30% of the contract balance); Russell v. Richards, 702 P.2d 993 (N.M.1985) (forfeiture enforced against purchaser who was repeatedly in default, even though she had paid over 40% of the contract balance and had a substantial equity in the real estate); Johnson v. Maxwell, 554 N.E.2d 1370 (Ohio.Ct. App.1988) ("Forfeiture clauses contained in land installment contracts are enforceable in Ohio, so long as the resulting benefit to the vendor is not 'extravagantly unreasonable or manifestly disproportionate to the actual damages sustained' by the vendor.").

For other examples of forfeiture enforcement, see Hicks v. Dunn, 622 So.2d 914 (Ala.1993); Hamner v. Rock Mountain Lake, Inc., 451 So.2d 249 (Ala.1984); Curry v. Tucker, 616 P.2d 8 (Alaska 1980); Ellis v. Butterfield, 570 P.2d 1334 (Idaho Ct.1977), review denied, 572 P.2d 509 (1978); McEnroe v. Morgan, 678 P.2d 595 (Idaho.Ct.App.1984); Daugherty Cattle Co. v. General Construction Co., 839 P.2d 562 (Mont.1992); Jacobs v. Phillippi, 697 P.2d 132 (N.M.1985); Albuquerque National Bank v. Albuquerque Ranch Estates, Inc., 654 P.2d 548 (N.M.1982); Braunstein v. Trottier, 635 P.2d 1379 (Or.Ct.App.1981), review denied, 644 P.2d 1129 (1982); Stonebraker v. Zinn, 286 S.E.2d 911 (W.Va.1982); Treemont, Inc. v. Hawley, 886 P.2d 589 (Wyo.1994). But see Blakely v. Kelstrup, 883 P.2d 814

(Mont.1994), casting doubt on forfeiture when a vendee invokes Mont. Code Ann. § 28-1-104 which provides that a party may be relieved from forfeiture "upon making full compensation to other party, except in the case of a grossly negligent, willful, or fraudulent breach of duty."

Judicial restrictions on forfeiture, Comment b. For an extensive analysis of judicial limitations on the enforcement of forfeiture clauses, see 7 Powell, The Law of Real Property ¶¶ 938.20[3], 938.22 (Freyfogle Revision 1991).

Recognition of an equity of redemption, Comment b(1). A significant number of courts have held that the purchaser in default has the right to defeat forfeiture by tendering the balance due on the contract. While some view this right as unconditional, others appear to limit it to those situations where the purchaser has made significant payments on the contract or otherwise has a substantial equity in the property and has not been guilty of gross negligence or bad faith. See, e.g., Petersen v. Hartell, 707 P.2d 232 (Cal. 1985) ("[A] purchaser who has made substantial payments on a land installment contract or substantial improvements on the premises and whose defaults, albeit wilful, consist of solely of failure to pay further amounts due, has an unconditional right to a reasonable opportunity to complete the purchase by paying the entire remaining balance ... together with interest and any consequential damages as determined by the court." Absent such redemption, vendor must bring a foreclosure action); White v. Brousseau, 566 So.2d 832 (Fla.Dist.Ct.App.1990) ("Like the legal mortgagor, the land contract buyer has an 'equity of redemption' which is a right recognized in equity to redeem his land from the consequences of default in payment of debt secured by the land, by fully paying the debt at any time before the judicial sale of the land becomes final."); Jenkins v. Wise, 574 P.2d 1337 (Haw.1978) (reversing a trial court decree of forfeiture and granting purchasers specific performance where purchasers had paid 16% of the contract balance, and stating: "[W]here the purchaser's breach has not been due to gross negligence, or to deliberate or bad-faith conduct on his part, and the vendor can reasonably and adequately be compensated for his injury, courts in equity will generally grant relief against forfeiture and decree specific performance of the contract."); Nigh v. Hickman, 538 S.W.2d 936 (Mo.Ct.App.1976) (forfeiture deemed inappropriate and specific performance to tardy purchaser granted where purchaser had paid almost 35% of the contract balance). See generally 1 G. Nelson and D. Whitman, Real Estate Finance Law 100-106 (3d ed. 1993); 7 Powell, The Law of Real Property ¶ 938.23[3] (Freyfogle Revision 1991). See also Blakely v. Kelstrup, 883 P.2d 814 (Mont.1994) (suggesting that a tardy vendee may utilize Mont. Code Ann. § 28-1-104 to redeem by tendering "full compensation under the contract."); BankWest v. Groseclose, 535 N.W.2d 860 (S.D.1995) ("The parties have the option to limit available remedies in their contract; however, those choices cannot lead to automatic forfeiture without any avenue to cure the default." Court affirmed the trial court's grant of specific performance to tardy vendee).

Restitution to the purchaser, Comment b(2). Some courts condition the availability of forfeiture on the willingness of the vendor to return the payments received to the extent that they exceed the actual damages. The restitutionary remedy has seen its most significant development in California. See Petersen v. Hartell, 707 P.2d 232 (Cal. 1985) ("We conclude that the [purchasers] are entitled to a conveyance of title to the property in exchange for payment of the entire remaining balance due under the contract together with interest and any consequential damages as determined by the court. Should [purchasers] fail to make such payments within a reasonable time fixed by the court, the adjudication that [purchasers] have no further interest in the property should become effective only upon [vendor's] payment of the sums due to [purchasers] as restitution.") Under this approach, the vendor apparently has the option of measuring damages by either the "rental value" (giving restitution to the purchaser of the amount by which the purchaser's payments exceed the fair rental value of the property during purchaser's possession) or the "difference value" (awarding the purchaser the amount by which the payments exceed the difference between the current market value and the higher contract price). See Honey v. Henry's Franchise Leasing Corp., 415 P.2d 833 (Cal. 1966). According to Professor Hetland, "rarely over the past few decades has the value of property dropped so that the vendor prefers difference value to his alternative measure—rental value." J. Hetland, Secured Real Estate Transactions 52 (1974).

For other decisions recognizing the restitutionary remedy, see, e.g., Moran v. Holman, 501 P.2d 769 (Alaska 1972); Randall v. Riel, 465 A.2d 505 (N.H.1983); Bellon v. Malnar, 808 P.2d 1089 (Utah 1991); Morris v. Sykes, 624 P.2d 681 (Utah 1981); Clampitt v. A.M.R. Corp., 706 P.2d 34 (Idaho 1985); Howard v. Bar Bell Land & Cattle Co., 340 P.2d 103 (Idaho 1959); K. M. Young & Associates v. Cieslik, 675 P.2d 793 (Haw. Ct. App. 1983). Under the Utah cases, for example, the vendor's damages consist of the fair rental value of the real estate during the purchaser's possession plus such incidental damages as repairs and resale costs. See, e.g., Weyher v. Peterson, 399 P.2d 438 (Utah 1965). Restitution is frequently denied, however, because the foregoing items exceed the purchaser's contract payments. See, e.g., Park Valley Corp. v. Bagley, 635 P.2d 65 (Utah 1981); Strand v. Mayne, 384 P.2d 396 (Utah 1963).

Moreover, even where purchaser's payments exceed the vendor's damages, courts may grant forfeiture and deny restitution unless that excess is significant. See, e.g., Clampitt v. A.M.R. Corp., 706 P.2d 34 (Idaho 1985) ("When comparing the $747,100 in actual damages to $752,874 [purchaser's payments], the amount forfeited under the liquidated damages clause in this case appears fair and reasonable"); Warner v. Rasmussen, 704 P.2d 559 (Utah 1985) (where purchaser's payments were 6% greater than vendor's damages, it was not deemed "unconscionable" to deny restitution to the purchaser). After a series of cases in which the South Dakota Supreme Court endorsed the application of restitution ("equitable adjustment") in contract for deed termination settings, the legislature repealed the statutory basis for its use. See Schultz v. Jibben, 513 N.W.2d 923 (S.D.1994).

Treatment as a mortgage, Comment b(3). In several states, the judicial movement is toward outright treatment of contracts for deed as mortgages, with foreclosure representing the exclusive means by which a vendor realizes on his or her security interest in the real estate. Indiana case law is most developed in this regard. In Skendzel v. Marshall, 301 N.E.2d 641 (Ind. 1973), the vendor sought a judicial declaration of forfeiture against a tardy purchaser who had already paid $21,000 out of a $36,000 contract price. In ordering that the contract be foreclosed in accordance with Indiana mortgage procedure, the Indiana Supreme Court stated that "conceptually, the retention of the title by the vendor is the same as reserving a lien or mortgage. Realistically, vendor-purchaser should be viewed as mortgagee-mortgagor. To conceive of the relationship in different terms is to pay homage to form over substance." The court limited forfeiture to cases of abandoning purchasers or to situations where a minimal amount has been paid and the purchaser seeks to retain possession while the vendor is making expenditures for taxes, insurance, and maintenance. For subsequent decisions denying forfeiture and ordering judicial foreclosure, see Looney v. Farmers Home Administration, 794 F.2d 310 (7th Cir.1986) (in applying Indiana law, foreclosure, not forfeiture, should have been ordered, even though purchaser had paid only $640 of a $250,000 contract price, where purchaser had also paid over $122,000 in interest, and appreciation in the land value created a $9,000 equity); Tidd v. Stauffer, 308 N.E.2d 415 (Ind. Ct.App.1974) (where purchasers had paid $23,000 out of a $39,000 contract balance, forfeiture was denied and judicial foreclosure was ordered unless purchaser tendered the contract balance); Parker v. Camp, 656 N.E.2d 882 (Ind.Ct.App.1995) (contract provision which permitted the vendor to obtain forfeiture until vendee had paid 75% of the purchase price void as a matter of public policy and inconsistent with *Skendzel*). But see Donaldson v. Sellmer, 333 N.E.2d 862 (Ind.Ct.App.1975) (forfeiture decree affirmed where purchaser had paid $7,000 out of a $23,158 contract price, but had failed to make repairs or to maintain insurance on the premises); Phillips v. Nay, 456 N.E.2d 745 (Ind. App.1983) (forfeiture decree sustained where less than 10% of contract price paid and purchaser failed to insure or pay real estate taxes).

The Nebraska Supreme Court, while not yet holding that contracts for deed are mortgages for all purposes, has increasingly subjected them to mortgage law analysis. See, e.g., Mackiewicz v. J.J. & Associates, 514 N.W.2d 613 (Neb.1994) ("We have refused to strictly enforce the traditional remedy of forfeiture ... in favor of recognizing the right of a seller to foreclose as if the contract were a mortgage.... Because this court has uniformly recognized that a seller in a land contract retains the title as security for the unpaid purchase money and has an equitable lien on the land to the extent of the debt, a seller has, for all intents and purposes, a purchase-money mortgage.").

New York intermediate appellate courts have taken a similar approach. In Bean v. Walker, 464 N.Y.S.2d 895 (N.Y.App.Div.1983), the tardy purchasers had made almost half of the payments on a $15,000 contract for deed and had made substantial improvements to the real estate. The New York Supreme Court, Appellate Division, finding "no reason why these purchasers should be treated any differently than the mortgagor at common law," reversed a trial court forfeiture decree and held that the "vendors may not summarily dispossess the purchasers of their equitable ownership without first bringing an action to foreclose the purchasers' equity of redemption." It nevertheless noted that forfeiture may be appropriate in the limited circumstances identified by the Indiana decisions. See also Call v. LaBrie, 498 N.Y.S.2d 652 (N.Y.App.Div.1986) (payment by purchaser of over 12% over the contract price deemed sufficient to convert contract for deed into an equitable mortgage); Madero v. Henness, 607 N.Y.S.2d 153 (N.Y.App.Div.1994), appeal dismissed, 637 N.E.2d 279 (N.Y. 1994) (even though vendees who had paid over 1/3 of the contract price were in default, "given that ... their interest had not been foreclosed, [the trial court] was eminently correct in ordering [vendor] to accept the insurance proceeds in payment of [vendees'] remaining obligations under the contract.").

The most unqualified support for treating the contract for deed as a mortgage can be found in Sebastian v. Floyd, 585 S.W.2d 381 (Ky.1979). In reversing a decree of forfeiture where the purchaser had paid almost 40 percent of the contract price, the Kentucky Supreme Court recognized a "modern trend ... to treat land sale contracts as analogous to conventional mortgages, thus requiring a seller to seek a judicial sale of the property upon buyer's default." Moreover, the opinion contained none of limitations on the foreclosure suggested by the Indiana approach.

While the Florida Supreme Court has not yet held that a purchaser has an absolute right to insist on foreclosure of a contract for deed, the case law surely points in that direction. Several Florida decisions recognize a tardy purchaser's right to redemption or specific performance. See, e.g., White v. Brousseau, 566 So.2d 832 (Fla.Dist.Ct.App.1990); Hoffman v. Semet, 316 So.2d 649 (Fla.Dist.Ct. App.1975); H & L Land Co. v. Warner, 258 So.2d 293 (Fla.Dist.Ct.App. 1972). Moreover, numerous Florida cases state, in a variety of contexts, that a contract for deed is a mortgage and that it must be foreclosed by judicial sale. See, e.g., Kubany v. Woods, 622 So.2d 22 (Fla.Dist.Ct. App.1993) ("This agreement for deed is treated under Florida law as a mortgage and is subject to the same rules of foreclosure."); Luneke v. Becker, 621 So.2d 744 (Fla.Dist.Ct. App.1993) ("[T]he vendor ... has no right to repossess the property; the vendor must proceed with a foreclosure action.... Accordingly, the proper remedy in this case was not ejectment, but a foreclosure action"); White v. Brousseau, 566 So.2d 832 (Fla.Dist.Ct App.1990) ("An equity judgment may not, in a quiet title action, 'cancel' a land contract buyer's equitable title or otherwise decree a forfeiture of the buyer-debtor's interest in land in favor of the seller-creditor. The land contract must be foreclosed in equity in the same manner as provided for foreclosure of mortgages and the equitable title of the land contract buyer, like the legal title of a mortgagor, terminated by judicial sale"); Ricard v. Equitable Life Assurance Society, 462 So.2d 592 (Fla.Dist.Ct.App.1985).

California case law is in a similar state. In Petersen v. Hartell, 707 P.2d 232 (Cal. 1985), the California Supreme Court specifically rejected the urging of its then Chief Justice to make foreclosure the sole remedy against a defaulting purchaser irrespective of whether substantial contract payments had been made. Because the purchasers in that case had made significant contract payments and neither sought such relief nor were unwilling to tender the contract balance, the court concluded that "sound development of the law in this complex area can best be assured by limiting our holdings to the issues necessarily presented for decision." Nevertheless, there is a strong likelihood that, if the issue is squarely presented to it, the California Supreme Court will conclude that purchaser has the right to foreclosure of a contract for deed in default.

In Oklahoma, a statute provides that contracts for deed shall be "deemed and held mortgages, and shall be subject to the same rules of foreclosure and to the same regulations, restraints and forms as are prescribed in relation to mortgages." 16 Okla. Stat. Ann. § 11A. The effect of this statute is to treat all contracts for deed as mortgages and to make the forfeiture remedy unavailable. A vendor's sole remedy with respect to the land will be foreclosure. See Kershen, Contracts for Deed in Oklahoma: Obsolete, But Not Forgotten, 15 Okla. City L. Rev. 715 (1990) ("If attorneys use contracts for deed to transfer Oklahoma real estate, they have not accomplished legally anything different under Oklahoma law, than if they had used a deed and mortgage"); Comment, The Decline of the Contract for Deed in Oklahoma, 14 Tulsa L.J. 557 (1979).

In Colorado, trial courts have the discretion to require that a contract for deed be foreclosed as a mortgage. See Grombone v. Krekel, 754 P.2d 777 (Colo.Ct.App.1988) ("The decision whether an installment land contract is to be treated as a mortgage is committed to the sound discretion of the trial court, based on the facts presented.... There are numerous Colorado decisions which have required that an installment land contract must be foreclosed as a mortgage.... There are also many cases which have refused to treat such an agreement as a mortgage.... The factors to be used by the trial court in determining whether to treat an installment land contract as a mortgage include the amount of the purchaser's equity in the property, the length of the default period, the willfulness of the default, whether the purchaser has made improvements, and whether the property has been adequately maintained.").

Legislative regulation of the contract for deed, Comment c. For a general overview of contract for deed legislation, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.28 (3d ed. 1993).

STATUTORY NOTE

Arizona: Ariz. Rev. Stat. Ann. §§ 33-741-33-749. Forfeiture remedy is available to a vendor against a purchaser who fails to pay one or more installments under the contract. Vendor must serve purchaser with notice of election to forfeit and purchaser may reinstate the contract by payment of arrearages within a time period which varies from 30 days to nine months, based on the percentage of the contract price that has been paid as of the time of default. If the contract contains an acceleration clause and the vendor accelerates, the contract may not be reinstated by payment of arrearages, but the vendor may only foreclose the contract as a mortgage.

Illinois: Ill. Ann. Stat. ch. 110, ¶ 15-1106, ¶ 9-102. A vendor must foreclose a contract for deed entered into after November 23, 1987, as a mortgage if the property is residential, the contract period is greater than five years and the amount due under the contract is less than 80 percent of the contract price. As to other contracts, forfeiture is available after notice through a "Forcible Entry and Detainer" proceeding.

Iowa: Iowa Code Ann. §§ 656.1-656.7. Forfeiture remedy is available to a vendor who provides written notice to defaulting purchaser that specifies the contract terms that are in default and informs the purchaser that he or she has 30 days "to perform the terms of default." If the purchaser fails to perform within this period, a notice of forfeiture may be recorded and will constitute constructive notice of the completed forfeiture.

Louisiana: La. Rev. Stat. Ann. 9:2941 et seq. Non-judicial cancellation of a contract for deed is available to a vendor after giving the purchaser written notice and a 45-day period in which to cure the default. The purchaser may cure by paying "as provided in the bond for deed." A contract for deed may be used only in extremely limited circumstances. The foregoing statute limits the contract for deed for use only for first purchase money transactions; it is unlawful to use it in other contexts unless senior mortgage holders consent. La. Rev. Stat. Ann. 9:2942, 2946.

Maryland: Md. Real Prop. Code Ann. §§ 10-101-10-108; Md.R.P. W79. A vendor must foreclose a contract for deed for the sale of residential real estate in the same manner as foreclosure of a mortgage.

Michigan: Mich. Comp. Laws Ann. § 606.5726. Summary proceedings to recover possession are available "after forfeiture of an executory contract for the purchase of the premises but only if the terms of the contract expressly provide for termination or forfeiture, or give the vendor the right to declare a forfeiture, in consequence of the nonpayment of any moneys required to be paid under the contract or any other material breach of the contract. For purposes of this chapter, moneys required to be paid under the contract shall not include any accelerated indebtedness by reason of breach of the contract."

Minnesota: Minn. Stat. Ann. § 559.21. Termination of a contract for deed is authorized after written notice and a grace period during which the purchaser may cure the default by payment of arrearages, costs, and statutory attorney's fees. The length of the grace period varies from 30 to 90 days depending on the percentage of the contract price paid at the time of default.

North Dakota: N.D. Cent. Code §§ 32-18-01 to 32-18-06. Cancellation of a contract for deed is authorized after written notice and a grace period during which the purchaser may cure by performing "the conditions" or complying "with the contract provisions upon which the default shall have occurred" and paying "the costs of service of notice." The length of the grace period varies from six months to one year depending on the percentage of the contract price paid at the time of default.

Ohio: Ohio Rev. Code §§ 5313.01-5313.10. Contracts for deed on "property improved by a dwelling" are categorized in two ways: those that have been in effect less than five years and on which less than 20 percent of the principal amount has been paid; and those which have been in effect five years or more or on which 20 percent or more has been paid. In the former situation, forfeiture is authorized, but subject to a 30-day grace period during which purchaser may avoid forfeiture by payment of arrearages. In the latter setting, the contract must be foreclosed as a mortgage.

Oklahoma: Okla. Stat. Ann. tit.16, § 11A. Contracts for deed are "deemed and held mortgages, and shall be subject to the same rules of foreclosure and to the same regulations, restraints and forms as are prescribed in relation to mortgages."

Oregon: Or. Rev. Stat. §§ 93.905–93.940. The forfeiture remedy is available against a purchaser in default after written notice and the expiration of a grace period during which the purchaser may cure the default by payment of arrearages. The grace period varies from 60 to 120 days depending on the percentage of the contract price paid at the time of the default. After the grace period expires and the vendor exercises the forfeiture remedy, no tender or offer of performance will reinstate the contract. Vendor is entitled to possession on the 10th day after a declaration of forfeiture is recorded.

Pennsylvania: Pa. Con. Stat. Ann. §§ 901–911. Termination is available against a purchaser upon default after written notice to the purchaser and a minimum 30-day period during which the purchaser may cure the default. A purchaser who voluntarily surrenders possession and has paid more than 25 percent of the contract price has limited restitution rights against the vendor.

Texas: Tex. Prop. Code §§ 5.061–5.063. Forfeiture is available against a purchaser upon default after written notice to the purchaser and a grace period during which the purchaser may cure the default by payments of arrearages. The grace period varies from 15 to 60 days depending on the percentage of the contract price paid at the time of default.

Washington: Wash. Rev. Code §§ 61.30.010–61.30.911. Forfeiture is available against a defaulting purchaser after a notice of intent to forfeit is recorded in the county where the contract land is located and is given to purchaser and others having a junior interest within 10 days of its recording. There is a right to cure by payment of arrearages for 90 days after the notice of intent to forfeit has been recorded. The purchaser has the right to request a court order of public sale of the land if its fair market value substantially exceeds the obligation owed on the contract. Any surplus from such a sale belongs to the purchaser. If no cure is made, a recording of a notice of cancellation of the contract gives effect to the forfeiture.

Rationale of this section, Comment d. For a consideration of the title problems for both vendor and purchaser incident to contract for deed use, see Mixon, Installment Land Contracts: A Study of Low Income Transactions, With Proposals for Reform and a New Program to Provide Home Ownership in the Inner City, 7 Houston L. Rev. 532, 545–546 (1970); Nelson, The Use of Installment Land Contracts in Missouri—Courting Clouds on Title, 33 J. Mo. Bar 161, 164 (1977); Warren, California Installment Land Sales Contracts: A Time for Reform, 9 U.C.L.A. L. Rev. 608 (1962). See generally 7 Powell, The Law of Real Property ¶¶ 938.25, 938.26 (Freyfogle Revision 1991).

For a consideration of the problems associated with taking security interests in contract for deed interests, see 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 3.35–3.37 (3d ed. 1993).

Courts are sharply divided on the question of whether a contract for deed should be deemed an "executory contract" in a purchaser bankruptcy proceeding. Compare In re Streets & Beard Farm Partnership, 882 F.2d 233 (7th Cir.1989); Heartline Farms, Inc. v. Daly, 128 B.R. 246 (D.Neb. 1990), affirmed, 934 F.2d 985 (8th Cir.1991); and In re Kratz, 96 B.R. 127 (Bankr.S.D.Ohio 1988) (treating the contract for deed as a mortgage or security device) with In re Terrell, 892 F.2d 469 (6th Cir.1989); In re Speck, 798 F.2d 279 (8th Cir.1986); In re Jones, 186 B.R. 71 (Bankr.W.D.Ky. 1995); In re Miskowski, 182 B.R. 5 (Bankr.M.D.Pa.1995) and In re Scanlan, 80 B.R. 131 (Bankr.S.D.Iowa 1987) (viewing the contract for deed as an executory contract). See generally Moringiello, A Mortgage by Any Other Name: A Plea for the Uniform Treatment of Installment Land Contracts and Mortgages Under the Bankruptcy Code, 100 Dickinson L. Rev. 733 (1996); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 8.19 (3d ed. 1993).

Effect on other vendor remedies, Comment e. For an analysis of vendor's non-forfeiture remedies, see 7 Powell, The Law of Real Property ¶ 938.22[3] (Freyfogle Revision 1991); 1 G. Nelson and D. Whitman, Real Estate Finance Law § 3.32 (3d ed. 1993).

Mortgageability of the purchaser's interest, Comment f. The overwhelming majority of cases hold that a purchaser's contract for deed interest is mortgageable. See Davis & Son v. Davis, 6 So. 908 (Ala.1889); Petz v. Estate of Petz, 467 N.E.2d 780 (Ind. Ct.App.1984); Stannard v. Marboe, 159 Minn. 119, 198 N.W. 127 (1924); Fincher v. Miles Homes, Inc., 549 S.W.2d 848 (Mo.1977); O'Neill Production Credit Association v. Mitchell, 307 N.W.2d 115 (Neb.1981); Shindledecker v. Savage, 627 P.2d 1241 (N.M.1981); Merchants Bank of Rugby v. Haman, 378 N.W.2d 869 (N.D.1985); Dirks v. Cornwell, 754 P.2d 946 (Utah.Ct.App.1988); Butler v. Wilkinson, 740 P.2d 1244 (Utah 1987); Bill Nay & Sons Excavating v. Neeley Construction Co., 677 P.2d 1120 (Utah 1984); Kendrick v. Davis, 452 P.2d 222 (Wash.1969); In re Jones, 186 B.R. 71 (Bankr.W.D.Ky. 1995); In re Willingham, 139 B.R. 670 (Bankr.N.D.Ohio 1991). But see Arkansas Supply, Inc. v. Young, 580 S.W.2d 174 (Ark.1979) (purchaser who had paid only $150 of a $15,000 contract for deed price did not possess a mortgageable interest).

Where the vendor has actual knowledge of the purchaser's mortgagee, vendor cannot enforce a forfeiture without first providing the purchaser's mortgagee with notification of an intent to forfeit and an opportunity to cure the default. See, e.g., Credit Finance, Inc. v. Bateman, 660 P.2d 869 (Ariz.Ct.App.1983); Yu v. Paperchase Partnership, 845 P.2d 158 (N.M.1992); Fincher v. Miles Homes, Inc., 549 S.W.2d 848 (Mo.1977); Stannard v. Marboe, 198 N.W. 127 (Minn. 1924); Kendrick v. Davis, 452 P.2d 222 (Wash.1969). But see Estate of Brewer v. Iota Delta Chapter, Tau Kappa Epsilon Fraternity, Inc., 692

P.2d 597 (Or. 1984) (vendor has no obligation to provide notice to the purchaser's mortgagee even where the vendor has actual knowledge of the mortgagee's existence).

Where such actual knowledge is absent, courts disagree as to whether recording by the purchaser's mortgagee constitutes constructive notice to the vendor. For the view that such recording is effective, see, e.g., Stannard v. Marboe, 198 N.W. 127 (Minn. 1924); Note, Mortgages—Mortgage of a Purchaser's Interest in an Installment Land Contract—Mortgagee's Rights Upon Default, 43 Mo. L. Rev. 371 (1978). Other authority holds that, absent actual knowledge of the mortgagee's existence, the vendor is not obligated to notify the mortgagee of the forfeiture. See, e.g., Shindledecker v. Savage, 627 P.2d 1241 (N.M.1981); Dirks v. Cornwell, 754 P.2d 946 (Utah.Ct.App.1988); Kendrick v. Davis, 452 P.2d 222 (Wash.1969). Under the latter approach, recording constitutes notice only to those who take an interest in the land subsequent to a recording and not to those whose interest antedates that recording. Where such reasoning prevails, the mortgagee, in order to be protected, must give actual notice to the vendor at or after the time the mortgage is taken.

Clogging the purchaser's equity of redemption, Comment g. For consideration of the application of the clogging prohibition to the contract for deed, see 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.31 (3d ed. 1993).

§ 3.5 Negative Covenant Does Not Create a Mortgage

In the absence of other evidence of intent to create a mortgage, a promise by a debtor to a creditor not to encumber or transfer an interest in real estate does not create a mortgage, equitable lien, or other security interest in that real estate.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 1.2, No Consideration Required; § 1.3, Mortgages Securing Obligations of Nonmortgagors; § 1.4, Obligation Must Be Measurable in Monetary Terms; § 1.5, Description of the Mortgagee and the Mortgage Obligation; § 3.2, The Absolute Deed Intended as Security; § 3.3, The Conditional Sale Intended as Security.

Comment:

a. Reasons for use of the negative covenant. Lenders sometimes require, incident to a loan transaction, that their debtors covenant not to encumber or transfer specific real estate. Such promises may also be exacted from debtors to reassure creditors who have previously advanced unsecured credit. These agreements are usually recorded. Lenders apparently believe such negative covenants afford them, in the event of a borrower's default, the option of proceeding either as secured or unsecured creditors. Should the defaulting borrower have sufficient assets to satisfy a judgment, the lender supposedly may opt for unsecured creditor status. By pursuing this course of action, lenders in some jurisdictions hope to avoid significant substantive and procedural limitations on their remedies. These debtor protections include, in several states a "one action" rule, under which a debt secured by real estate must first be foreclosed and any deficiency must be sought in the foreclosure proceeding. On the other hand, where the debtor lacks other assets, the creditor wants the option, notwithstanding the foregoing limitations, to proceed against the "negative covenant" real estate as a mortgagee.

b. Rationale of the section. This section reflects the judicial consensus that neither a mortgage nor an equitable lien arises from a covenant by a debtor to refrain from encumbering or transferring specific real estate. Only if the negative covenant is accompanied by specific language of grant or conveyance or by words such as "mortgage," "security," "security interest," "lien," or language of similar import to refer to the lender's interest, will extrinsic evidence normally be admissible to establish that a mortgage in real estate was intended. Even then, for example, such a word as "security" may refer simply to the layperson's notion of "feeling more secure" rather than to the creation of a lien on specific real estate.

Nor does it make a difference if the negative covenants are accompanied by a debtor's assignment or mortgage of rents from the affected real estate. While such an assignment or mortgage may generally be effective to perfect a security interest in the rents from the real estate, standing alone it creates no security interest in the real estate itself. See § 4.2.

Note, however, that this section takes no position on the extent to which a violation of a negative covenant subjects the debtor to an action for damages or equitable relief. Nor does this section eliminate all risks for a subsequent lender who is on notice of the debtor's negative covenant. Conceivably, such a lender may be enjoined from taking a mortgage from the debtor or may be answerable in damages for tortious interference with contractual relations.

Illustrations:

1. Debtor executes a promissory note to Bank-1 in the amount of $50,000. Debtor also executes an instrument entitled "Covenant Not to Encumber or Convey Certain Real Estate." This instrument identifies Blackacre and provides that "so long as Debtor remains indebted to Bank-1, Debtor will not cause any mortgage or lien to be placed on Blackacre or transfer any interest in it." Bank-1 immediately records the instrument. A few months thereafter, Debtor gives a mortgage on Blackacre to

Bank-2. Debtor then defaults on the indebtedness to Bank-1. Bank-1 accelerates the indebtedness and brings suit to foreclose on the instrument. Bank-2 asserts that Bank-1 has no lien on Blackacre. The instrument cannot be construed to create a mortgage or other lien on Blackacre. Extrinsic evidence to show that the parties intended the instrument to serve as a mortgage or other lien on Blackacre is inadmissible.

2. The facts are the same as Illustration 1 except that the instrument also contains language by which Debtor "assigns, pledges, and transfers all rents and profits from Blackacre effective upon default by debtor in its indebtedness to Bank-1." The instrument cannot be construed to be a mortgage or other lien on Blackacre. Extrinsic evidence to show that the parties intended the instrument to serve as a mortgage or other lien on Blackacre is inadmissible.

3. The facts are the same as Illustration 2 except that the instrument also contains language that states: "This instrument represents security for performance of the obligation described herein." Extrinsic evidence is admissible to show that the parties intended the instrument to serve as a mortgage or other lien on Blackacre.

REPORTERS' NOTE

Reasons for use of negative covenant, Comment a. For a consideration of lender motivation for the use of the negative covenant, see J. Hetland, Secured Real Estate Transactions, 73 (1974) (characterizing the use of the negative covenant in California as an "attempted have-their-cake and eat-it-too device."); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 3.38 (3d ed. 1993); Reichman, The Anti-Lien: Another Security Interest in Land, 41 U. Chi. L. Rev. 685 (1974).

Rationale of the section, Comment b. Until recently, there was little suggestion that a covenant not to encumber or transfer specific real estate creates any type of security interest in that real estate. Rather, the "creation of a lien" is deemed "an affirmative act, and the intention to do such an act cannot be implied from an express negative." Knott v. Shepherdstown Manufacturing Co., 5 S.E. 266 (W.Va.1888). See also Palmeri v. Allen, 299 A.2d 552 (Conn. Ct. 1972); Western States Finance Co. v. Ruff, 215 P. 501 (Or.1923); Kuppenheimer & Co. v. Mornin, 78 F.2d 261 (8th Cir.1935). On the extent to which a debtor may be subject to legal or equitable relief upon violation of such a covenant and a third person with notice may be enjoined from taking a mortgage, see Coast Bank v. Minderhout, 392 P.2d 265 (Cal. 1964); G. Osborne, Mortgages § 43 (1970).

However, this analysis was rendered less certain by the California Supreme Court by its decision in Coast Bank v. Minderhout, 392 P.2d

265 (Cal. 1964). That opinion suggested that a purely negative covenant could be the basis for the creation of an equitable mortgage. The agreement in that case was executed contemporaneously with a promissory note covering some small loans and contemplated future advances. Under the agreement, the debtor promised not to sell or encumber certain described real estate until all of his indebtedness had been satisfied. Upon debtor default either in payment or under the negative covenants the bank was authorized to accelerate the entire indebtedness. Although recording of the agreement was also authorized, it contained no language suggesting that the parties intended to create a lien on real estate. The bank in fact recorded the agreement. Thereafter, while still indebted, debtor conveyed the real estate without the knowledge or consent of the bank. After the debtor also defaulted on the indebtedness, the bank accelerated and brought an action to foreclose the agreement as an equitable mortgage. The debtor entered a general demurrer and failed to answer the bank's allegation that the parties intended to create a lien on the real estate. A lower court decree of foreclosure was entered and was affirmed on appeal. According to the California Supreme Court,

> the question presented is not what meaning appears from the face of the instrument alone, but whether the pleaded meaning is one to which the instrument is reasonably susceptible.... It is essentially the question that would be presented had [debtor] denied that the parties intended to create a security interest and [bank] had offered extrinsic evidence to prove that they did. Such evidence would be admissible to interpret the instrument, but not to give it a meaning to which it is not reasonably susceptible.... The instrument restricts the rights of the [debtor] in dealing with [the] property for [bank's] benefit; it describes itself as "For use with Property Improvement Loan," it specifically sets forth the property it covers, and it authorizes [bank] to record it. These provisions afford some indication that the parties intended to create a security interest and are clearly sufficient to support the pleaded meaning.

On the other hand, seven years later the same court in Tahoe National Bank v. Phillips, 480 P.2d 320 (Cal. 1971), interpreting a similar agreement, held that no lien was created. *Tahoe* involved an attempt by the bank to foreclose as a mortgage an instrument entitled "Assignment of Rents and Agreement Not to Sell or Encumber Real Property." Unlike *Coast Bank*, the debtor had not conveyed or sold the real estate in question, but instead had declared a homestead exemption on it. The court determined that the *Tahoe* format was not customarily used to create a security interest in real estate and that it was not "reasonably susceptible of interpretation" "as a mortgage." According to the court,

> to permit a creditor to choose an allegedly ambiguous form of agreement, and then by extrinsic evidence seek to give it the effect of a different and unambiguous form, would be to disregard totally the rules respecting interpretation of adhesion contracts, and to create an extreme danger of over-reaching on the part of creditors with superior bargaining positions.

Since the bank was the party that dictated the documents, it was required

> to bear the responsibility for the creation and use of the assignment it now claims as ambiguous; it is only 'poetic justice' ... if such ambiguity is construed in favor of the borrower. Legal alchemy cannot convert an assignment into an equitable mortgage, violating the customer's reasonable expectation and bestowing upon the bank the riches of an hypothecation of title.... [W]e are not dealing with homemade security instruments in which the parties labor to produce a mortgage but fall short of the legal requirements and must be rescued by a court of equity. The form used was carefully drafted to produce a security interest with incidents differing from that of a mortgage.

Subsequent California Court of Appeals decisions evidenced significant difficulty in dealing with the ambiguities created by *Coast Bank* and *Tahoe.* In Kaiser Industries v. Taylor, 94 Cal.Rptr. 773 (Cal.Ct.App.1971), the court followed *Coast Bank* and held that a letter of instructions incident to a loan transaction, containing an agreement not to transfer or encumber certain real estate was "reasonably susceptible" of interpretation as an equitable mortgage. *Kaiser* involved the application of the California "one-action" rule. The creditor had initially sued on the debt and the trial court entered a judgment in the creditor's favor. On appeal, the Court of Appeal determined that because an equitable mortgage existed, the "one-action" rule authorized no creditor remedy other than foreclosure. On the other hand, in Orange County Teachers Credit Union v. Peppard, 98 Cal.Rptr. 533 (Cal.Ct.App.1971), the California Court of Appeals held that an agreement that was similar to the ones in *Coast Bank* and *Tahoe* was not "reasonably susceptible" to a construction creating an equitable mortgage.

The United States Court of Appeals for the Ninth Circuit also experienced difficulty with the California Supreme Court's approach to negative covenants. In Browne v. San Luis Obispo National Bank, 462 F.2d 129 (9th Cir.1972), the debtor signed a promissory note and an instrument entitled "Assignment of Rents and Agreement Not to Sell or Encumber Real Property" covering a lot she owned. The bank promptly recorded the instrument. Later she went into bankruptcy, listed the bank as an unsecured creditor and claimed that her real estate was exempt as a homestead. The homestead exemption was granted and she received a bankruptcy discharge. Almost two years later the bank commenced a proceeding in a California trial court to foreclose an equitable mortgage it purported to hold on her real estate. She returned to bankruptcy court to seek an injunction against the foreclosure proceeding. Ultimately the case reached the Ninth Circuit and that court held that no mortgage had been created. The court stated:

> The *Tahoe* document, like the document here, contained no hint of any power of foreclosure. None of the covenants purported to create a lien; its language was inconsistent with that interpretation. Given *Tahoe* and the lack of any evidence that [debtor] intended to create a security interest, there can be no doubt that the bank never obtained any mortgage or lien, equitable or otherwise, upon [debtor's] property.

Whatever the current status of *Coast Bank* and its "reasonable susceptibility" approach to negative covenants, this section rejects its suggestion that extrinsic evidence can generally be used to show that such covenants were intended to create a security interest in real estate. Rather the section bars such use unless the agreement containing the negative covenants also contains the traditional specific language of mortgage creation described in Comment *b*. Stated slightly differently, negative covenants, without such additional specific language, cannot be interpreted to create a mortgage or other lien on real estate, equitable or otherwise.

This approach is consistent with the rejection of *Coast Bank* by virtually all subsequent non-California decisions. These decisions reflect a general judicial unwillingness to permit negative covenants to become the vehicle for mortgage or lien creation. See Weaver v. Tri City Credit Bureau, 557 P.2d 1072 (Ariz.Ct.App. 1976) (*Coast Bank* deemed "weak"; equitable mortgage may be established only where the parties tried to create a mortgage but failed for technical reasons to do so); Equitable Trust Co. v. Imbesi, 412 A.2d 96 (Md. 1980) (the intent to create a lien cannot be implied from an express negative covenant, and where the instrument is plain and unambiguous and does nothing more than recite that there is a debt and that debtor will not encumber or convey specific land so long as debt remains unpaid, extrinsic evidence concerning the intent of the parties is inadmissible for the purpose of determining whether the instrument is an equitable mortgage); Perpetual Federal Savings and Loan Association v. Willingham, 370 S.E.2d 286 (S.C.App.1988) (a covenant by the debtor not to encumber or transfer specific real estate does not create an equitable lien in that real estate; similarly, an assignment of rents by the debtor creates neither an interest in or lien on the real estate itself); Chase Manhattan Bank v. Gems-By-Gordon, 649 F.2d 710 (9th Cir.1981); In re Aumiller, 168 B.R. 811 (Bankr. C.D. 1994) ("an agreement not to sell or encumber or an agreement not to assign the rents and profits of the property, absent a foreclosure provision or a specific grant of a lien in the property, does not evidence an intent to create a mortgage and therefore fails to create a lien on the property"); In re Slover, 71 B.R. 9 (Bankr. E.D.Mo.1986) (covenant not to encumber creates no security interest in the property described); In re Friese, 28 B.R. 953 (Bankr.D.Conn.1983).

Finally, this section reflects Professor Gilmore's view that "negative covenants should not ... be allowed to operate as informal or inchoate security arrangements, even against third parties with notice. If a creditor wants security let him take his security in some recognized form: mortgage, pledge, Article 9 security interest or what not.... Nothing is to be gained by giving shadowy effectiveness to informal arrangements which conform to no recognized pattern." G. Gilmore, Security Interests in Personal Property 1017 (1965). Thus, according to Professor Gilmore, the "debtor's covenant not to encumber property ... should be treated, as on the whole case law has done, as a covenant 'merely personal,' good enough to give rights against the covenantor for breach, to bring an acceleration clause into play, to constitute 'an event of default' under a loan agreement, but not good enough to give rights, whether they be called legal or equitable, in the property."

CHAPTER 4

RIGHTS AND DUTIES OF THE PARTIES PRIOR TO FORECLOSURE

Introductory Note: A principal theme of this Chapter is that a mortgage creates only a security interest in real estate. This reflects the adoption of the "lien" theory and the rejection of the "title" and "intermediate" theories of mortgage law. This principle is articulated in § 4.1.

Section 4.2 represents an attempt to rationalize and clarify the law governing security interests in rents, profits, and issues of real estate. State law governing this area, reflected in both case law and statutes, is often confusing and complex. While issues concerning rents, issues, and profits are currently most frequently litigated in bankruptcy courts, they are generally governed by state law. Consequently, clarification and rationalization of this state law have become especially important. In general, § 4.2 contains a broad definition of "rents, profits, and issues" and provides an efficient mechanism for both perfection and enforcement of security interests in them.

Section 4.3 deals with the standards for the appointment of a mortgage receiver. It continues the traditional rule associated with "lien" theory jurisdictions that makes it difficult to obtain a receivership in the absence of an appropriate mortgage clause. However, where the mortgage or other instrument contains language mortgaging the rents or authorizing a receivership upon mortgagor default, that language should be enforced if the mortgagor is in default.

Section 4.4 represents an attempt to clarify and restate the authority of a mortgage receiver to deal with "bad faith" and "sweetheart" leases entered into by tenants and the mortgagor-landlord when the latter is acting in response to the impending loss of the real estate. In general, the section provides broad authority to disaffirm such transactions.

Section 4.5 deals with competing requests for a receivership by mortgagees. The priority of their underlying mortgages, is, with one minor exception, the governing principle. This section also resolves the rights of the parties when a junior mortgage receiver is succeeded by a senior receivership.

Section 4.6 restates the law of waste in the mortgage relationship. It defines waste broadly to include both physical and financial injury, whether committed by the mortgagor or third parties. The mortgagee's remedies include foreclosure or other remedies provided in the mortgage itself, injunction, and damages, but the remedies may be exercised only if and to the extent that an impairment of the security has occurred or is threatened.

Section 4.7 deals with the rights of mortgagees to casualty and eminent domain proceeds. It gives them access to these funds only to the extent necessary to prevent impairment of security, and it also recognizes the mortgagor's right te employ the funds for reconstruction of the real estate if that can be accomplished without risk to the mortgagee.

Section 4.8 attempts to clarify and restate the rights of the parties when a casualty loss or condemnation takes place in the foreclosure context. In general this section represents the traditional judicial approach to the problems raised in this setting.

Finally, § 4.9 restates the basic axiom that foreclosure destroys subordinate interests in the real estate and, in so doing, deals with the exceptional case when that axiom is not automatically applied. This exception prohibits the mortgagor or other holder of the equity of redemption from using foreclosure purchase as a vehicle for destroying mortgages and other interests in the real estate.

§ 4.1 Mortgage Creates Security Interest Only

(a) A mortgage creates only a security interest in real estate and confers no right to possession of that real estate on the mortgagee.

(b) Any agreement, whether in a mortgage or not, that grants the mortgagee, as mortgagee, the right to possession in the future is unenforceable, except as provided in § 3.1(c).

(c) Notwithstanding Subsections (a) and (b), a mortgagee who obtains possession of the mortgaged real estate may retain it until the mortgage is redeemed or foreclosed if:

(1) the mortgagor voluntarily delivers possession to the mortgagee;

(2) the mortgagee enters after abandonment by the mortgagor; or

(3) the mortgagee enters after purchasing the real estate in good faith at an invalid foreclosure sale.

Cross-References:

§ 1.1, The Mortgage Concept; No Personal Liability Required; § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 6.4, Redemption from Mortgage by Performance or Tender.

Comment:

a. The "title," "lien," and "intermediate" theories of mortgage law. American courts have traditionally recognized one of three theories of mortgage law. Under the title theory, legal "title" to the mortgaged real estate remains in the mortgagee until the mortgage is satisfied or foreclosed; in lien theory jurisdictions, the mortgagee is regarded as owning a security interest only and both legal and equitable title remain in the mortgagor until foreclosure. Under the intermediate theory, legal and equitable title remain in the mortgagor until a default, at which time legal title passes to the mortgagee. These three mortgage law theories are the product of several centuries of English and American legal history.

(1) *The title theory.* English legal history is crucial to understanding the title theory. As was explained in § 3.1, Comment *a*, when the mortgage transaction became the conveyance of the fee on condition subsequent, with defeasance based on performance by the mortgagor on law day, the mortgagee obtained legal title to the land, and, with it, acquired the right to possession and to collect rents and profits. Thus, actual possession by the mortgagee became the norm. There were two reasons for this. First, livery of seisin was required for the conveyance. Second, under English law at this time, any collection of interest was deemed usurious. Consequently, possession and its access to rents

and profits proved to be a practical economic substitute for interest. Indeed, until the middle of the 17th century the usual practice was for the mortgagee to take possession upon execution of the mortgage; only thereafter did it become common for the mortgagor to be left in possession.

In all probability, the development of mortgagor possession coincided with the creation by equity of the mortgagor's equity of redemption. See § 3.1, Comment *a*. This was a logical development because, with the acceptance of the mortgagor as the equitable owner of the real estate, there was an implicit recognition that, notwithstanding the mortgagee's legal title, its major interest in the real estate was that of security. With the acceptance of this view, the mortgagee who actually exercised the right to possession was held to strict standards of accountability. Consequently, the exercise of the possessory right by mortgagees became relatively infrequent. Nevertheless, while seldom used, the right to possession was, as it still is in a few states today, a fundamental element of the mortgagee's legal title. As a result, the mortgagee could maintain ejectment against the mortgagor until the mortgage was satisfied, and a mortgagee who entered by self-help was not liable to be removed on the basis of trespass or ejectment.

The American states initially adopted the title theory in substantially the form it had developed in England. Usually, however, there was an express agreement permitting the mortgagor to stay on the mortgaged real estate. If the agreement provided for possession until a certain date, the mortgagor was regarded as a tenant for years; if it gave a right to possession until default, the mortgagor was viewed as a tenant at will. Even without such express agreements, courts often found from the other terms and conditions of the mortgage documents an implicit right in the mortgagor to remain in possession.

Today, however, title jurisdictions differ in only a few respects from their lien theory counterparts. Such states recognize that mortgagees hold title for security purposes only, and for both practical and theoretical purposes they usually view the mortgagor as the owner of the land. Moreover, title theory states have eliminated or reduced numerous incidents of legal title, although this process has often been uneven and inconsistent. In a few states this process has gone so far that the mortgagee's interest is characterized as a chattel interest or chose in action. In addition, two other developments have placed significant limitations on the title theory. First, statutes in some title states give the mortgagor the right to possession until default. Second, commonly used mortgage forms containing similar provisions achieve the same result.

This is not to say that the title theory is now irrelevant. As legal titleholder, in the absence of agreement to the contrary, the mortgagee has a right to immediate possession against the mortgagor. This right is occasionally asserted after the mortgagor has defaulted and incident to the commencement of foreclosure. Its assertion can be important where a lengthy foreclosure proceeding could mean a substantial period during which mortgagor could divert the rents and profits of the land to purposes other than service of the mortgage obligation. Moreover, in relatively rare circumstances, a mortgagee may seek possession even where mortgagor is not currently in default. However, these advantages for the title theory mortgagee are more apparent than real, since a lien theory mortgagee is often able to accomplish similar results through the appointment of a receiver or enforcement of an assignment of rents agreement.

The title theory may also be relevant for purposes of the statute of limitations. Under the title theory there are independent rights and remedies on the secured obligation and the mortgage lien. The running of the statute of limitations on the mortgage obligation does not abrogate the existence of the obligation itself, and hence has no impact upon either the mortgage lien or the remedies to enforce it. While most lien theory states follow the same approach, a minority of them hold that when the remedy on the obligation is barred so also is the remedy on the mortgage. This result is justified on the ground that the mortgage is merely an incident of the obligation and should not be enforceable if the obligation is not.

(2) *The lien theory.* The substantial majority of American jurisdictions follow the lien theory. Under this theory, the mortgagee acquires only a "lien" on the mortgaged real estate and the mortgagor retains both legal and equitable title and the right to possession until foreclosure or a deed in lieu of foreclosure. Given the early acceptance of the title theory by American courts, the adoption of the lien theory was largely the product of legislation. Some lien theory statutes provide that the mortgagee is not entitled to maintain a possessory action for the mortgaged real estate; some also state that "mortgagor shall be deemed to be the owner of the land." Others accomplish the same result by slightly different terminology. Several statutes state that a mortgage shall not be deemed a conveyance so as to allow the mortgagee to obtain possession other than by foreclosure. Identical results usually follow even if a deed of trust, rather than a mortgage, is employed, and likewise where an absolute deed or conditional sale is intended as a security device. See §§ 3.2 and 3.3.

Lien theory jurisdictions have been far from uniform as to the effect of mortgage language that purports to give the mortgagee a right to possession of the mortgaged real estate before foreclosure.

While some states enforce such agreements, others invalidate them on the theory that they contravene the public policy in favor of mortgagor possession underlying lien theory statutes. However, where such language is either absent or ineffective, the lien theory means that a mortgagor, prior to foreclosure, may prevail against the mortgagee for any interference with the mortgagor's possession of the mortgaged real estate to the same extent that any owner of land would prevail against a trespasser.

(3) *The intermediate theory.* A few states purport to follow a compromise position between the title and lien theories. Under this "intermediate" approach, the mortgagor is deemed to have legal title until default occurs; after default, legal title passes to the mortgagee. In other words, the mortgagee has the right to possession and to collect rents and profits after mortgagor default. This approach is grounded variously in statutes and case law. Since it is uncommon for title theory mortgagees to assert a right to possession prior to default, in practice the intermediate theory seems to differ, little, if at all, from its title theory counterpart.

b. Rationale for the section. This section adopts the lien theory of mortgages by its language that a mortgage creates only "a security interest in real estate." In so doing, it accurately reflects the current law in the substantial majority of jurisdictions. Moreover, in the minority of jurisdictions that adhere to the title theory, its adoption will prejudice no material reliance interest in the real estate lending community. Consequently, it should enhance uniformity and thus facilitate the operation of the growing secondary mortgage market.

In addition, the adoption of the lien theory avoids the difficult conceptual question in title theory states of how to characterize the interest of junior mortgagees. If the delivery of a first mortgage conveys legal title to the mortgagee, what type of interest does a junior mortgagee on the same land receive? Does the latter "share" in the legal title or simply hold a lien? This question has never been satisfactorily answered. It makes little sense to perpetuate in the modern real estate financing environment a title concept that arose in large measure as a result of now obsolete English usury law. Thus, ejectment and other possessory remedies will be unavailable to place a mortgagee in possession over the objection of the mortgagor. Ultimately only the appointment of a receiver or purchase by the mortgagee at a foreclosure sale will be sufficient to accomplish such a purpose.

The section also invalidates any agreement, in the mortgage or contemporaneous with it, by which the mortgagor purports to grant the mortgagee the right to possession of the mortgaged real estate. A contrary result would probably lead to widespread inclusion in mortgages of language waiving the mortgagor's possessory rights and, in so doing, vitiate the policy implicit in this section. Because the lien theory reflected in this section is pervasively statutory in origin, it is especially important that attempts at circumvention by drafting be permitted only where such efforts are legislatively sanctioned.

This section does not limit the mortgagee's ability to gain access to the rents and profits of the mortgaged real estate through enforcement of a mortgage on rents agreement or to secure the appointment of a receiver. Each of these remedies should stand on its own merits, unencumbered by the implications of the title-lien theory dichotomy. Access to these remedies is widely available to mortgagees. See §§ 4.2, 4.3 infra.

Illustrations:

1. Mortgagor delivers a mortgage on Blackacre to Mortgagee to secure a $50,000 obligation to Mortgagee. The obligation is payable in 10 equal annual installments with 10 percent interest per annum. After Mortgagor has made three annual payments and while the obligation is not in default, Mortgagee discovers that Mortgagor's financial situation has deteriorated and that Mortgagor is unlikely to be able to pay the remaining installments on the obligation. Mortgagee files an action to obtain possession of Blackacre. The action will be dismissed.

2. The facts are the same as Illustration 1 except that after making three installment payments, Mortgagor defaults on the fourth. Mortgagee commences a proceeding to foreclose the mortgage and, in connection therewith, requests the court to enter an order placing Mortgagee in possession of Blackacre. The request will be denied.

3. The facts are the same as Illustration 2, except that the mortgage contains the following provision: "Mortgagor agrees that Mortgagee shall have the right to possession of the mortgaged premises while this mortgage is in effect, and Mortgagor further agrees to surrender possession to Mortgagee immediately upon written demand by Mortgagee." After default, Mortgagee makes a written demand of Mortgagor for possession and Mortgagor refuses to comply. Mortgagee commences a proceeding to foreclose the mortgage and, in connection therewith, requests the court to enter an order placing Mortgagee in possession of Blackacre. The request for a possessory order will be denied.

c. Situations where mortgagee is validly in possession. Notwithstanding the general rule of this section, there are a few situations where the mortgagee's status as the holder of a security interest should be sufficient to justify its acquisition and retention of possession of the mortgaged real estate until the mortgagor redeems or the mortgage is foreclosed. This can be the case where the mortgagee is invited into possession by the mortgagor or in some other manner acquires possession with the mortgagor's consent. A mortgagee may also become a lawful mortgagee in possession as the result of a peaceful entry in good faith after purchasing the premises at a void or voidable foreclosure sale. So too should a mortgagee's security interest be sufficient to give the mortgagee the right to take and retain possession of the mortgaged real estate after abandonment by the mortgagor. In the latter situation, public policy clearly supports mortgagee possession. Not only is it important to protect the real estate against the elements and vandalism, but society is benefited by its productive use. In each of these situations, the mortgagee's claim to possession must be *qua* mortgagee, by virtue of the security interest. Consequently, when the mortgagee acquires possession in a capacity as a tenant or agent of the mortgagor, that possession cannot properly be retained after the expiration of the lease or agency relationship without the consent of the mortgagor.

A mortgagee who properly acquires "mortgagee in possession" status is held accountable for that possession to the mortgagor, to junior lienors, and in some instances to third parties. In general, the mortgagee in possession is held to the standard of the provident owner to use reasonable diligence to keep the property rented and in a good state of repair. The rents and other proceeds from the property, less reasonable expenses incurred in its management and repair, must be credited on the mortgage debt. On the other hand, the mortgagee need expend no more on repair than is generated by the cash flow from the property. The mortgagor or any junior lienholder may bring an accounting action to enforce the foregoing obligations against the mortgagee in possession.

Illustrations:

4. The facts are the same as Illustration 2, except that when Mortgagee commences the proceeding to foreclose the mortgage, it does not request an order for possession. Instead, after negotiation, Mortgagor agrees to deliver possession to Mortgagee and, as a result, Mortgagee takes possession of the real estate. A few weeks thereafter, but before a foreclosure decree is entered, Mortgagor files an action to regain possession of Blackacre. Mortgagor's request for relief will be denied. Mortgagee is entitled to remain in possession until foreclosure is completed.

5. Mortgagor delivers a mortgage on Blackacre to Mortgagee to secure a $100,000 obligation that is payable in 120 equal monthly installments at 12 percent per annum. After Mortgagor makes three payments, the market value of Blackacre drops drastically. As a result, Mortgagor ceases making payments, vacates the premises and moves to a different location. Shortly thereafter, Mortgagee validly accelerates the mortgage obligation, commences a foreclosure proceeding and, in order to protect it from vandalism and the weather, takes possession of Blackacre. The only manner in which Mortgagor may lawfully regain possession of Blackacre prior to a foreclosure sale is to redeem by satisfying the mortgage obligation or to reinstate pursuant to an applicable statute.

6. The facts are the same as Illustration 5, except that Mortgagor does not abandon the premises after going into default. Mortgagee validly accelerates the obligation and commences a nonjudicial proceeding. Mortgagee purchases at the foreclosure sale in good faith. As a result, Mortgagor vacates the premises and Mortgagee goes into possession. A few months thereafter, Mortgagor discovers serious defects in the foreclosure proceeding. As a result, Mortgagor files suit to set aside the sale and prevails in that action. Mortgagee is entitled to remain in possession until Mortgagor redeems by satisfying the mortgage obligation or reinstates pursuant to applicable statute.

7. Mortgagor delivers to Mortgagee a promissory note for $50,000 secured by a mortgage on Blackacre. The note is payable in 10 equal annual installments at an interest rate of 10 percent per annum. Two years later, while the mortgage is in good standing, Mortgagor gives Mortgagee, as lessee, a valid three-year lease on Blackacre. During the last year of the lease, Mortgagor defaults under the mortgage and Mortgagee validly accelerates the mortgage obligation, and commences a judicial foreclosure proceeding. During the pendency of the proceeding, the lease expires and Mortgagee refuses to give up possession of Blackacre. Mortgagor will prevail in a possessory action against Mortgagee.

REPORTERS' NOTE

The "title," "lien," and "intermediate" theories of mortgage law, Comment a. For a consideration of the historical development of the three theories, see Maitland, Equity 274; 1 G. Nelson & D. Whitman, Real Estate Finance Law 150–59 (3d ed. 1993); 5 H. Tiffany, The Law of Real Property 233–34 (3d ed. 1939); Turner, The Equity of Redemption 91–

103; Kratovil, Mortgages Problems In Possession, Rents, and Mortgagee Liability, 11 DePaul L. Rev. 1 (1961); Lloyd, Mortgages The Genesis of the Lien Theory, 32 Yale L.J. 233 (1922).

For further analysis of the impact of the "title-lien" distinction on the application of statutes of limitation to actions on the obligation and on the mortgage, see 1 G. Nelson and D. Whitman, Real Estate Finance Law § 6.11 (3d ed. 1993). Significant cases considering this problem include Goldwater v. Hibernia Savings & Loan Society, 126 P. 861 (Cal.Ct.App. 1912); Martinez v. Continental Enterprises, 730 P.2d 308 (Colo.1986); Phinney v. Levine, 381 A.2d 735 (N.H.1977); Cracco v. Cox, 414 N.Y.S.2d 404 (N.Y.App.Div.1979).

NOTE ON MORTGAGE THEORIES FOLLOWED BY AMERICAN JURISDICTIONS

This Note summarizes the mortgage theory adhered to by American jurisdictions. At least 32 states follow the "lien" theory of mortgage law. The balance subscribe either to the "title" or "intermediate" theory.

Alabama: Alabama follows the title theory. See Bailey Mortgage Co. v. Gobble-Fite Lumber, 565 So.2d 138 (Ala.1990) ("Alabama is a title theory state ... a mortgage passes legal title to the mortgagee, and the mortgagor is left with the equity of redemption."); Trauner v. Lowrey, 369 So.2d 531 (Ala.1979); Matter of Turtle Creek, Ltd., 194 B.R. 267 (Bankr. N.D.Ala.1996); In re Thomas, 121 B.R. 94 (Bankr.D.Ala.1990) ("Under Alabama common law execution of a mortgage passes legal title to the mortgagee, leaving the mortgagor only with the equity of redemption.").

Alaska: Alaska follows the lien theory. Alaska Stat. § 09.45.680 provides that "a mortgage of real property is not a conveyance which will enable the owner of the mortgage to recover possession of the real property without a foreclosure and sale." See Brand v. First Federal Sav. & Loan Ass'n, 478 P.2d 829 (Alaska 1970) ("We believe that the territorial view that mortgages in Alaska convey to the mortgagee only a lien, not any sort of title, should be retained.... We think the lien theory ought to be applied to deeds of trust as well as to mortgages in the ancient two party form. We see no reason to apply lien theory only to one of these two functionally similar security devices.").

Arizona: Arizona follows the lien theory. Ariz. Rev. Stat. Ann. § 33–703 provides that "a mortgage is a lien upon everything that would pass by a grant of the property but does not entitle the mortgagee to possession of the property unless authorized by the express terms of the mortgage. After execution of the mortgage, the mortgagor may agree to a change of possession without new consideration." See Lane Title & Trust Co. v. Brannan, 440 P.2d 105 (Ariz.1968).

Arkansas: It is unclear which theory Arkansas follows. See Bank of Oak Grove v. Wilmot State Bank, 648 S.W.2d 802 (Ark.1983) ("Our cases do not support the argument [that Arkansas is a lien theory state] that clearly. While recognizing that parties to a mortgage have a duality of interest in mortgaged lands, our decisions suggest that legal title does, indeed, pass from the mortgagor to the mortgagee, the former retaining only an equitable interest conditioned on payment of the indebtedness.").

California: California follows the lien theory as to mortgages. Cal. Civ. Proc. Code § 744 provides that "a mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure sale." Cal. Civ. Code § 2927 provides that "a mortgage does not entitle the mortgagee to possession of the property, unless authorized by the express terms of the mortgage; but after the execution of the mortgage, the mortgagor may agree to such change of possession without new consideration." See Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450 (Cal.1941); Santacroce Bros. v. Edgewater–Santa Clara Inc., 51 Cal.Rptr. 613 (Cal.Ct.App.1966).

California courts have had difficulty in determining which theory applies to deeds of trust, but the lien theory seems to be preferred. See, e.g., Bank of Italy National Trust & Savings Association v. Bentley, 20 P.2d 940 (Cal.1933) ("In [an] early case it was held that mortgages and deeds of trust were fundamentally different, in that in a mortgage only a 'lien' was created, while in a deed of trust, 'title' actually passed to the trustee."). Compare: Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450 (Cal.1941) ("No distinction is to be made in this regard between mortgages and deeds of trust; the possessory rights of trustors have been held to be the same as those of mortgagors."); Hamel v. Gootkin, 20 Cal. Rptr. 372 (Cal.Ct.App.1962) ("The legal estate thus left in the trustor or his successors entitles them to the possession of the property until their rights have been fully divested by a conveyance made by the trustees in the lawful execution of their trust, and entitles them to exercise all the ordinary incidents of ownership, in regard to the property, subject always, of course, to the execution of the trust."); In re Capital Mortgage & Loan, 35 B.R. 967 (Bankr.E.D.Cal. 1983) ("[T]he title theory has been discarded in most situations and the deed of trust has been deemed to create a mere lien on the property. Upon the giving of a deed of trust, the trustor nevertheless retains the 'legal estate' as against all persons except the trustee.").

Colorado: Colorado follows the lien theory as to both mortgages and deeds of trust. Colo. Rev. Stat. § 38–35–117 provides that "[m]ortgages, trust deeds, or other instruments intended to secure the payment of an obligation affecting title to or an interest in real property shall not be deemed a conveyance, regardless of its terms, so as to enable the owner of the obligation secured to recover possession of real property without foreclosure and sale, but the same shall be deemed a lien." See Martinez v. Continental Enter., 730 P.2d 308 (Colo.1986) ("To the extent the clause in the deed of trust giving the mortgagee the right to possession on default is inconsistent with the letter and policy of the statutes dealing with the right to possession, the latter must prevail. Here the public policy favoring possession by the mortgagor prior to foreclosure is buttressed by § 38–35–117. . . . In these circumstances, the statutory provisions must prevail over any contrary contractual provisions.").

Connecticut: Connecticut follows the title theory. See First Federal Bank, FSB v. Whitney Development Corp., 677 A.2d 1363 (Conn.1996)

("Under our common law, a mortgagee holds legal title to the mortgaged property upon execution of the mortgage, subject to defeasance upon redemption by the mortgagor."); Conference Center Ltd. v. TRC The Research Corp. of New England, 455 A.2d 857 (Conn.1983) ("[A] mortgagee ..., both by the common law and by statute is deemed to have taken legal title upon the execution of the mortgage.... As a titleholder, in the absence of any agreement to the contrary, the mortgagee has a right to immediate possession against the mortgagor.") See also Barclays Bank of New York v. Ivler, 565 A.2d 252 (Conn. App. Ct. 1989).

Delaware: Delaware follows the lien theory. See Matter of Spencer, 115 B.R. 471 (D.Del.1990) ("[I]n Delaware a mortgage is merely a security for the payment of a debt, or for the performance of some other condition." Thus in Delaware a mortgage "is not a conveyance of the title in the land, and as a consequence the mortgagee acquires only a chattel interest, and cannot maintain ejectment for possession of the land."); In re Skelly, 38 B.R. 1000 (D.Del.1984).

District of Columbia: The District of Columbia follows the title theory. Under D.C. Code § 45–703, "the legal estate conveyed to a mortgagee ... or to a trustee to secure a debt ... shall be construed and held to be a qualified fee simple, determinable upon the release of the mortgage or deed of trust." See Marshall v. Kraak, 23 App. D.C. 129 (1904).

Florida: Florida follows the lien theory. Fla. Stat. Ann. § 697.02 provides that "[a] mortgage shall be held to be a specific lien on the property therein described, and not a conveyance of the legal title or of the right of possession." See Waldock v. Iba, 153 So. 915 (Fla.1934); City of Gainesville v. Charter Leasing Corp., 483 So.2d 465 (Fla.Dist.Ct.App.1986); In re Thymewood Apartments, Ltd., 123 B.R. 969 (S.D.Ohio 1991) (interpreting Florida law).

Georgia: Georgia appears to follow the lien theory as to mortgages and the title or intermediate theory as to security deeds. Ga. Code Ann. § 44–14–30 provides that "[a] mortgage in this state is only security for a debt and passes no title." See Turner Advertising Co. v. Garcia, 311 S.E.2d 466 (Ga.1984) ("The interest in land of a grantee of a security deed is sufficient in order to maintain an action for ejectment against anyone other than the grantor, and against the grantor if in default.").

Hawaii: Hawaii probably follows the lien theory. Hawaii Rev. Stat. § 506-1 provides that a mortgage "shall create a lien only as security for the obligation and shall not he deemed to pass title." See Adair v. Kona Corporation, 452 P.2d 449 (Hawai'i 1969) ("Hawaii has espoused the lien theory of mortgages since 1939."). Moreover, Hawaii Rev. Stat. § 506-1 states that a "mortgagor of real property ... is entitled to the use or possession thereof until default."

Idaho: Idaho follows the lien theory as to mortgages. Idaho Code § 6–104 provides that "a mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure sale." It also appears to follow the lien theory as to the deed of trust. See Long v. Williams, 671 P.2d 1048 (Idaho 1983) ("We hold that the deed of trust conveys to the trustee nothing more than a power of sale, capable of exercise upon the occurrence of certain contingencies (such as default in payment) and leaves in the trustor a legal estate comprised of all incidents of ownership.").

Illinois: The general view is that Illinois adopted the lien theory in 1984. See Harms v. Sprague, 473 N.E.2d 930 (Ill. 1984); Kelley/Lehr & Assoc., Inc. v. O'Brien, 551 N.E.2d 419 (Ill. App. Ct. 1990) (referring to Illinois as a "lien theory" state). But see Mattis, Severance of Joint Tenancies by Mortgages: A Contextual Approach, 1977 S. Ill. U. L.J. 27, 50 (for the view that Illinois adopted the lien theory 30 years earlier in Kling v. Ghilarducci, 121 N.E.2d 752 (Ill. 1954)). See also In re Cadwell's Corners Partnership, 174 B.R. 744 (Bankr.N.D.Ill.1994). However, under 1987 legislation, if there is authorization in the mortgage, and "the court is satisfied that there is a reasonable probability that the mortgagee will prevail on a final hearing [in foreclosure], the mortgagee shall upon request be placed in possession of the real estate, except that if the mortgagor shall object and show good cause, the court shall allow the mortgagor to remain in possession." Ill. Rev. Stat. ch. 110, par. 15–1701(b)(2). As to residential real estate, "the mortgagor shall be entitled to possession of the real estate" except if the mortgage so authorizes and "the court is satisfied that there is a reasonable probability that the mortgagee will prevail on a final hearing [in foreclosure] and the mortgagee shows 'good cause' [for being placed in possession], the court shall upon request place the mortgagee in possession." Ill. Rev. Stat. ch. 110, par. 15–1701(b)(1). Consequently, as to non-residential property, the foregoing legislation seems to suggest an "intermediate theory" approach, while, as to residential real estate, it seems sympathetic to a lien theory analysis.

Indiana: Indiana follows the lien theory. Under Ind. Code § 56–701, "unless a mortgage specially provides that the mortgagee shall have possession of the mortgaged premises, he shall not be entitled to the same." See Egbert v. Egbert, 132 N.E.2d 910 (Ind.1956) ("Indiana is unequivocally committed to the lien theory and the mortgagee has no title to the land mortgaged"); In re Demoff, 90 B.R. 391 (Bankr.N.D.Ind.1988).

Iowa: Iowa follows the lien theory. Iowa Code Ann. § 557.14 provides that "in the absence of stipulations to the contrary, the mortgagor of real estate retains the legal title and right of possession thereto." See Moad v. Neill, 451 N.W.2d 4 (Iowa Ct. App. 1989).

Kansas: Kansas follows the lien theory. Kan. Stat. Ann. § 58–2301 provides that "[I]n the absence of stipulations to the contrary, the mortgagor of real property may retain the possession thereof." See Hoelting Enterprises v. Trailridge Investors, L.P., 844 P.2d 745 (Kan.Ct.App.1993) ("Kansas is a 'lien theory' jurisdiction"); Application of Small Business Admin. for Exemption from Ad Valorem Taxation in Meade County, Kan., 797 P.2d 879 (Kan.Ct.App.1990); Missouri Valley Investment Co. v. Curtis, 745 P.2d 683 (Kan.Ct.App.1987); In re Foxhill Place Associates, 119 B.R. 708 (Bankr.W.D.Mo.1990) ("Kansas is a lien theory state").

Kentucky: Kentucky is a lien theory state. See Watt's Adm'r v. Smith, 63 S.W.2d 796 (Ky. 1933) ("[A] mortgage creates only a lien on the real estate in favor of the mortgagee, the legal title being left in the mortgagor.").

Louisiana: Unlike other states, Louisiana follows a Civil Law tradition; nevertheless, its classification of mortgage law theory is the equivalent of the lien theory. Under La. Civ. Code Ann. art. 3278, a "mortgage is a right granted to the creditor over the property of the debtor for the security of his debt, and gives him the power of having the property seized and sold in default of payment." La. Civ. Code art. 3281(2) provides that the "mortgage only subjects to the right of the creditor the property on which it is imposed, without it being necessary that he should have actual possession." See Fidelity Credit Co. v. Winkle, 202 So.2d 280 (La.1967) ("A mortgage is the alienation of a right in the property, not the alienation of the property itself. Perfect ownership becomes imperfect when the property is mortgaged, by the alienation of that real right; but the title and the possession still remain in the owner.").

Maine: Maine follows the title theory. Under Me. Rev. Stat. tit. 33, § 502, "[a] mortgagee ... may enter on the premises or recover possession thereof, before or after breach of condition, when there is no agreement to the contrary." See Martel v. Bearce, 311 A.2d 540 (Me.1973); In re Roberts, 26 B.R. 397 (Bankr.D.Me.1983) ("Maine has adopted the title theory of mortgages which provides that a mortgage is a conditional conveyance that vests legal title in the mortgagee. Although legal title to the mortgaged real estate vests in the mortgagee, the mortgagee is not entitled to all the incidents of ownership unless the mortgage obligation is breached and he subsequently takes possession.").

Maryland: Maryland follows the intermediate theory as to mortgages and deeds of trust. See Williams v. Safe Deposit & Trust Co., 167 Md. 499, 175 A. 331 (1934) ("[I]n Maryland, a mortgage conveys the whole legal estate to the mortgagee, subject, generally, to the condition subsequent that, upon due payment of the mortgage debt and a performance of all the covenants by the mortgagor, the mortgage deed is avoided"); Darnestown Valley-WHM Ltd. Partnership v. McDonald's Corp., 650 A.2d 1365 (Md.Ct.App.1994) ("Although a mortgage technically conveys legal title to the property to the mortgagee, such title is not absolute, being merely for security for payment."); In re Bond, 122 B.R. 39 (D.Md.1990) ("Maryland is an 'intermediate theory' state with regard to mortgages.... Mortgages and deeds of trust are in para materia in this and other regards under Maryland law."); In re Bethesda Air Rights Limited Partnership, 117 B.R. 202 (Bankr.D.Md.1990) ("Until demand after default, the mortgagor retains the right to possession.").

Massachusetts: Massachusetts probably follows the title theory. See Cooperstein v. Bogas, 58 N.E.2d 131 (Mass.1944); Krikorian v. Grafton Co-op. Bank, 44 N.E.2d 665 (Mass.1942); Maglione v. BancBoston Mortg. Corp., 557 N.E.2d 756 (Mass. Ct. App. 1990) ("Literally, in Massachusetts, the granting of a mortgage vests title in the mortgagee to the land placed as security for the underlying debt. The mortgage splits the title in two parts: the legal title, which becomes the mortgagee's and the equitable title, which the mortgagor retains.... Under the [title theory] the mortgagee may enter into possession of the mortgaged premises upon default and before foreclosure, whereas under the lien theory there is no right to possession; the mortgagee must await sale of the mortgaged property and obtains satisfaction of the mortgagor's debt from the proceeds of sale"); G. Davis, Massachusetts Conveyancers' Handbook 113 (1984). But see In re Prichard Plaza Associates Ltd. Partnership, 84 B.R. 289 (Bankr.D.Mass.1988) (describing Massachusetts mortgage law as "intermediate between title and lien theory").

Michigan: Michigan follows the lien theory. See Midwest Bank v. O'Connell, 405 N.W.2d 201 (Mich.Ct. App.1987) ("In Michigan, a mortgagee has no title to the premises mortgaged"); Foote v. City of Pontiac, 409 N.W.2d 756 (Mich.Ct.App.1987) ("A real estate mortgage does not transfer title to the land to a mortgagee, but creates a lien on the land in favor of the mortgagee to secure the debt.").

Minnesota: Minnesota follows the lien theory. Minn. Stat. Ann. § 559.17(1) provides that "[a] mortgage of real property is not to be deemed a conveyance, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure [with certain exceptions]." See Ewert v. Anderson, 359 N.W.2d 293 (Minn.Ct.App.1984) ("[The foregoing] statute and its predecessors have long been interpreted to mean that during the period of redemption, the mortgagor retains his rights of ownership, including the right to possession and the right to profits."); In re Metro Square, 93 B.R. 990 (Bankr.D.Minn.1988) ("Minnesota is a lien theory state.").

Mississippi: Mississippi appears to follow either the lien or intermediate theory. See Meyers v. American Oil Co., 5 So.2d 218 (Miss.1941) ("The mortgagor is allowed to retain possession of the property until condition broken, or more generally until foreclosure, but upon the trust necessarily implied that he will not do or permit to be done anything which will lessen the sufficiency of the security.").

Missouri: Missouri probably follows the lien theory. See R. L. Sweet Lumber Co. v. E. L. Lane Inc., 513 S.W.2d 365 (Mo.1974) (referring to the "lien theory" of mortgages as the law of this state). But see Pine Lawn Bank v. M. H. & H. Inc., 607 S.W.2d 696 (Mo.Ct.App.1980) ("[T]he general rule is that a mortgagee after default by a mortgagor has the right to possession of the mortgaged premises for the purposes of applying the rents and profits to the discharge of the mortgage debt.").

Montana: Montana follows the lien theory. Mont. Code Ann. § 71-1-105 provides that a "mortgage does not entitle the mortgagee to the possession of the property unless authorized by the express terms of the mortgage, but after the execution of the mortgage, the mortgagor may agree to such change of possession without a new consideration." See In re Kurth Ranch, 110 B.R. 501 (Bankr. D.Mont.1990) (Montana follows the "lien" theory of mortgages, which provides the mortgagee is not the owner of the property and is not therefore entitled to possession, rents or profits.).

Nebraska: Nebraska follows the lien theory. Neb. Rev. Stat. § 76-276 provides that "[i]n the absence of stipulations to the contrary, the mortgagor of real estate retains the legal title and right of possession thereof." See Dupuy v. Western State Bank, 375 N.W.2d 909 (Neb.1985).

Nevada: Nevada follows the lien theory. Nev. Rev. Stat. § 40.050 provides that a "mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to take possession of the real property without a foreclosure and sale." See Borden v. Clow, 30 P. 821 (Nev.1892).

New Hampshire: New Hampshire follows the title theory. See State v. Marion, 440 A.2d 448 (N.H.1982); Brown v. Cram, 1 N.H. 169 (1818).

New Jersey: New Jersey follows the intermediate theory. See Guttenberg Sav. & Loan Ass'n v. Rivera, 428 A.2d 1289 (N.J.1981) ("It has long been well settled in this State that upon and after default a mortgagee is entitled to possession of the premises."); City Fed. Sav. & Loan Ass'n v. Jacobs, 457 A.2d 1211 (N.J. Super. Ct. 1983) ("It is well established that prior to default, a mortgagor has the exclusive right of possession and all the incidents thereof.... Once the mortgagor defaults in performance, the mortgagee has the right of possession subject to the owner's equity of redemption"); McCorristin v. Salmon Signs, 582 A.2d 1271 (N.J. Super. Ct. 1990).

New Mexico: New Mexico follows the lien theory. N.M. Stat. Ann. § 48-7-1 provides that "[i]n the absence of stipulation to the contrary, the mortgagor of real property shall have the right of possession." See Texas American Bank/Levelland v. Morgan, 733 P.2d 864 (N.M.1987) ("In New Mexico, a mortgage is merely a lien and title does not pass to the mortgaged property.").

New York: New York follows the lien theory. N.Y. Real Prop. Acts. § 611 provides that an action for the recovery of real property "cannot be maintained ... [b]y a mortgagee, or his assignee, or other representative." See Barson v. Mulligan, 84 N.E. 75 (N.Y.1908); Ganbaum v. Rockwood, 308 N.Y.S.2d 436 (N.Y. App. Div. 1970) ("It is the law of New York that a mortgage gives the mortgagee only a lien upon the mortgaged premises. The common law doctrine that the mortgagee held title thereto ... has been abolished. A clear indication of this was the abolition by the legislature in 1830 of the right of the mortgagee to maintain action in ejectment to recover possession of the mortgaged premises, by the enactment of the statute which is now § 611 of the Real Property Actions and Proceedings Law.").

North Carolina: North Carolina follows either the title or intermediate theory. See Butner v. United States, 440 U.S. 48, 52 n.3 (1979) ("North Carolina has been classified as a 'title' State, although it does not adhere to this theory in its purest form. Under its case law, a mortgagee is entitled to possession of the mortgaged property upon default, and need not await actual foreclosure. Such possession might be secured either with the consent of the mortgagor or by an action in ejectment."); Stevens v. Turlington, 119 S.E. 210 (N.C.1923); Neil Realty Co., Inc. v. Medical Care, Inc., 431 S.E.2d 225 (N.C.Ct.App.1993) ("North Carolina is considered a title theory state with respect to mortgages, where a mortgagee does not receive a mere lien on mortgaged real property, but receives legal title to the land for security purposes."); In re DiCello, 80 B.R. 769 (Bankr.E.D.N.C.1987).

North Dakota: North Dakota follows the lien theory. N.D. Cent. Code § 35-03-01.1 provides that a "mortgage is a contract by which specific real property ... is hypothecated for the performance of an act without requiring a change in possession, and includes a transfer of an interest in real property, other than a trust, made only to secure the performance of an act." See Knauss v. Miles Homes, Inc., 173 N.W.2d 896 (N.D. 1969) ("It is elementary that a mortgage on land is a mere lien, or security, for the payment of a debt and that it does not convey any title or estate in the property to the mortgagee.").

Ohio: Ohio follows either lien or intermediate theory. See Levin v. Carney, 161 Ohio St. 513, 120 N.E.2d 92 (1954) ("It has been held that a mortgagor in possession has both the legal and equitable title.... [A]s between the mortgagor and mortgagee in a mortgage upon real estate, after condition broken the legal title to the mortgaged premises is in the mortgagee."). But see Hunter Sav. Ass'n v. Georgetown of Kettering Ltd., 14 B.R. 72 (Bankr.S.D.Ohio 1981) ("Ohio has adopted the lien theory of mortgages.").

Oklahoma: Oklahoma follows the lien theory. Okla. Stat. Ann. tit. 42, § 10 provides that "[n]otwithstanding an agreement to the contrary, a lien or a contract for a lien transfers no title to the property subject to the lien." See Rives v. Mincks Hotel Company, 30 P.2d 911 (Okla.1934) ("[U]nder the mortgage lien theory prevailing in our state ... it appears to be well settled law that a mortgaging of real property gives no right to the mortgagee [to the rents]; this, manifestly, because the mortgage is nothing more than a lien upon the property to secure payment of the mortgage debt, and in no sense a conveyance entitling the mortgagee to possession or enjoyment of the property as owner."); Teachers Ins. and Annuity Ass'n v. Oklahoma Tower Assoc. Ltd. Partnership, 798 P.2d 618 (Okla.1990) ("Oklahoma is a lien theory state."); Coursey v. Fairchild, 436 P.2d 35 (Okla.1967); Virginia Beach Fed. Sav. & Loan Ass'n v. Wood, 901 F.2d 849 (10th Cir.1990) ("Oklahoma is a lien theory state. Thus, the mortgagor remains the legal owner of the mortgaged property. The right of possession to the property ... is dependent wholly upon the termination of a foreclosure action, except as to the statutory and equitable powers relating to the appointment of a receiver.").

Oregon: Oregon follows the lien theory. Or. Rev. Stat. § 86.010 provides that a "mortgage of real property is not a conveyance so as to enable the owner of the mortgage to recover possession of the property without a foreclosure and sale." See West v. White, 758 P.2d 424 (Or.Ct. App.1988) ("[A] beneficiary's interest under a trust deed is analogous to a mortgagee's interest under a mortgage. A mortgage conveys no legal or equitable interest in fee for life to the mortgagee, but merely creates a lien which constitutes security for the debt and grants the mortgagee, upon the mortgagor's default, the right to have the property sold to satisfy the debt. The same is true of a beneficiary's interest under a trust deed, which is merely a lien on the land as security for the payment of the debt. If the note is paid, the lien is extinguished.... The beneficiary acquires no more than a lien on the real property unless and until the grantor defaults and the beneficiary purchases the property at the trustee's or foreclosure sale."); McLennan v. Holbrook, 23 P.2d 137 (Or.1933).

Pennsylvania: Pennsylvania follows either the intermediate or the title theory. See In re Wynnewood House Assoc., 121 B.R. 716 (Bankr. E.D.Pa.1990) ("Simplified slightly, as a 'title' jurisdiction, Pennsylvania generally proclaims that a mortgagee . . . has the right to seek possession of the realty in certain circumstances (i.e. default) and in prescribed ways"); In re Panas, 100 B.R. 734 (Bankr.E.D.Pa.1989) ("By the twentieth century, the rule seems to have been softened by the principle that the mortgagor is entitled to possession unless he defaults under the mortgage"); Lloyd, The Mortgage Theory of Pennsylvania, 73 U. Pa. L. Rev. 43 (1942). But see Commerce Bank v. Mountain View Village, 5 F.3d 34 (3d Cir.1993) (referring to Pennsylvania as a "title state"); In re Union Meeting Partners, 160 B.R. 757 (Bankr.E.D.Pa.1993) (same); Comment, The Mortgagee's Right to Rent After Default, 50 Yale L. Rev. 1424 (1941) (referring to Pennsylvania as a "title" state).

Rhode Island: Rhode Island is a title theory stato. See Houle v. Guilbeault, 40 A.2d 438 (R.I.1944) ("In this state a first mortgage is a conveyance to [the] mortgagee of the legal fee in the land defeasible upon condition that the mortgagor will perform the condition of the mortgage. Under this theory of the nature of a first mortgage, which has remained unquestioned over the years, the mortgagor is not seised of the legal fee in the land until he performs the condition."); In re D'Ellena, 640 A.2d 530 (R.I.1994) (same).

South Carolina: South Carolina follows the lien theory. S.C. Code Ann. § 29-3-10 provides that "[n]o mortgagee shall be entitled to maintain any possessory action for the real estate mortgaged, even after the time allotted for the payment of the money secured by mortgage is elapsed, but the mortgagor shall be deemed the owner of the land and the mortgagee as owner of the money lent or due and the mortgagee shall be entitled to recover satisfaction of such money out of the land by foreclosure and sale according to law." See Bredenberg v. Landrum, 10 S.E. 956 (S.C. 1890).

South Dakota: South Dakota is a lien theory state. See State of Wis. Inv. Bd. v. Hurst, 410 N.W.2d 560 (S.D.1987) ("[T]he right of possession and right to rents and profits remains in the mortgagor until the expiration of the period of redemption.").

Tennessee: Tennessee follows the title theory. See In re Maryville Sav. & Loan Corp., 31 B.R. 597 (E.D.Tenn.1983) ("In Tennessee, execution and delivery of a deed of trust or mortgage on real property passes legal title to the land to the trustee or mortgagee.... Tennessee is therefore known as a 'title theory' state. Tennessee courts, however, are not strict in their application of the "title theory."); Bertha v. Smith, 110 S.W.2d 474 (Tenn.1937).

Texas: Texas follows the lien theory. See Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981) ("Texas follows the lien theory of mortgages. Under this theory the mortgagee is not the owner of the property and is not entitled to its possession, rentals or profits"); Oryx Energy Co. v. Union Nat'l Bank, 895 S.W.2d 409 (Tex. Ct. App. 1995) ("Texas adheres to the lien theory of mortgages."); In re The Landing Assoc., Ltd., 122 B.R. 288 (Bankr.W.D.Tex.1990).

Utah: Utah follows the lien theory as to mortgages. Utah Code Ann. § 78-40-8 provides that "a mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure and sale." The status of the deed of trust, in this regard, is unclear. See General Glass Corp. v. Mast Constr. Co., 766 P.2d 429 (Utah.Ct.App.1988) ("Unlike a trust deed, a mortgage in Utah is not a title-conveying instrument. The mortgagor retains legal title, and the mortgagee's interest is a lien on the property to secure payment of a debt.... Although a trust deed, like a mortgage, is given as security for the performance of some obligation, it is nevertheless a conveyance by which title to the trust property passes to the trustee.").

Vermont: Vermont follows the intermediate theory. See Rassman v. American Fidelity Co., 460 A.2d 461 (Vt.1983) ("Once the condition of a mortgage is broken, the mortgagee becomes at law the absolute owner of the property and is entitled to immediate possession, and may, without notice, enter upon the property and take possession thereof, if he can do so peaceably and unresisted"); In re Galvin, 120 B.R. 767 (Bankr.D.Vt. 1990).

Virginia: There is disagreement as to whether Virginia follows the title or lien theory. See Eastern Sav. Bank v. Epco Newport News Associates, 14 B.R. 990 (Bankr.S.D.N.Y.1981) (concluding that Virginia followed the "title theory" of mortgages and deeds of trust). But see Interstate R.R. v. Roberts, 105 S.E. 463 (Va.1920); Gravatt v. Lane, 92 S.E. 912 (Va.1917); In re Vienna Park Prop., 120 B.R. 332 (Bankr.S.D.N.Y.1990) ("[D]espite this Court's strong reliance on the Epco decision, there is room to doubt the conclusion in Epco that Virginia recognizes the title theory.").

Washington: Washington follows the lien theory. Wash. Rev. Code Ann. § 7.28.230(1) provides that "[a] mortgage of any interest in real property shall not be deemed a conveyance so as to enable the owner of the mortgage to recover possession of the real property, without a foreclosure and sale according to law." See Norlin v. Montgomery, 367 P.2d 621 (Wash.1961); State ex rel. Gwinn v. Superior Court, 16 P.2d 831 (Wash. 1932) ("The law is well-settled in this state that a mortgagee of real property is not entitled by virtue of the mortgage, either prior or subsequent to default, to the possession of the mortgaged property"); Western Loan & Building Co. v. Mifflin, 297 P. 743 (Wash.1931).

West Virginia: West Virginia appears to follow the lien theory. See In re Babco, Inc., 28 B.R. 656 (Bankr. W.D. Pa. 1983) ("West Virginia law provides that unless otherwise stipulated, a grantor of a trust deed is entitled to the rents from the property until the trust is foreclosed by sale, or a decree is entered in a foreclosure action to sequester the rents"); Cox v. Horner, 28 S.E. 780 (W.Va.1897).

Wisconsin: Wisconsin follows the lien theory. See Glover v. Marine Bank of Beaver Dam, 345 N.W.2d 449 (Wis.1984) ("Wisconsin is a state which follows the lien theory of mortgages. In other words, the mortgagee does not have legal title in the mortgaged premises. The mortgagor retains full ownership in the property, which consists of equitable and legal title, while the mortgagee's status is that of a holder of a security interest"); Bank of Commerce v. Waukesha County, 279 N.W.2d 237 (Wis. 1979); Matter of Clark, 738 F.2d 869 (7th Cir.1984).

Wyoming: Wyoming follows the lien theory. See L Slash X Cattle Company v. Texaco, Inc., 623 P.2d 764 (Wyo.1981) ("This state, as do the majority of jurisdictions, follows the lien theory of mortgage law. A Wyoming mortgagee, therefore, has nothing more than a lien on the property with its appurtenant right of foreclosure. After default on a mortgage, the mortgagee's only remedy is foreclosure and public sale"). See also Cliff & Co., Ltd. v. Anderson, 777 P.2d 595 (Wyo.1989) ("Wyoming has long adhered to the mortgage lien theory.").

Rationale for the section, Comment b. For support for the view that continued reliance on a "title" or "intermediate" approach to mortgage law is anachronistic, see In re Rancourt, 123 B.R. 143 (Bankr.D.N.H.1991) ("Concepts of 'title' as a dispositive factor in determining legal rights proved entirely unsatisfactory in the personal property field and resulted in the abandonment of that concept in the Uniform Commercial Code. Its existence in real property matters stems largely from economic, cultural, and feudal property law concepts that existed in the Middle Ages but have no continuing relevance.").

Lien theory states vary in their treatment of agreements contained in the mortgage or contemporaneous therewith that permit the mortgagee to enter prior to foreclosure. Some states enforce such agreements. See Dick & Reuteman Co. v. Jem Realty, 274 N.W. 416 (Wis.1937); Penn Mutual Life Insurance Co. v. Katz, 297 N.W. 899 (Neb.1941); Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450 (Cal. 1941); Kelly v. Roberts, 17 P.2d 65 (Mont.1932); Geraldson, Clauses Increasing the Possessory Rights of Mortgagees, 10 Wis. L. Rev. 492 (1935). Moreover, such agreements sometimes are authorized by statute. See Ariz. Rev. Stat. § 33-703; Cal. Civ. Code § 2927; Ind. Code § 56-701; Iowa Code Ann. § 557.14; Kan. Stat. Ann. § 58-2301; Mont. Code Ann. § 71-1-105; Neb. Rev. Stat. § 76-276; N.M. Stat. Ann. § 48-7-1. This section, however, adopts the perspective of other lien jurisdictions that hold that mortgagee possession agreements contravene the public policy inherent in lien theory statutes, which confer possession on the mortgagor until foreclosure. See Ganbaum v. Rockwood Realty Corp., 308 N.Y.S.2d 436 (N.Y. App. Div. 1970); Teal v. Walker, 111 U.S. 242 (1884); Orr v. Bennett, 161 N.W. 165 (Minn.1917); State ex rel. Gwinn v. Superior Court, 16 P.2d 831 (Wash. 1932); Western Loan & Bldg. Co. v. Mifflin, 297 P. 743 (Wash.1931); Rives v. Mincks Hotel Co., 30 P.2d 911 (Okla.1934). Indeed, some lien theory statutes seem specifically to invalidate such agreements. See Colo. Rev. Stat. § 38-35-117; Idaho Code § 6-104; Nev. Rev. Stat. § 40.050; Okla. Stat. Ann. tit. 42, § 10; Utah Code Ann. § 78-40-8.

This section rejects, as inconsistent with the lien theory, the approach of § 502 of the Uniform Land Security Interest Act (ULSIA). The latter provision permits the mortgagee, except in certain limited residential transactions, to take possession of the real estate after mortgagor default without using judicial process so long as possession can be accomplished without breach of the peace. ULSIA § 502(a). Where such an authorization is absent, the mortgagee has the right in such non-residential transactions to acquire possession by judicial process. ULSIA § 502(h). In the case of certain mortgagor-occupied dwelling units, the mortgagee may obtain possession only through a judicial proceeding and a court must stay any order of possession "until after the debtor's interest in the real estate has been terminated, unless the court finds that termination of the debtor's possession at an earlier time is necessary to protect the value of the real estate against deterioration or destruction." ULSIA § 502(c). While this section largely bars mortgagee possession prior to foreclosure, this Chapter provides mortgagees with alternative pre-foreclosure remedies. See §§ 4.2, 4.3, infra.

Situations where mortgagee is validly in possession, Comment c. For cases supporting the proposition that mortgagee may remain in possession pending foreclosure after having entered with the express or implied consent of the mortgagor, see Barson v. Mulligan, 84 N.E. 75 (N.Y.1908); Myers–Macomber Eng'rs v. MLW Constr. Corp., 414 A.2d 357 (Pa. Super. Ct. 1979); Gandrud v. Hansen, 297 N.W. 730 (Minn.1941); McClory v. Ricks, 88 N.W. 1042 (N.D.1902); In re Panas, 100 B.R. 734 (Bankr. E.D.Pa.1989). See also Fireman's Fund Mortgage Corp. v. Zollicoffer, 719 F.Supp. 650 (N.D.Ill.1989) ("By not accepting [mortgagee's] letters and by not stopping [mortgagee] from securing the premises even though he was present, [mortgagor] effectively consented to [mortgagee] securing the premises."). See generally 1 G. Nelson and D. Whitman, Real Estate Finance Law § 4.24 (3d ed. 1993); Note, 8 Colum. L. Rev. 486 (1908); Note, 15 Mich. L. Rev. 58 (1915).

For the view that a peaceable entry, in good faith, and under color of right (e.g., under a defective foreclosure sale) suffices to make the possession lawful irrespective of consent, see Jasper State Bank v. Braswell, 111 S.W.2d 1079 (Tex.Com.App.1938); Raggio v. Palmtag, 103 P. 312 (Cal. 1909); Cameron v. Ah Quong, 165 P. 961 (Cal.1917); Pettit v. Louis, 129 N.W. 1005 (Neb.1911); Caro v. Wollenberg, 136 P. 866 (Or.1913). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.24 (3d ed. 1993).

For the proposition that a mortgagee who takes possession of the abandoned mortgaged real estate may retain it pending either foreclosure or mortgagor redemption, see Fisher v. Norman Apartments, Inc., 101 Colo. 173, 72 P.2d 1092 (1937) ("If the mortgagor abandons the possession, which was not done in this case, the mortgagee may take possession and collect the rents"); Gandrud v. Hansen, 297 N.W. 730 (Minn.1941) ("Where the mortgagor expressly abandons possession, his assent that the mortgagee might go into possession under his mortgage might well be implied, especially when he allows him to remain in possession for a considerable length of time without objection"); In re Panas, 100 B.R. 734 (Bankr.E.D.Pa.1989) (concluding that the facts, "taken together, cause us to conclude that the [mortgagor] abandoned the premises when he departed from it early in 1982. His course of conduct subsequent to 1982 is consistent with only such a conclusion.... Consequently, we find that the mortgagee properly took possession of the premises and has properly retained same as a mortgagee in possession at all times to date, subject to the [mortgagor's] right of redemption."). See also Fireman's Fund Mortgage Corp. v. Zollicoffer, 719 F.Supp. 650 (N.D.Ill.1989) (since mortgagee had reasonable belief that mortgaged premises were abandoned it was justified in taking possession).

A few statutes authorize the mortgagee to go into possession after mortgagor abandonment. See, e.g., Ky. Rev. Stat. Ann. § 426.525:

> "[T]his section shall not preclude a mortgagee after default from taking possession of property subject to the mortgage which has been abandoned by the mortgagor, for the purpose of preserving and maintaining the same, harvesting crops, or letting the same, all to the account of the mortgagor.... For the purpose of this section, property shall be deemed to have been abandoned when the mortgagor has moved from the property and when by the nature of the property in question when [sic] further neglect or failure to attend will decrease its value."

See also Colo. Rev. Stat. § 38–39–112(2):

> "If the facts would justify the appointment of a receiver under this section but one is not applied for and if the premises are abandoned by the owner thereof, the holder of the lien may take possession until the sale and shall be subject to same duties and liabilities for the care of the premises and for the application of the rents and profits as would a receiver."

Questions have sometimes been raised as to whether possession by the mortgagee can ever be justified under the lien theory unless there is mortgagor consent. See 1 G. Nelson & D. Whitman, Real Estate Finance Law 214 (3d ed. 1993). Probably the best justification for such possession is that the mortgagee's "right to retain possession does not depend upon an estate held by him. His possession is protected by his lien. It is certainly more simple and just that the mortgagee should be left in possession, and the mortgagor forced to redeem, than that the mortgagor should be permitted to recover possession by an action at law, and be immediately liable to the consequences of a foreclosure suit in equity brought by the mortgagee." 4 Pomeroy, Equity Jurisprudence 560–61 (5th ed. 1941).

A recent Oklahoma decision described the rights and responsibilities of the mortgagee in possession:

> A mortgagee lawfully in possession of the estate without foreclosure or before a foreclosure has the right and duty to collect the rents and profits, although he is bound to apply them on the mortgage debt and to account for the surplus.... A mortgagee in possession ... is liable for any waste or his gross mismanagement or wrongful or tortious acts which injure the property, including permanent depreciation of the property caused by the failure to make necessary or proper repairs.... [In] Oklahoma, a mortgagee in possession is held to the exercise of such care and diligence as a prudent owner in charge of the premises would exercise.... However, a mortgagee in possession will be held accountable for the reasonable rental value of the premises, even if he did not actually receive any rent therefrom, only if he is guilty of willful default or gross negligence in the renting of the property or the collecting of its rents.

Prince v. Brown, 856 P.2d 589, 590–91 (Okla.Ct.App.1993). For further consideration of the rights and responsibilities of a mortgagee in possession, see Marcon v. First Fed. Sav. & Loan Ass'n, 374 N.E.2d 1028 (Ill. App. Ct.

1978); Myers–Macomber Eng'rs v. M.L.W. Constr. Corp., 414 A.2d 357 (Pa. Super. Ct. 1979); Essex Cleaning Contractors, Inc. v. Amato, 317 A.2d 411 (N.J. Super. Ct. 1974); ComFed Savings Bank v. Newtown Commons Plaza Assoc., 719 F.Supp. 367 (E.D.Pa.1989); 1 G. Nelson & D. Whitman, Real Estate Finance Law 219–235 (3d ed. 1993). As to the tort liability of the mortgagee in possession to third parties who are injured on the premises, see, e.g., Mortimer v. East Side Savings Bank, 295 N.Y.S. 695 (N.Y.App.Div.1937); Ferman v. Lombard Inv. Co., 57 N.W. 309 (Minn.1894); Zisman v. City of Duquesne, 18 A.2d 95 (Pa. Super. Ct. 1941).

§ 4.2 Mortgaging Rents

(a) "Rents" means the proceeds payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real property of another.

(b) A mortgage may be given on the rents of real property. Such a mortgage may be included in a mortgage on the real property or may be a separate instrument. The mortgage is effective as against the mortgagor and, subject to the operation of the recording act, as against third parties, upon execution and delivery.

(c) The mortgage may provide that the mortgagee may commence collection of the rents at any time or, in any event, upon mortgagor default. The mortgagee's right to actual possession of the rents arises upon:

(1) satisfaction of any conditions in the mortgage; and

(2) delivery of a demand for the rents to the mortgagor, the holder of the equity of redemption, and each person who holds a mortgage on the real property or on its rents of which the mortgagee has notice.

(d) The delivery referred to in Subsection (c) is effective upon receipt and may be accomplished by personal service, the United States Mail, or any other means reasonably calculated to afford an addressee actual notice of the demand.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 1.2, No Consideration Required; § 1.3, Mortgages Securing Obligations of Nonmortgagors; § 3.2, The Absolute Deed Intended as Security; § 3.3, The Conditional Sale Intended as Security; § 4.1, Mortgage Creates Security Interest Only; Restatement, Second, Contracts §§ 338–339.

Comment:

a. Introductory note. Mortgagees frequently rely not only on the real property itself as security for the mortgage obligation, but also on the rents it produces. Hence they often utilize mortgage clauses or separate agreements by which the mortgagor "assigns" the rents as additional security for the obligation. These agreements are employed under the assumption that a mortgage on real property alone will carry no security interest in the rents.

Somewhat infrequently, such agreements give the mortgagee immediate access to the rents. More commonly, the mortgagee's right of access is activated by mortgagor default. Because rents from real estate are deemed to be realty rather than personalty, security interests in them are governed solely by the law of real property security. Consistent with this view, § 9–104(j) of the Uniform Commercial Code (U.C.C. § 9–104(j) (1995)) provides that the Code is inapplicable "to the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder."

Virtually all jurisdictions, irrespective of the mortgage law theory to which they adhere, recognize the validity of assigning rents of real property for security purposes. This unanimity ends, however, as soon as courts confront the question of when such assignments become effective and at what point the mortgagee gains actual access to the rents. Some jurisdictions recognize the validity of "absolute" assignments, under which the mortgagee gains a present right to the rents subject to the condition precedent that they shall become collectible automatically upon mortgagor default. At the other extreme are decisions holding that such assignments create at most an inchoate security interest in the rents, issues, and profits which becomes effective only when the mortgagee takes "affirmative action" to enforce it. This usually means that the mortgagee must take possession of the real property, impound the rents, or secure the appointment of a receiver. The law in the remaining jurisdictions, while often far from precise, tends to treat assignments as effective upon execution and recordation, but requires some further action on the mortgagee's part as a condition precedent to actual collection of the rents.

The foregoing issues are especially crucial when the mortgagor seeks the protection of the Bankruptcy Code. An important question arises as between the trustee in bankruptcy, who represents the unsecured creditors, and the rents mortgagee as to whether the latter has an effective interest in the rents collected during the pendency of the bankruptcy proceeding. The 1980s witnessed an explosion of bankruptcy litigation over this and related questions. This litigation has raised numerous thorny questions. They include: (1) how mortgages on rents are perfected pre-petition; (2) what "affirmative action," if any, is necessary to trigger the mortgagee's right to collect the rents; and (3) whether perfection, or at least any affirmative action requirements for collection of the rents, may be accomplished post-petition in the bankruptcy court. Since the first two of these questions are governed by state mortgage law, it is important that state law not only be clear, but also afford an efficient mechanism for perfecting and realizing upon a mortgage on rents.

b. Scope of the section. This section makes it clear that the rents of real estate are mortgageable to the same extent as any other interest in real property. Such a mortgage is effective whether it is contained in a mortgage on the real property itself or in a separate instrument. Moreover, collection of the rents may begin at whatever time the parties specify in the loan documents. Normally the parties agree that the mortgagee may commence collection after mortgagor defaults. However, the loan documents may specify an earlier date. Thus, for example, where language in those documents authorizes the mortgagee to commence collection at the inception of the loan transaction, that language is enforceable.

This section does not use the word "assignment" to characterize a security interest in rents, but instead employs the term "mortgage." Traditionally, the former term has been used indiscriminately either to describe an outright transfer of ownership of property or simply to signify the creation of a security interest in it. Indeed, it is not uncommon for courts to use the phrase "absolute assignment," not with reference to an outright sale or gift of the rents, but rather simply to signify the creation of a security interest in them. The use of the term "mortgage" makes clear the intent of the parties to enter into a security transaction and avoids the confusion inherent in the continuing use of "assignment" terminology.

While a mortgage on rents is effective between the parties on execution and delivery, recordation will usually be required to protect the mortgagee of rents against claims of third persons, or to determine the priority of the mortgage as against such claimants. It should be stressed that the word "effective," as applied against third parties, is intended to convey the same meaning as the term "perfected" as used in the Bankruptcy Code and Article 9 of the Uniform Commercial Code.

This section does not govern the right to rents after foreclosure in those jurisdictions that have post-foreclosure redemption legislation that is inconsistont with this section.

c. Means of enforcing the mortgage on rents. Although a mortgagee of real property can realize on its security and deprive the mortgagor of possession only by foreclosure (see § 4.1), this is not the case with respect to a mortgage on rents. Rather, satisfaction of a simple notice procedure is all that is required to enable the mortgagee to collect the rents for purposes of applying them to the mortgage debt. Thus, for example, if the mortgage gives the mortgagee the right to collect immediately, collection may commence as soon as the notice requirements are satisfied. If, as is more common, the mortgage provides that the right to collect accrues only upon mortgagor default, then after such a default, the mortgagee must comply with the notice requirements before collection can commence. Moreover, the mere collection of rents pursuant to such a mortgage does not constitute the mortgagee a "mortgagee in possession," with the duties and liabilities attendant to that status.

While the mortgagee of rents will also almost always be a mortgagee on the real property itself, such a dual status is not required by this section. Thus, for example, it would be possible for a senior mortgage to encompass the real estate only and for a subsequent lender simply to take a mortgage on the rents of that real estate. See Illustration 4. On the other hand, when such a senior mortgage is foreclosed, it will terminate any subsequent mortgage on the rents. This result follows from the basic mortgage law principle that a properly conducted foreclosure of a senior mortgage on real estate wipes out all junior interests in that real estate. Since the rents are derived from the real estate, the junior mortgage on rents is thus destroyed. See Illustration 5.

d. Rights of lessees and other obligors. This section does not delineate the rights and obligations of the lessee or other obligor after the mortgagee triggers the right to collect rents. A lessee may, for example, be concerned with the potential for double liability if it erroneously pays the mortgagee rather than mortgagor. Such questions are to be resolved in accordance with Restatement, Second, Contracts § 338, under which the "assignor (mortgagor) retains the power to discharge the duty of the obligor . . . until but not after the obligor receives notification" of the assignment and the mortgagee's right to commence collection under it.

e. Definition of the term "rents." The term "rents," as used in this section, encompasses also "issues and profits" of real estate. Moreover, the definition includes not only rents and royalties that arise out of lease relationships, but also other proceeds that are paid primarily for the possession, occupancy, or use of real property. To the extent that a lease requires a tenant to pay a pro-rata share of mortgagor's real estate taxes or common area expenses, such obligations are treated as "rents." Moreover, the definition includes hotel room charges as well as fees generated from most parking facilities.

On the other hand, the definition does not encompass accounts receivable and other proceeds that result primarily from the sale of goods or services. Security interests in such proceeds are solely within the purview of the Uniform Commercial Code.

The parties to any mortgage transaction are free to define "rents" narrowly so as to limit the mortgage's coverage to proceeds derived from a landlord-tenant relationship, or otherwise to exclude certain revenues produced from the use or occupancy of real estate. For example, a mortgage on the rents of an office building may be structured to include revenues generated from leases to tenants, but to exclude revenues derived from the building's parking facility.

f. Satisfaction of the delivery requirement. The delivery of the demand for rents becomes effective upon receipt by those persons described in Subsection (c)(2). While the delivery requirement of Subsection (c) may be satisfied by personal service or the United States Mail, it may also be accomplished by any other means "reasonably calculated to afford actual notice." Thus, a wide variety of other means of delivery are permissible. These include, for example, electronic facsimile, computer networks, electronic mail, and courier and commercial delivery services.

Illustrations:

1. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located an office building that is subject to numerous leases. A provision in the mortgage mortgages the rents from Blackacre and provides that Mortgagee may collect the rents at any time until the mortgage obligation is fully satisfied. The mortgage is promptly recorded. The mortgage on the rents is effective immediately between the parties and as to other persons. Two days later, Mortgagee delivers the notices required by this section. Upon delivery of the notices, Mortgagee is entitled to collect the rents. Rents so collected must be applied to current amounts due on the mortgage obligation, and any excess must be remitted to Mortgagor.

2. The facts are the same as Illustration 1 except that the mortgage on rents is contained in a separate instrument that is executed and recorded at the same time as the mortgage on Blackacre. The mortgage on the rents is effective immediately between the parties and as to other persons. Upon the delivery of the notices, Mortgagee is entitled to collect the rents. Rents so collected must be applied to current amounts due on the mortgage obligation, and any excess must be remitted to Mortgagor.

3. The facts are the same as Illustration 1 except that the provision mortgaging the rents states that Mortgagee may collect the rents only after Mortgagor default. The mortgage on the rents is effective immediately between the parties and as to other persons. Mortgagor defaults and Mortgagee validly accelerates the mortgage obligation. Mortgagee then delivers the notices required by this section. Upon the delivery of the notices, Mortgagee is entitled to collect the rents.

4. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a mortgage on Blackacre, on which is located an office building that is subject to numerous leases. The mortgage is immediately recorded. Mortgagee-1 does not take a mortgage on the rents. Mortgagor then borrows money from Mortgagee-2 and gives, as security for the loan, a mortgage on the rents from Blackacre, which mortgage is immediately recorded. The mortgage on the rents provides that Mortgagee-2 may collect the rents only after default by Mortgagor on the obligation to Mortgagee-2. The mortgage on the rents is effective immediately between the parties and as to other persons. Mortgagor then defaults on the obligation to Mortgagee-2 and the latter validly accelerates the obligation. Mortgagee-2 then delivers the notices required by this section. Upon delivery of the notices, Mortgagee-2 is entitled to collect the rents.

5. The facts are the same as Illustration 4, except that after Mortgagee-2 begins collecting the rents, the obligation to Mortgagee-1 is defaulted upon and the latter's mortgage on Blackacre is foreclosed. That foreclosure terminates Mortgagee-2's mortgage and the right to collect the rents from Blackacre.

6. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a mortgage on the rents of Blackacre, on which is located an office building that is subject to numerous leases. The mortgage provides that Mortgagee-1 may collect the rents only after default by Mortgagor on the underlying obligation. The mortgage is immediately recorded. Mortgagor later borrows money from Mortgagee-2 and gives Mortgagee-2 a mortgage on Blackacre. Several months thereafter the mortgage on Blackacre goes into default, the obligation is accelerated, and Mortgagee-2 forecloses on its mortgage. The purchaser at the foreclosure sale will purchase Blackacre subject to the mortgage on rents in favor of Mortgagee-1.

7. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located a hotel. The mortgage also contains language mortgaging the rents from

Blackacre and authorizing Mortgagee to collect them upon Mortgagor's default. The mortgage is recorded immediately. The hotel contains 200 guest rooms and two restaurants, both of which are operated by Mortgagor. On the main floor, Mortgagor leases to lessees several areas of commercial space on long-term leases. Both the lease rentals and the room revenues constitute rents for purposes of this section. The proceeds collected by Mortgagor from the two restaurant operations do not constitute rents for purposes of this section.

8. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located a horse race track which Mortgagor operates. The mortgage also contains language mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. Because the gate receipts are derived primarily from the entertainment provided to race track customers, they do not constitute rents and Mortgagee has no right to collect them.

9. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located a large parking structure which Mortgagor operates as a public parking facility. The mortgage also contains language mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. The mortgage is immediately recorded. Because receipts from parking patrons primarily represent fees paid for the right to park motor vehicles on Mortgagor's real estate, they constitute rents and Mortgagee has the right to collect them until the mortgage obligation is satisfied.

10. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located a grocery store which Mortgagor owns and operates. The mortgage also contains a provision mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. The mortgage is immediately recorded. Because the receipts from the grocery store operation are derived primarily from the sale of goods and services, they do not constitute rents and Mortgagee has no right to collect them.

11. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, which is a section of farmland on which soybeans are grown. The mortgage also contains a provision mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. The mortgage is recorded immediately. Blackacre is leased

to a tenant who pays $100 per acre annual rent. Mortgagor goes into default and Mortgagee delivers the notices required by this section. Mortgagee is entitled to collect the rent due under Mortgagor's lease with tenant until the mortgage obligation is satisfied.

12. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, which is a section of agricultural land. The mortgage also contains a provision mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. The mortgage is recorded immediately. Mortgagor leases the mineral rights to Blackacre to Mineral Company. Under the lease, Mortgagor is to receive a royalty of $25 per ton of minerals extracted. Mortgagor goes into default under the mortgage obligation and Mortgagee delivers the notices required by this section. Mortgagee is entitled to collect the royalties due under the lease with Mineral Co. until the mortgage obligation is satisfied.

g. Mortgagor not liable for imputed rent. A mortgage on the rents gives the mortgagee the right to collect only rents actually owing to the mortgagor. It does not confer on the mortgagee the right to collect a use or occupancy charge from a mortgagor in possession for the reasonable rental value of the premises. Stated slightly differently, such a mortgagor is not liable for imputed rent. This prohibition applies whether the mortgagor resides on the premises or uses them to conduct a commercial enterprise. To permit the exaction of such a charge would violate the basic premise of § 4.1 that protects a mortgagor's right to possession until foreclosure.

Illustrations:

13. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located a single-family dwelling in which Mortgagor resides. The mortgage also contains a provision mortgaging the rents from Blackacre. Mortgagee is authorized to commence collection of the rents upon Mortgagor default. The mortgage on Blackacre is recorded immediately. Several months thereafter, Mortgagor defaults on the mortgage obligation and Mortgagee delivers to Mortgagor the notice required by this section demanding that Mortgagor pay to Mortgagee an amount equal to the reasonable rental value of Blackacre. Mortgagee is not entitled to collect rent or any other charge from Mortgagor with respect to Mortgagor's continued possession of Blackacre.

14. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is situated a duplex, in one half of which Mortgagor resides. The mortgage also contains a provision mortgaging the rents from Blackacre. Mortgagee is authorized to commence collection of the rents upon Mortgagor default. The mortgage on Blackacre is recorded immediately. Mortgagor leases the other half of the duplex to tenant for $600 per month. Several months thereafter, Mortgagor defaults on the mortgage obligation and Mortgagee delivers the notices required by this section. Mortgagee is entitled to collect the rent due under Mortgagor's lease with tenant, but is not entitled to collect rent or any other charge from Mortgagor with respect to Mortgagor's continued possession of the non-leased half of the duplex.

15. The facts are the same as Illustration 10 except that after Mortgagor goes into default, Mortgagee delivers the notice required by this section demanding that Mortgagor pay to Mortgagee an amount each month equal to the reasonable rental value of Blackacre. Mortgagee has no right to collect rent or any other charge with respect to Mortgagor's continued possession of Blackacre.

16. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, which is a section of farmland. The mortgage also contains a provision mortgaging the rents from Blackacre and authorizing Mortgagee to commence collection of them upon Mortgagor default. The mortgage is recorded immediately. Mortgagor farms Blackacre and leases none of it to others. Mortgagor goes into default and Mortgagee delivers the notice required by this section demanding that Mortgagor pay to Mortgagee an amount annually equal to the reasonable rental value of Blackacre. Mortgagee has no right to collect rent or any other charge with respect to Mortgagor's continued possession of Blackacre.

REPORTERS' NOTE

Introductory note, Comment a. Because rents constitute an interest in real estate and not personalty, a mortgage on them is governed by the law of real property security rather than Article 9 of the Uniform Commercial Code. Thus an attempt to perfect a security interest in rents under the Uniform Commercial Code is both unnecessary and ineffective. See U.C.C. § 9-104(j) (1995) (the Code is inapplicable "to the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder"); In re Carley Capital Group, 128 B.R. 652 (Bankr.W.D.Wis.

1991) (North Carolina law); Matter of Hollinrake, 93 B.R. 183 (Bankr. S.D.Iowa 1988); First Fed. Sav. v. City Nat'l Bank, 87 B.R. 565 (W.D.Ark.1988); In re Prichard Plaza Assoc. Ltd. Partnership, 84 B.R. 289 (Bankr.D.Mass.1988); In re Standard Conveyor Company, 773 F.2d 198 (8th Cir.1985). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.35 (3d ed. 1993).

Some jurisdictions purport to recognize the validity of so-called "absolute assignments" under which the mortgagee acquires a present right to the rents even though the language of the assignment defers the right to collect until mortgagor default. Under such an approach, no further affirmative action on mortgagee's part usually is needed either to perfect its interest or to commence collection. See Cal. Civ. Code § 2938 ("A written assignment ... stating that it is absolute, shall be deemed to constitute a present transfer of the assignor's interest in existing and future rents, issues and profits effective upon the execution and delivery of the assignment by the assignor ... and the interest granted by the assignment shall be deemed perfected as of the date of recording"); HomeCorp v. Secor Bank, 659 So.2d 15 (Ala.1994) (mortgagee entitled to pre-foreclosure rents pursuant to absolute assignment); First Fed. Sav. v. City Nat'l Bank, 87 B.R. 565 (W.D.Ark. 1988) ("It is true that the instruments go on to give the debtors the power to collect the rents and the duty to apply them to the mortgage indebtedness; but this need not destroy their effect as [an] absolute conveyance of the rent to lender. The effect of these provisions would simply be to encumber the rent in the hands of the lender with a charge in favor of the debtor or to have the rent applied to the debt. Even if, therefore, the assignment did not operate as a mortgage it operated as an absolute conveyance of the rent rendering lender the owner of the rent subject to the charge described above"); MDFC Loan Corp. v. Greenbrier Plaza Partners, 26 Cal.Rptr.2d 596 (Cal.Ct.App.1994) (recognizing absolute assignment); In re Ventura–Louise Properties, 490 F.2d 1141 (9th Cir.1974); In re Jason Realty, L.P., 59 F.3d 423 (3d Cir. 1995) ("The instant assignment was quintessentially absolute."); First Fidelity Bank v. Eleven Hundred Metroplex Assoc., 190 B.R. 510 (S.D.N.Y.1995) (assignment held to absolute and the rents not part of bankruptcy estate); MacArthur Executive Assoc. v. State Farm Ins. Co., 190 B.R. 189 (D.N.J.1995) (same); In re Gould, 78 B.R. 590 (D.Idaho 1987) (absolute assignments are created if (1) there is an absolute assignment with the mortgagee being authorized prior to default to collect the rents to apply them to the mortgage debt with the excess to be remitted to the mortgagor or (2) there is an absolute assignment that becomes effective upon default); In re Somero, 122 B.R. 634 (Bankr.D.Me.1991) (applying Maine law); Fidelity Bankers Life Ins. Co. v. Williams, 506 F.2d 1242 (4th Cir. 1974) (recognizing "the validity of an absolute assignment of rents and holding that pursuant to such an assignment, the mortgagee had an absolute right to possession of rents, issues and profits immediately on default by the mortgagor"); In re Winslow Center Assoc., 50 B.R. 679 (Bankr.E.D.Pa.1985) (holding under New Jersey law that a mortgagee has title to rents if the mortgage gives it a present interest, even though for security purposes, instead of an interest only upon default); In re Galvin, 120 B.R. 767 (Bankr.D.Vt.1990) (an "absolute assignment" is possible under Vermont law); In re Townside Partners, Ltd., 125 B.R. 8 (Bankr. W.D.Va.1991) (recognizing validity of absolute assignments). See generally Randolph, When Should Bankruptcy Courts Recognize Lenders' Rents Interests?, 23 U.C.D. L. Rev. 833 (1990).

The use of "absolute assignment" terminology by the foregoing courts and statutes creates needless confusion and is rejected by this section. None of the cited cases involve an outright sale or transfer of the substantive right to the rents. Rather, the assignment in each instance was intended to represent security for an obligation and not to confer an absolute ownership of the rents on the mortgagee. As one court aptly observed:

> To borrow a concept from tort law, but for the loan transaction, the Debtors would not have assigned rents to the Bank. No independent consideration was given for the assignments. The fact that the assignments are conditioned upon default and will terminate upon satisfaction of the debt indicates that they are merely additional security for the loan, and not an absolute transfer of the Debtor's interest in the rents to the Bank.

In re Lyons, 193 B.R. 637, 644 (Bankr.D.Mass.1996). See In re Guardian Realty Group, L.L.C., 205 B.R. 1 (Bankr.D.D.C.1997). Perhaps courts utilizing the "absolute assignment" approach intend simply to emphasize that an assignment for security purposes becomes effective (or perfected) immediately upon execution and recording, and the use of the "absolute" language serves to reinforce that point. See In re GOCO Realty Fund I, 151 B.R. 241 (Bankr. N.D.Cal.1993) ("California law holds that even when an assignment is absolute, an affirmative enforcement step in addition to perfection is a prerequisite to the lender's possession of the rents, and that the lender is entitled to all the rents, issues and profits *from the time of demand* upon the defaulting borrower to deliver possession and pay over the rents."); Federal Deposit Ins. Corp. v. Colonial Cromwell Commons Ltd. Partnership, 881 F.Supp. 87 (D.Conn. 1995); In re 1301 Connecticut Ave. Assoc., 117 B.R. 2, 8 (Bankr. D. Colo. 1990); Matter of Hollinrake, 93 B.R. 183 (Bankr.S.D.Iowa 1988). But see NCNB Texas Nat'l Bank v. Sterling Projects, Inc., 789 S.W.2d 358 (Tex. Ct. App. 1990) ("The absolute assignment does not create a security interest but instead passes title to the rents. An absolute assignment of rents is not security but is a pro tanto payment of the obligation.").

Other jurisdictions hold that an assignment of rents is effective ("perfected") upon execution and recording, but the right to commence collection requires some further action, albeit often relatively nominal, on the part of the mortgagee. This is the approach adopted by this section. The Florida statute represents this approach:

> (2) If such an assignment is made, the mortgagee shall hold a lien on the rents, and the lien created by the assignment shall be perfected and effective against third parties upon recordation of the mortgage or separate instrument.
>
> (3) Unless otherwise agreed to in writing by the mortgagee and mortgagor, the assignment of rents shall be enforceable upon the mortgagor's default and written demand for the rents made by the mortgagee to the mortgagor, whereupon

> the mortgagor shall turn over all rents in the possession of the mortgagor at the time of the written demand or collected thereafter.

Fla. Stat. § 697.07(2),(3); Ginsberg v. Lennar Florida Holdings, Inc., 645 So.2d 490 (Fla.Dist.Ct.App.1994) ("According to the statute an assignment of rents creates a lien on the rents in favor of the mortgagee, and the mortgagee will have the right to foreclose that lien and collect the rents without the necessity of foreclosing on the underlying mortgage."); In re Thymewood Apartments, Ltd., 123 B.R. 969 (Bankr. S.D. Ohio 1991) (interpreting Florida law to confer an absolute ownership in rents in mortgagee upon execution); In re 163rd Street Mini Storage, Inc., 113 B.R. 87 (Bankr.S.D.Fla. 1990). Note, however, that such "absolute ownership" should probably not be taken literally; rather the probable intent of the legislature was to make an assignment for security purposes automatically effective or "perfected" on execution, but not to transfer ownership for all purposes. See In re Aloma Square, 85 B.R. 623 (Bankr.M.D.Fla.1988); In re One Fourth Street North, Ltd., 103 B.R. 320 (Bankr.M.D.Fla.1989).

For other jurisdictions following a similar approach, see In re Bethesda Air Rights Ltd. Partnership, 117 B.R. 202 (Bankr.D.Md.1990); New York Life Ins. Co. v. Bremer Towers, 714 F.Supp. 414 (D.Minn.1989) (in interpreting Minn. Stat. Ann. § 559.17, which authorizes assignments of rents and profits in mortgages exceeding $500,000 on non-homestead and non-agricultural real estate, the court analogized to Article 9 of the Uniform Commercial Code, stating that an "agreement between the parties creates the initial security interest in the property. The secured interest is then perfected by recording the assignment with the appropriate authority. The mere perfection of the interest, however, does not give the creditor the immediate access to the property. If the debtor defaults on its obligations, though, the creditor can take action to enforce its security interest"); In re Fluge, 57 B.R. 451 (Bankr.D.N.D.1985) ("Under applicable North Dakota case law, an assignment of rents clause may be enforced apart from the security in the property itself and in advance of foreclosure by affording either the lessee or mortgagor/lessor notification of an intention to invoke the assignment of rents clause"); East Grand Forks Fed. Sav. & Loan Ass'n v. Mueller, 198 N.W.2d 124 (N.D.1972); Skinner v. American State Bank, 189 N.W.2d 665 (N.D.1971); Teachers Ins. and Annuity Ass'n v. Oklahoma Tower Assoc. Ltd. Partnership, 798 P.2d 618 (Okl.1990); Tenn. Code Ann. § 66–26–116 (upon recordation of any instrument assigning leases or rents, the interest of the assignee "shall be fully perfected as to the grantor ... and all third parties without the necessity of furnishing notice to the assignor or lessee, obtaining possession of the real property, impounding the rents, securing the appointment of a receiver, or taking any other affirmative action.... The lessee is authorized to pay the assignor until the lessee receives notification that rents due or to become due have been assigned and that payment is to be made to the assignee"); In re McCutchen, 115 B.R. 126 (Bankr.W.D.Tenn.1990) (foregoing statute "makes it clear that the perfected secured creditor is not entitled to possession of the rents until a proper notice is received by the lessee, directing the lessee to pay the assignee.").

On the other hand, some states recognize perfection of an assignment upon execution and recording, but impose onerous requirements for actual mortgagee collection of the rents. See 641 Avenue of the Americas, Ltd. Partnership v. 641 Assoc., Ltd., 189 B.R. 583 (S.D.N.Y.1995) ("a security interest in rents is perfected upon recordation"; however, "an assignment of rents becomes enforceable when the assignee takes affirmative steps to assert his rights, such as appointing a receiver to collect the rents, taking possession of the property, commencing foreclosure proceedings, or seeking an order for sequestration of rents"); In re Rancourt, 123 B.R. 143 (Bankr. D.N.H.1991) ("The fact that the mortgagee can't enforce his security interest in specific rents prior to taking over possession and management of the rental premises does not destroy the legal existence of an effective security interest in rents as a type of collateral held by the mortgagee at the time of recording of the pertinent documents"); In re Westchase I Assoc., L.P., 126 B.R. 692 (W.D.N.C.1991); In re Raleigh/Spring Forest Apartments Associates, 118 B.R. 42 (Bankr.E.D.N.C.1990) (assignment is perfected upon recording in the real estate records, but the right to the rents is incomplete until mortgagee takes some affirmative action to enforce collection of them such as obtaining the appointment of a receiver or taking possession of the premises); In re Park At Dash Point L.P., 121 B.R. 850 (Bankr.W.D.Wash. 1990) (in Washington, "assignments of rents are perfected by recording, and the mortgagee obtains the right to collect rents only after enforcing its security interest, which may be accomplished either by obtaining possession of the real property, or by the appointment of a receiver.").

Finally, a significant number of jurisdictions take the position articulated by the Texas Supreme Court that a rents agreement is presumed to create an inchoate security interest that is ineffective "until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action." Taylor v. Brennan, 621 S.W.2d 592 (Tex.1981); Oryx Energy Co. v. Union Nat'l Bank, 895 S.W.2d 409 (Tex. Ct. App. 1995). Professor Glenn once articulated the analytical underpinnings of this approach as follows:

> If, then, the mortgage pledges in advance these rents to the mortgagee, what really has happened? Essentially, there is an agreement; but the question is, what specific right does this create?
>
> It must be an equitable right of some sort; but equitable obligations vary in that they may confer a specific right to a specific thing from the outset; or they may create no such specific right, but merely confer protection upon the party if he takes affirmative action in his own behalf and assumes dominion over the thing that is described in the instrument.... [W]ith the rights of the [latter] class there is no specific equity that will prevail, just so, against later liens. The 'equitable lien' or 'equitable pledge' of this variety becomes effective only when the one who asserts it follows up his claim by assuming dominion over the thing that he demands. Having taken possession, one will be protected by the fact that he had an 'equitable lien' or 'equitable pledge,' but unless and until he

thus follows up his right, he has nothing.

2 G. Glenn, Mortgages 939–40 (1943). For other examples of this approach, see Bevins v. Peoples Bank, 671 P.2d 875 (Alaska 1983) (adopting the rule "that a rent clause in a deed of trust, which allows the beneficiary to collect rents upon default to satisfy secured debt, does not automatically assign the rents accruing after the date of default to the beneficiary. The beneficiary must take some action to acquire possession of the rents before the rent clause becomes operative"); In re Kurth Ranch, 110 B.R. 501 (Bankr.D.Mont.1990) (in Montana, "a mortgagee may secure a security interest in rents from the mortgaged property only by appointment of a receiver, even though ... the mortgage instrument contains an assignment of rent provision upon default"); Saline State Bank v. Mahloch, 834 F.2d 690 (8th Cir.1987) ("An analysis of Nebraska cases to date clearly demonstrates that it is only upon default that the assignment clause of the security agreement becomes an equitable lien. Thereafter Nebraska law requires affirmative action ... to perfect the lien."); Sullivan v. Rosson, 223 N.Y. 217, 119 N.E. 405 (1918); Prudential Ins. Co. v. Liberdar Holding Corp., 74 F.2d 50 (2d Cir.1934); In re Brose, 254 F. 664 (2d Cir.1918) (an assignment of rents clause operates merely as a pledge of the rents, to which pledgee becomes entitled only after it takes the requisite affirmative action); In re Constable Plaza Associates, L.P., 125 B.R. 98 (Bankr. S.D.N.Y.1991); Matter of Riverside Nursing Home, 100 B.R. 683 (Bankr. S.D.N.Y.1989); Matter of Village Properties, Limited, 723 F.2d 441 (5th Cir.1984) (applying Texas law); Wuorinen v. City Fed. Sav. & Loan Ass'n, 191 N.W.2d 27 (Wis.1971); Matter of Century Investment Fund VIII Ltd. Partnership, 937 F.2d 371 (7th Cir.1991) (applying Wisconsin law). For criticism of this approach, see In re Baltic Associates, L.P., 170 B.R. 568 (E.D.Pa.1994) (the foregoing view "confuse[s] the issues of *perfection* of a security interest and *enforcement* of a security interest.").

The affirmative action required by this latter approach is, however, often insubstantial. Some courts, for example, have held that a refused demand for possession suffices. See, e.g., Long Island Bond & Mortgage Guarantee Co. v. Brown, 11 N.Y.S.2d 793 (N.Y.Sup.Ct.1939). Sometimes a mere request for a receivership, rather than its actual appointment, satisfies the affirmative action requirement. See, e.g., Matter of Century Inv. Fund VIII Ltd. Partnership, 937 F.2d 371 (7th Cir.1991); In re Flower City Nursing Home, 38 B.R. 642 (Bankr. N.Y.1984). Still others require only that the mortgagee notify the mortgagor of default and demand payment of the rents. See, e.g., Bevins v. Peoples Bank, 671 P.2d 875 (Alaska 1983) (if the mortgagee notifies the mortgagor of a default and "demands payment of rent, the [mortgagee] is entitled to the rents accruing after such notice as against the [mortgagor]); In re Fluge, 57 B.R. 451 (Bankr. D. N.D. 1985) (assignment agreement "may be enforced ... by affording either the lessee or mortgagor-lessor notification of intention to invoke the assignment of rents clause.... [I]t seems that any notice must be in the nature of a demand for payment or unequivocal language to the effect that a claim for rents is being made pursuant to an assignment of rents clause.").

While most of the litigation concerning agreements for rents during the past decade has been in bankruptcy courts, state law governs their enforceability. In Butner v. United States, 440 U.S. 48, 55, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979), the United States Supreme Court stated:

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.' ... The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.

Although *Butner* was decided under an earlier bankruptcy code, courts have uniformly followed it in applying the current 1978 Bankruptcy Code. See, e.g., Matter of Village Properties, Ltd., 723 F.2d 441 (5th Cir.1984); In re Rancourt, 123 B.R. 143 (Bankr. D.N.H.1991); In re Mid-City Hotel Assoc., 114 B.R. 634 (Bankr.D.Minn. 1990); In re Kurth Ranch, 110 B.R. 501 (Bankr.D.Mont.1990); In re Multi-Group III, Ltd. Partnership, 99 B.R. 5 (Bankr.D.Ariz.1989).

The Bankruptcy Reform Act of 1994 (the "Act") added the following language to § 552(b) of the Bankruptcy Code:

> (2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security extends to property of the debtor acquired before the commencement of the case and to the rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C.A. § 552(b)(2). According to legislative history, the foregoing subsection "provides that lenders may have valid security interests in postpetition rents for bankruptcy purposes notwithstanding their failure to have fully perfected under applicable State law." 140 Cong.Rec. H. 10752, at H. 10768 (October 4, 1994) (statement of Congressman Brooks). Conceivably, this could mean that if a mortgagee has not even recorded the agreement containing a security interest in rents, it will be good in bankruptcy simply because the agreement purported to grant the mortgagee a security interest in the rents. On the other hand, this provision may simply be intended to protect a mortgagee in a state where full "perfection" requires not merely recording

the security interest, but taking other "affirmative action" with respect to the rents as well.

In any event, the impact of § 552(b)(2) on state law is far from clear. As one scholar has noted,

> While this argument [that Congress preempted state law limitations on the effectiveness of postpetition rent assignments] may have some surface appeal . . . , it ignores one critical point—even after the 1994 amendments, Section 552(b)(2)'s protection for postpetition rents *remains by its terms expressly subject to the strong-arm powers under Section 544*. Under Section 544, there is no question that the debtor-in-possession may avoid any security interest that a judgment creditor of personalty or a bona fide purchaser of realty could have avoided under state law as of the petition date. If state law provides that a mortgagee does not have an enforceable security interest in rents unless it has taken actual or constructive possession of the property, and a distressed real estate debtor owning commercial property in that state files for bankruptcy before the mortgagee has taken actual or constructive possession, Section 544(a) would authorize the debtor-in-possession to avoid the mortgagee's security in postpetition rents. Because Section 552(b)(2)'s protection for rents is expressly subject to the Section 544 strong-arm provision, it seems problematic to conclude that Section 552(b)(2) establishes a federal standard for the enforceability of an assignment of rents. Thus, while Congress may have intended to resolve the knotty issues surrounding rent assignments in bankruptcy, it failed to do so in an effective manner—leaving open the possibility of continued divergence of opinion over the proper interpretation of state law on rent assignments.

Freyermuth, The Circus Continues—Security Interests in Rents, Congress, the Bankruptcy Courts, and the "Rents Are Subsumed in the Land" Hypothesis, 6 J. Bankr. L. & Prac. 115, 120–121 (1997). For further consideration of Congressional intent, see Carlson, Rents in Bankruptcy, 46 S.C. L. Rev. 1075, 1085, 1145–1146 (1995).

For additional scholarly commentary on security interests in rents, see Forrester, A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan, 46 Rutgers L. Rev. 349 (1993); Freyermuth, Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance, 40 UCLA L. Rev. 1461 (1993); Randolph, When Should Bankruptcy Courts Recognize Lenders' Rents Interests?, 23 U.C. Davis L. Rev. 833 (1990).

Means of enforcing the mortgage on rents, Comment c. Traditionally, a mortgagee does not become a mortgagee in possession simply because it collects rent. See Prince v. Brown, 856 P.2d 589 (Okla.Ct.App.1993) ("[A] mortgagee who receives rents and profits does not become a mortgagee in possession 'unless the mortgagee also enters into continued physical possession of the mortgaged real property and exercises exclusive operating control of the mortgaged real property.'").

This section seeks a practical and efficient "middle ground" approach to mortgages on rents. On the one hand, it avoids the semantic and logical difficulties inherent in the "absolute assignment" approach. On the other, it rejects the analytical and practical morass of the "inchoate lien" approach, which purports to confer either "nothing" or at most, an ambiguous "inchoate equitable interest" on the mortgagee until the requisite "affirmative action" is accomplished. Moreover, unlike some of its "middle ground" counterparts, it contains a relatively efficient notice mechanism for enforcing or "foreclosing" the mortgage rather than for such cumbersome and impractical means as requiring the mortgagee to take possession or obtain the appointment of a receiver.

Rights of lessees and other obligors, Comment d. As to the potential double liability of the lessee or other obligor after the mortgagee asserts the right to collect rents under its mortgage on rents, see E. A. Farnsworth, Contracts § 11.7 (2d ed. 1990) ("If the obligor pays the assignor without knowing of the assignment, it would plainly be unfair to require the obligor to pay again. Therefore, if the obligor pays before being notified of the assignment, the debt is discharged. But if the obligor pays after having been notified of the assignment, the debt is not discharged; the obligor's payment is not a defense against the assignee"); Restatement, Second, Contracts § 338. For a consideration of the rights and remedies of the lessee or other obligor when both mortgagor and mortgagee demand payment of the rents, see Restatement, Second, Contracts § 339.

Definition of the term "rents," Comment e. The definition of "rents" under this section also encompasses "issues and profits." Moreover, it not only includes proceeds derived from lessee-lessor relationships, it also encompasses revenues that are produced primarily from licenses and similar agreements governing the use or occupancy of real estate. On the other hand, the definition excludes revenue that is generated primarily from the sale of goods and services. Drawing a line between these two categories of proceeds can sometimes prove difficult. The following analysis, which focuses on this problem in the mortgage receivership setting, is also helpful in the context of a mortgage on rents:

> When a mortgagor conducts a business of any sort on his own land, the rental value of that land, whether explicitly recognized or not, is one of the elements comprising the gross income of the business, along with other factors such as the price of materials, management, and interest on capital. Attempts to segregate from gross income that portion earned by the mortgaged real property can be little more than an arbitrary estimate in most cases. It is not surprising, therefore, to find the courts appointing receivers in cases where the rent element clearly predominates and the services of the mortgagor are essentially the same in kind as those of any landlord ... and the contribution to the income of other conveniences is small. This would cover apartment houses and, probably, a garage or parking lot. Where, in addition to the land and buildings, the business utilizes considerable amounts of chattels, good will is a substantial factor and the part that management plays is large, the propriety of permitting the mortgagee to take over the business through a receiver is dubious. [Nevertheless], receivers have been appointed for hotels, although there is some authority to the con-

trary, and one case limited the receivership to that portion of the revenues derived from rent actually paid for rooms occupied. On the other hand a receiver of mortgaged premises on which mortgagor conducted a dance hall, restaurant and ice cream parlor was denied on the ground that there were no rents and profits.

1 G. Nelson & D. Whitman, Real Estate Finance Law 265–266 (3d ed. 1993).

As the foregoing illustrates, the treatment of hotel room charges is an especially troubling issue. Many courts have held that such proceeds are personalty and thus not encompassed in a mortgage on the rents of real estate. See In re Green Corp., 154 B.R. 819 (Bankr.D.Me.1993); In re Shore Haven Motor Inn, Inc., 124 B.R. 617 (Bankr.S.D.Fla.1991); In re Majestic Motel Assoc., 131 B.R. 523 (Bankr.D.Me.1991); In re Sacramento Mansion, Ltd., 117 B.R. 592 (Bankr. D.Colo.1990); In re Investment Hotel Properties, Ltd., 109 B.R. 990 (Bankr.D.Colo.1990); In re Prime Motor Inns, Inc., 123 B.R. 104 (Bankr. S.D.Fla.1990); In re M. Vickers, Ltd., 111 B.R. 332 (D.Colo.1990); In re Oceanview/Virginia Beach Real Estate, 116 B.R. 57 (Bankr.E.D.Va. 1990); In re Greater Atlantic and Pacific Investment Group, Inc., 88 B.R. 356 (Bankr.N.D.Okla.1988); In re Kearney Hotel Partners, 92 B.R. 95 (Bankr.S.D.N.Y.1988); In re Ashkenazy Enter., Inc., 94 B.R. 645 (Bankr. C.D.Cal.1986). On the other hand, there is significant authority that such room charges qualify either as "rents" or "issues or profits" of real estate and thus are properly mortgageable as real estate. See Travelers Ins. Co. v. First Nat'l Bank, 621 N.E.2d 209 (Ill. App. Ct. 1993) ("The conclusion that room revenue is not rent generated by real property is counter-intuitive. It is indisputable that the common understanding is that rent is compensation for use of property for shelter. Also, the commonly held view is that a hotel guest primarily seeks shelter not service."); Great-West Life Assur. Co. v. Raintree Inn, 837 P.2d 267 (Colo.Ct.App. 1992); Financial Security Assur., Inc. v. Tollman-Hundley Dalton, L.P., 74 F.3d 1120 (11th Cir. 1996) (treating room revenues as rents under earlier version of § 552(b) of the Bankruptcy Code); In re Days California Riverside Ltd. Partnership, 27 F.3d 374 (9th Cir.1994) ("[w]e determine for ourselves that California law includes hotel room charges as rents for security purposes. To hold otherwise ... would discourage the financing of what is a multi-billion dollar industry in that state."); Matter of T-H New Orleans Ltd. Partnership, 10 F.3d 1099 (5th Cir.1993) ("hotel revenues are sufficiently 'like rent' under Louisiana law to be included within the term 'rents' in § 552(b) [of the Bankruptcy Code]"); Great-West Life & Annuity Assur. Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843 (N.D.Ohio 1994) ("This court holds that the term 'profits' in section 552(b) of the Bankruptcy Code is broad enough to include hotel room revenues and hotel room receipts"); In re Bellevue Place Assoc., 173 B.R. 1009 (Bankr.N.D.Ill. 1994) (under Illinois, mortgagee's security interest in hotel's "rents, issues and profits" included room revenues); In re Churchill Properties VIII Ltd. Partnership, 164 B.R. 607 (Bankr. N.D.Ill.1994) (hotel room revenue qualifies as "rent"); In re S.F. Drake Hotel Assoc., 131 B.R. 156 (Bankr. N.D.Cal.1991) (hotel room revenue deemed "rent"); In re Mid-City Hotel Assoc., 114 B.R. 634 (Bankr.D.Minn.

1990) (hotel revenue deemed "issues and profits"). See Freyermuth, Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance, 40 UCLA L. Rev. 1461 (1993) (taking the position that "there is no legal or functional basis ... to treat hotel room revenues ... differently from rents paid by tenants holding leasehold estates in land," even though advocating that "all income generated pursuant to contracts for the occupancy of land should be characterized as personal property when that income is pledged as security").

This section reflects the latter view and takes the position that hotel room charges constitute rents from real estate. This approach is justifiable on at least two grounds. First, a hotel guest not only has the right to occupy building space for a delineated period, but he or she also has the right to exclude others, including, in many situations, the hotel management. Second, blanket real estate treatment obviates the need to distinguish between daily room charges and rates collected for longer stays. If daily charges are treated as personalty, should the same hold true for weekly or monthly rates? Some hotels, whether classified as luxury or modest, cater to guests who are, for practical purposes, long-term tenants.

Until recently whether hotel room revenues were characterized as rents had important consequences in bankruptcy. For example, if hotel room charges were not treated as "rents," taking a security intorest in them as accounts receivable or general intangibles under Article 9 of the Uniform Commercial Code did not protect a lender with respect to room revenues that accrued after the mortgagor filed a bankruptcy petition. This is because such revenues would have been treated as "property acquired by the ... debtor after the commencement of the case" for purposes of § 552(a) of the Bankruptcy Code. As such, room revenues would not have been "subject to any lien" arising from a pre-petition security agreement. Id. On the other hand, if such revenues were deemed to be rents, the lender was able to have them characterized as its "cash collateral" subject to the "adequate protection" requirements under § 363 of the Bankruptcy Code and thus often be able to prevent their use by the trustee or debtor-in-possession. See In re S.F. Drake Hotel Assoc., 131 B.R. 156 (Bankr.N.D.Cal.1991). See also In re Bering Trader, Inc., 944 F.2d 500 (9th Cir.1991). This result is consistent with the usual treatment of rents in office buildings and rental apartment buildings.

Congress resolved the foregoing bankruptcy issue with the enactment of § 552(b)(2) in the Bankruptcy Reform Act of 1994. See Reporters' Note to Comment *a*, supra for the text of § 552(b)(2). That section makes it clear that hotel and motel room charges will receive the same treatment as rents for "cash collateral" and "adequate protection" purposes. Mortgagees are thus assured that so long as they take the appropriate security interest in those room charges (a mortgage or assignment of rents in states that hold that such charges are rents or an Article 9 security interest in those states that treat such charges as personalty) they will be treated as "cash collateral" and entitled to "adequate protection" under § 363 of the Bankruptcy Code. Moreover, the decision by Congress to treat room charges as rents in this bankruptcy context supports the position of this section to treat them as rents for state mortgage law purposes.

Illustration 8 is based on In re Zeeway Corporation, 71 B.R. 210 (9th Cir.BAP 1987).

Illustration 9 is based on In re Ashford Apartments, Ltd. Partnership, 132 B.R. 217 (Bankr.D.Mass. 1991).

Landfill dumping fees represent an especially troublesome issue. One decision holds that they are neither rents nor profits, but simply "accounts" or some other form of personal property. See In re West Chestnut Realty of Haverford, Inc., 166 B.R. 53 (Bankr.E.D.Pa.1993). However, since material deposited in a landfill remains there permanently, such fees should, at a minimum, be characterized as proceeds payable by a licensee for the right to use or occupy another's real estate and therefore treated as "rents" under this section.

Illustration 14 is based in part on Matter of Hollinrake, 93 B.R. 183 (Bankr.S.D.Iowa 1988).

Satisfaction of the delivery requirement, Comment f. The requirement of Subsection (d)(2) that delivery of the demand for rent becomes effective upon receipt is consistent with § 9-318(3) of the Uniform Commercial Code (U.C.C. § 9-318(3) (1995)), which deals with the duty of an account debtor to pay an assignee of an account. Under the latter section the "account debtor is authorized to pay the assignor until the account debtor receives notification ... that payment is to be made to the assignee."

Mortgagor not liable for imputed rent, Comment g. Illustrations 14–17 exemplify the principle that a mortgage on rents can be used only to capture *actual* rent. It may not be used to hold a mortgagor who is occupying the premises liable for their reasonable rental value. This prohibition applies whether the mortgagor resides on the premises or uses it for commercial purposes. Case law provides at least indirect authority for this position. In People v. Gustafson, 127 P.2d 627 (Cal.Ct.App.1942), a statute authorized the state, upon its purchase of tax delinquent property, to "exact from the former owner of said property ... or any person in the possession, actual or constructive, of said property, an accounting for said rents, issues and profits." The state claimed that the former owner, who remained in undisturbed possession of the real estate after the tax sale, was liable for the reasonable value of his period of use and occupancy. However, in affirming a trial court judgment in favor of the former owner, the appellate court noted that the property was subject to redemption and stated that "it is the settled policy of the law to give a delinquent taxpayer every reasonable opportunity ... to redeem his property, and to make his burden as light as possible." Moreover, the court stressed that "the phrase 'rents, issues and profits' has a well understood meaning and refers to rents collected by the party in possession, and/or the net profits accruing to him from said property, and not to the rental value or the value of use and occupation."

Indirect support for Illustrations 14–17 can be found in cases denying a receiver of rents and profits the right to collect from a mortgagor a reasonable rent for mortgagor's continued occupation of the premises, notwithstanding a mortgage clause authorizing the appointment pending foreclosure of a receiver "of the rents, issues and profits" of the mortgaged real estate. See Holmes v. Gravenhorst, 188 N.E. 285 (N.Y.1933) ("There are no rents and profits. To authorize the receiver to evict the mortgagor and take possession of the premises in order to create rents and profits, or to compel the mortgagor to pay rent, would be to deprive the mortgagor of a vested right to possession which she had not contracted away"); Carlin Trading Corp. v. Bennett, 264 N.Y.S.2d 43 (N.Y.App.Div. 1965) ("We do not believe that a provision in the mortgage ... that allows a receiver to collect rent from a mortgagor in possession of a residence, allows him to obtain possession of the premises by eviction. There is a marked distinction between the right to collect rent and the right to obtain possession, and the yielding of one does not imply the cessation of the other"); Grusmark v. Echelman, 162 F.Supp. 49 (S.D.N.Y. 1958) ("Clearly, if the mortgagor is in total possession of the premises as in the case of a dwelling house, there are no rents and profits and therefore there is no occasion for the appointment of a receiver to collect them. The same is true if he is in possession of mortgaged premises on which he is conducting a business. On the other hand, an apartment house that is occupied by tenants produces rents in the form of payments by the tenants which are compensation primarily for the use of the property although they may cover also incidental services such as heat, gas and electricity.") But see Union Dime Sav. Bank v. 522 Deauville Assoc., 398 N.Y.S.2d 483 (N.Y.Sup.Ct.1977) ("The contention of [mortgagor] that as an owner of the premises he cannot be required to pay rent completely overlooks the provisions of ... the mortgage which specifically requires the mortgagor to pay a receiver the reasonable value of the use and occupation of any portion of the premises occupied by the mortgagor after the appointment of a receiver."). To the extent that a rents and profits receiver may be prohibited from collecting imputed rent from a mortgagor-occupant, it seems probable that a similar prohibition is applicable to a mortgagee seeking to accomplish the same result by means of a mortgage on the rents, profits, and issues.

§ 4.3 Appointment of a Receiver

(a) A mortgagee is entitled to the appointment of a receiver to take possession of the real estate if:

(1) the mortgagor is in default under the mortgage;

(2) the value of the real estate is inadequate to satisfy the mortgage obligation; and

(3) the mortgagor is committing waste.

(b) A mortgagee is entitled to the appointment of a receiver to take possession of the real estate if the mortgagor is in default under the mortgage and the mortgage or other agreement contains either a mortgage on the

rents or a provision authorizing appointment of a receiver to take possession and collect rents upon mortgagor default.

(c) A receiver appointed under this section has the authority to preserve the real estate, to collect rents, to pay real estate taxes and senior liens, to enter into, enforce, and terminate leases for the purpose of generating rental income, and to carry out such other functions as may be authorized by the court to enforce the receivership. A receiver is entitled to collect rent accruing after the date of appointment and, if the mortgagor has also mortgaged the rents, any unpaid rent that accrued prior to the appointment. The rents from the real estate, less amounts paid for real estate taxes, senior liens, and other reasonable expenses incurred in its management, maintenance, and repair, must be credited on the mortgage obligation.

(d) A receiver appointed under this section may collect imputed rent or a use or occupancy charge from a mortgagor who is in actual possession of tbe real estate only if:

(1) The mortgage or other agreement specifically authorizes such collection; and

(2) A specific provision of the mortgage documents bars personal liability of the mortgagor on the mortgage obligation.

(e) "Rents" means tbe proceeds defined in § 4.2(a).

(f) "Waste" means the occurrences defined in § 4.6(a).

Cross-References:

Section 4.1, Mortgage Creates Security Interest Only; § 4.2, Mortgaging Rents; § 4.6, Waste; § 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability.

Comment:

a. Introductory note. Because this Chapter adopts the "lien" theory of mortgages by its language that a mortgage creates only "a security interest in real estate" (see § 4.1), a mortgagee will rarely have a right to preforeclosure possession of the real estate. While this restriction on the mortgagee's possessory rights is significantly ameliorated by making mortgages on rents readily perfectible and enforceable (see § 4.2), there still are situations in which a more effective preforeclosure remedy, the equitable receivership, should be available to the mortgagee.

A receivership entails the judicial appointment of a third party to take possession of the mortgaged real estate, to repair or preserve it, and to collect rents. When this centuries-old remedy is sought, it is almost always in connection with foreclosure. It may be attractive to the mortgagee for at least two reasons. First, if the mortgagor is committing waste or otherwise failing to maintain the real estate, a receiver will be able to make repairs and take other steps to safeguard mortgagee's security. A mortgage on rents is not in itself effective for this purpose. Second, the mortgage on rents is effective only to the extent that rents currently are owing to the mortgagor. Where portions of the real estate are vacant, there are no rents to which the mortgage on rents attaches. A receiver, on the other hand, often will be able to lease the vacant space and thus reestablish or enhance the cash flow from the mortgaged real estate. Finally, a receivership may be preferable even in the limited settings where the mortgagee may have the option of becoming a mortgagee in possession (see § 4.1, supra), because it generally will insulate the mortgagee from tort and related landowner-type liabilities.

b. Availability of a receivership. This section follows the traditional rule in lien theory jurisdictions that limits the possibility of obtaining the appointment of a receiver where neither the mortgage nor other agreement contains language mortgaging the rents or authorizing a receivership upon mortgagor default. Where this is the case, not only must the mortgage obligation be in default, but the real estate must be inadequate to satisfy the mortgage obligation and waste must be occurring or have occurred. See Illustrations 1–3. In order to establish that the real estate is inadequate to satisfy the mortgage obligation, its value must be less than the obligation owing to the mortgagee seeking the receivership and the value of any senior liens against it. The waste requirement may be satisfied not only by showing that mortgagor has committed traditional acts of voluntary waste, but also by infractions of the broader set of duties defined as waste in § 4.6(a). They include not only the failure by the mortgagor to make reasonable repairs or to pay real estate taxes, but also the failure to pay casualty insurance premiums, if payment by the mortgagor is required by the mortgage documents. In addition, "waste" encompasses the improper taking by the mortgagor of rents which should be paid to the mortgagee under § 4.2. For purposes of this section, the term "mortgagor" includes successors in interest to the mortgagor, whether personally liable on the mortgage obligation or not.

However, where the real estate mortgage or other instrument contains language mortgaging the rents or authorizing the appointment of a receiver to take possession and collect rents upon default, the only requirement for a receivership is that the mortgagor be in default.

Illustrations:

1. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located an office building that is subject to numerous leases. There is neither a mortgage on the rents nor an agreement authorizing the appointment of a receiver upon default. Mortgagor defaults in payment of the mortgage debt. The value of Blackacre is less than the mortgage balance owing to Mortgagee and the value of any senior liens against it. Mortgagor fails to install a new roof on the building and, as a result, the building is no longer wind and water tight. Mortgagee is entitled to the appointment of a receiver.

2. The facts are the same as Illustration 1 except that the building is in good repair, but Mortgagor has either failed to pay (a) real estate taxes prior to their becoming delinquent or (b) casualty insurance premiums as required by the terms of the mortgage. Mortgagee is entitled to the appointment of a receiver.

3. The facts are the same as Illustration 1 except the value of Blackacre is greater than the mortgage balance owing to Mortgagee and the value of any senior liens against it. Mortgagee is not entitled to the appointment of a receiver.

4. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located an office building that is subject to numerous leases. The mortgage also contains a provision mortgaging the rents, stating that Mortgagee may collect the rents upon mortgagor default. Mortgagor defaults. The value of Blackacre exceeds the balance owing to Mortgagee. The building on Blackacre is in good repair. There is no delinquency in real estate taxes or senior liens and casualty insurance premiums have been paid. Mortgagee is entitled to the appointment of a receiver.

5. The facts are the same as Illustration 4 except that, instead of a mortgage on the rents, the mortgage contains a provision authorizing the appointment of a receiver to take possession and collect rents upon mortgagor default. Mortgagee is entitled to the appointment of a receiver.

c. Scope of receivership. A receiver appointed under this section is authorized to collect rents, to pay real estate taxes and senior liens, to enter into and to terminate leases, and to preserve the real estate. Although the court has broad authority to define the receiver's powers, any exercise of that authority must be consistent with the purpose of the receivership as delineated in this section. A receivership created under this section is not a "general" or "equity" receivership and thus the receiver has no general authority to take possession of all of mortgagor's assets for purposes of satisfying creditors out of those assets or to liquidate or reorganize mortgagor. To the extent that the business housed on the mortgaged real estate does not generate revenue "payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real property of another" (§ 4.2(a)), a receiver appointed under this section may not exercise control over it. Thus, a receiver may exercise control only over those proceeds that are paid primarily for the possession, occupancy, or use of real property and are capable of being separately mortgaged pursuant to § 4.2. On the other hand, where the latter condition is met, the receiver may collect rents, make repairs, purchase insurance, pay real estate taxes and other senior liens, create, enforce, and terminate leases, and undertake other activities that are normally associated with being a "landlord."

A receiver has the authority to collect all rents that accrue after the date of appointment. In addition, the receiver may collect unpaid rent that accrued prior to the receivership appointment if there is also a mortgage on the rents. See Illustration 6. Note that, while this section and Chapter broadly delineate the powers of a mortgage receiver, they do not, with few exceptions, (see § 4.5(b) and Comment *b*) define the receiver's duties and liabilities. Nor do they deal with the extent of the receiver's fiduciary obligation, the standard of liability to be imposed on the receiver's actions or failure to act, or the question of receiver compensation.

Illustration:

6. A receiver is appointed under this section. The mortgage contains an agreement mortgaging the rents. A tenant of the mortgagor owes $1,000 in rent that accrued prior to the appointment of a receiver. The receiver is entitled to the $1,000.

d. Receiver may not collect imputed rent from mortgagor in actual possession who is personally liable on the mortgage obligation. The receivership remedy of this section has only limited application to a mortgagor who is not a landlord. Thus, a receiver may not collect rent or a use or occupancy charge from a mortgagor who actually occupies the premises and is personally liable on the mortgage obligation. In other words, such a mortgagor is not liable for imputed rent to the receiver. This is so even though the mortgage or other agreement contains a mortgage on the rents and a receivership clause. See § 4.2, Comment *g*. Moreover, this result is not altered by the fact that the mortgagor agrees in advance to pay the receiver a reasonable rent. This prohibition applies whether the mortgagor resides on the premises or uses them to conduct a commercial enterprise. See Illustrations 7–11. A receiver in such a setting is limited to ameliorating and preventing waste, if any, and to performing the landlord's role as to any space that is vacant or rented to tenants.

Significant policy considerations support Subsection (d). Because it protects the residential mortgagor from eviction and having to pay rent to the receiver prior to foreclosure, it is consistent with the traditional lien theory concern for protecting the homeowner's right to possession prior to foreclosure. Nor is it unduly protective of the commercial mortgagor who is not a landlord. Those who lend to manufacturers and similar non-landlord mortgagors rarely rely on potential rental income from the mortgaged real estate as a significant source of security. Moreover, to allow a receiver to impose a rental obligation for the continued use of such real estate could have an especially detrimental impact on vulnerable third parties. A receiver who takes possession of rental real estate will almost always continue to operate the building in the same manner. Consequently, there will be relatively minor impact on tenant and other third-party expectations. On the other hand, where the mortgagor is a manufacturer or is otherwise operating a business on the mortgaged premises, a demand by the receiver for rent may lead to a termination of the mortgagor's activities. The mortgagor's employees may well lose their jobs and others who have business relationships with the mortgagor may be severely prejudiced.

On the other hand, a court will enforce language in the mortgage or other agreement authorizing the receiver to collect rent from a mortgagor in actual possession where the loan documents specifically insulate the mortgagor from personal liability on the mortgage obligation. See Illustrations 12–13. Thus, in the usual mortgage loan involving commercial or residential rental real estate where the obligation is specifically nonrecourse, a receiver will be able to collect rent from a mortgagor who has chosen to occupy rather than rent all or a part of the mortgaged real estate. The obligation is nonrecourse in such settings largely at the request of a mortgagor who seeks to obtain desirable treatment under federal and state income tax laws. To allow such a mortgagor in default both to occupy the mortgaged real estate rent-free for its own purposes and to escape personal liability on the mortgage obligation as well, is difficult to justify. Moreover, there should be no significant concern that routine inclusion of such language in the mortgage documents will defeat the policies that support this subsection. Only rarely will the language of mortgage loan documents relieve homeowners, merchants, manufacturers, or other borrowers who occupy or use the real estate themselves of personal liability on the mortgage obligation. More important, a receiver will be unable to collect rent from home mortgagors and other borrowers where state anti-deficiency legislation rather than the language of the loan documents make their loans nonrecourse. See Illustrations 14–15.

Finally, there may be rare situations where abusive or unconscionable conduct by a mortgagor may justify empowering the receiver to collect imputed rent irrespective of mortgage language or whether the mortgagor is personally liable on the mortgage obligation. For example, a mortgagor in default who is personally liable on the mortgage obligation may simply decide to terminate some or all existing leases and to occupy the space for its own business or other purposes. Where rental space is appropriated in such a manner, the mortgagor will be liable to the receiver for its reasonable rental value. See Illustration 16.

Any mortgagor who is liable for imputed rent under this section may be evicted for its nonpayment.

Illustrations:

7. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is located a single-family dwelling in which Mortgagor resides. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default. The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or any other charge from Mortgagor with respect to Mortgagor's continued possession of Blackacre.

8. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, on which is situated an apartment building containing 12 apartments, in one of which Mortgagor resides. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default.

The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or any other charge from Mortgagor with respect to the apartment in which Mortgagor resides. The receiver is entitled to collect rent due from Mortgagor's tenants with respect to the other apartments.

9. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located a grocery store which Mortgagor owns and operates. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default. The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or other charge from the Mortgagor with respect to Mortgagor's continued possession of Blackacre.

10. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located an automobile parts factory which Mortgagor owns and operates. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default. The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or other charge from the Mortgagor with respect to Mortgagor's continued possession of Blackacre.

11. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre, which is a section of farmland. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default. Mortgagor farms a portion of the land and leases the balance to tenant. The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is

appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or other charge from Mortgagor with respect to the portion that Mortgagor farms. The receiver is entitled to collect rent due from Mortgagor's tenant.

12. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located an office building. Language in the mortgage documents relieves mortgagor of personal liability on the mortgage obligation. The mortgage contains a provision mortgaging rents from Blackacre and authorizing the appointment of a receiver to take possession and to collect rents upon mortgagor default. The mortgage also contains a clause under which the mortgagor agrees to pay a reasonable rent in the event a receiver is appointed. Mortgagor thereafter defaults on the mortgage obligation. Any receiver appointed pursuant to this section may collect a reasonable rental from Mortgagor with respect to any space in the office building on Blackacre actually occupied by Mortgagor, and, absent its payment, may evict Mortgagor from such space.

13. Same facts as in Illustration 12, except that an automobile parts factory operated by Mortgagor is located on Blackacre. Any receiver appointed pursuant to this section may collect a reasonable rental from Mortgagor with respect to the factory on Blackacre and, absent its payment, evict Mortgagor from Blackacre.

14. Same facts as in Illustration 7, except that Mortgagor has no personal liability on the mortgage obligation because of state anti-deficiency legislation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or any other charge from Mortgagor with respect to Mortgagor's continued possession of Blackacre.

15. Same facts as in Illustration 9, except that Mortgagor has no personal liability on the mortgage obligation because of state anti-deficiency legislation. Any receiver appointed pursuant to this section may neither deprive Mortgagor of possession nor collect rent or any other charge from Mortgagor with respect to Mortgagor's continued possession of Blackacre.

16. Mortgagor borrows money from Mortgagee and gives Mortgagee a mortgage on Blackacre on which is located an office building that is leased to third-party tenants. Mortgagor is personally liable on the mortgage obligation. The mortgage contains provisions mortgaging the rents from Blackacre and authorizing

the appointment of a receiver to take possession and to collect rents upon mortgagor default. Mortgagor thereafter defaults on the mortgage obligation. Mortgagor and tenant then agree to terminate a lease covering a significant amount of space in the office building. After the lease is terminated, Mortgagor occupies that space and conducts its own business on it. Any receiver appointed under this section may collect a reasonable rental from Mortgagor with respect to the space occupied by Mortgagor and, absent its payment, evict Mortgagor from it.

e. Mortgagee may serve as receiver. While a mortgagee will normally not wish to take on the burdens and potential liability of being in possession of the mortgaged real estate, this section does not prohibit the appointment of the mortgagee as receiver. Indeed, there may be situations where the mortgagee serving as receiver will reduce costs or where the mortgagee's expertise or knowledge of a particular mortgaged property may make it especially qualified for such a role.

It may be argued that the appointment of a mortgagee as receiver is objectionable because, as a party, it cannot act impartially. Yet in title theory states, mortgagee in possession status is relatively common and there is no compelling evidence that conflict of interest represents an undue problem. In many instances, this concern for impartiality is overemphasized. For example, many institutional mortgagees have significant general managerial experience with rental real estate or special expertise or knowledge concerning the particular mortgaged property and thus may be highly qualified to undertake the role of receiver. In addition, the mortgagee-receiver often has a greater incentive than its third-party counterpart to control receivership costs. More important, it has a strong incentive to secure high-quality tenants and otherwise to improve the condition of the mortgaged property. Doing so may encourage third-party bidding at the foreclosure sale and, at the very least, make the property more attractive for the resale market in the event the mortgagee becomes the foreclosure purchaser.

REPORTERS' NOTE

Introductory note, Comment a. For an analysis of the substantive requirements and practical considerations associated with the use of a mortgage receivership, see 2 Glenn, Mortgages §§ 168–193 (1943); 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 4.33–4.43 (3d ed. 1993); Kratovil, Possession, Rents, and Mortgage Liability, 11 DePaul L. Rev. 1, 7 (1961); Lifton, Real Estate in Trouble: Lender's Remedies Need an Overhaul, 31 Bus. Lawyer 1927 (1976); Randolph, The Mortgagee's

Interest in Rents: Some Policy Considerations and Proposals, 29 Kan. L. Rev. 1 (1980); Comment, 50 Yale L.J. 1424 (1941).

The mortgagee normally is not responsible to third parties, whether private or governmental, for the physical condition of the mortgaged real estate or injuries that occur on it. See, e.g., Cantrell v. DuQuoin State Bank, 647 N.E.2d 1114 (Ill.Ct. App.1995); Smith v. Fried, 424 N.E.2d 636 (Ill.Ct.App.1981); Marcon v. First Federal Savings & Loan Ass'n, 374 N.E.2d 1028 (Ill.Ct.App. 1978) (only a mortgagee exercising dominion and control over the property can be held responsible for damages for damages to third parties caused by the unsafe conditions on the property); Commonwealth v. Advantage Bank, 550 N.E.2d 1388 (Mass.1990); Hausman v. Dayton, 653 N.E.2d 1190 (Ohio 1995) ("[A] mortgage of real property ... gives the mortgagee no right of possession or control.... A mortgagee, then, has no ability to create or prevent a nuisance from arising on the mortgaged property, and to hold such a mortgagee for abatement would be arbitrary and unconstitutional."); Solecki v. United States, 693 F.Supp. 770 (N.D.Iowa 1988). On the other hand, by becoming a mortgagee in possession, the mortgagee assumes the normal responsibilities of an owner or possessor of real estate. See § 4.1, Comment *a* and Reporters' Note; 1 G. Nelson and D. Whitman, Real Estate Finance Law § 4.26 (3d ed. 1993). The receivership remedy, however, generally will insulate the mortgagee from such liabilities. See, e.g., In re Greenleaf Apartments, Ltd., 158 B.R. 456 (Bankr. S.D. Ohio 1993) ("Where the mortgagee does not have possession ... and possession is in the hands of a receiver, an agent of the court, the mortgagee has no duty to protect the property or to notify the [mortgagor or guarantor] of any deterioration in the value of the property.").

Availability of a receivership, Comment b. This section reflects the traditional position of lien theory states that a mortgage creates only "a security interest in real estate" and confers no possessory right in it on the mortgagee. See § 4.1(a). As a result, where neither the mortgage nor other agreement specifically mortgages the rents or authorizes the appointment of a receiver upon mortgagor default, this section places a significant burden on a mortgagee seeking a preforeclosure receiver of rents. Indeed, it may be asked why a receivership should ever be appointed in such a setting. The principal rationale for such an appointment was articulated by the New York Court of Appeals as follows:

> There can be no doubt, that in a proper case where a bill was filed for specific performance of a contract to convey land, the court might appoint a receiver of the rents accruing during the pendency of the action, for equity treats that as done which ought to be done, and, therefore, considers a conveyance as made at the time when it ought to have been made, and the rents as belonging in equity, to the vendee from the time when he became entitled to the conveyance. On the same principle it may deem the foreclosure of a mortgage completed as of the time when the mortgagee becomes entitled to it. The legal right to the rents, as well as to the possession, continues in the mortgagor until foreclosure and sale, as it does in a vendor until

> conveyance. But when default has been made in the condition of the mortgage, the mortgagee at once becomes entitled to a foreclosure of the mortgage and a sale of the mortgaged premises. *This process requires time*, and on general principles of equity, the court may make the decree, when obtained, relate back to the time of the commencement of the action, *and where necessary for the security of the mortgage debt*, may appoint a receiver of the rents and profits accruing in the meantime, thus anticipating the decree and sale.

Hollenbeck v. Donnell, 94 N.Y. 342, 347 (1884). See also Totten v. Harlowe, 90 F.2d 377 (D.C.Cir.1937). An additional justification for a "lien" state receivership "stresses wrongful conduct by the mortgagor in impairing the res to which the mortgagee is entitled, or threatening to do so by active misconduct or neglect. Such wrongdoing arguably makes it reasonable to give the mortgagee the yield of the res as a compensatory substitute." 1 G. Nelson and D. Whitman, Real Estate Finance Law § 4.34 (3d ed. 1993).

It is difficult to identify a predominant standard for the appointment of a receiver among lien-theory states. Some decisions maintain that "a mortgagee is not entitled to a receiver if the security is adequate and no waste is threatened." Dart v. Western Savings & Loan Association, 438 P.2d 407 (Ariz.1968); Atco Construction & Development Corporation v. Beneficial Savings Bank, F.S.B., 523 So.2d 747 (Fla.Dist.Ct.App.1988) (appointment of receiver improper because mortgagee "failed to show either a waste of the property or any impairment of security"); Societe Generale v. Charles & Company Acquisition, Inc., 597 N.Y.S.2d 1004 (N.Y. App. Div. 1993) ("Appointment of a receiver may be denied where the property is sufficient security for the debt and the property is not in danger."). Other decisions identify three requirements. Under this approach, proof is required that "(1) the mortgagor is insolvent; (2) the mortgagor is committing waste; and (3) the value of the security is inadequate to cover the mortgage debt." Mutual Benefit Life Insurance Co. v. Frantz Klodt & Son, Inc., 237 N.W.2d 350 (Minn.1975); Brown v. Muetzel, 358 N.W.2d 725 (Minn.Ct.App.1984). See also Chase Manhattan Bank v. Turabo Shopping Center, Inc., 683 F.2d 25 (1st Cir. 1982). In any event, inadequacy of security is always required. See, e.g., Turtle Lake Associates, Ltd. v. Third Financial Services, Inc., 518 So.2d 959 (Fla.Dist.Ct.App.1988); Colley v. First Federal Savings and Loan Association of Panama City, 516 So.2d 344 (Fla.Dist.Ct.App.1987).

Many jurisdictions have statutes or court rules governing the appointment of receivers. Typical is the California provision that provides for the appointment of a receiver

> where it appears that the mortgaged property is in danger of being lost, removed, or materially injured, or that the condition of the mortgage has not been performed, and that the property is probably insufficient to discharge the mortgage debt.

West's Ann. Cal. Code Civ. Proc. § 564(2). See Barclays Bank of California v. Superior Court, 69 Cal. App.3d 593, 137 Cal.Rptr. 743 (1977); Turner v. Superior Court, 140 Cal. Rptr. 475 (Cal.Ct.App.1977). For similar statutes, see Ark. Code Ann. § 16–117–208; Colo. Rev. Stat. § 38–39–112; Application of Northwestern

Mutual Life Insurance Company, 703 P.2d 1314 (Colo.Ct.App.1985); Idaho Code § 8-601; West's Ann. Ind. Code § 34-1-12-1; Johnson v. LaPorte Bank & Trust Co., 470 N.E.2d 350 (Ind.Ct.App.1984); Neb. Rev. Stat. § 25-1081; Federal Land Bank of Omaha v. Victor, 440 N.W.2d 667 (Neb.1989); Nev. Rev. Stat. § 32.010(2); N.D. Cent. Code § 32-10-01; Mont. Rev. Code § 27-20-102; S.D. Codified Law § 21-21-2; Wash. Rev. Code Ann. 7.60.020(4); Utah Rule Civ. Pro. 66(a). While the standard adopted by this section (§ 4.3(c)) is not identical to any of the foregoing state approaches, it clearly reflects the traditional lien-theory disinclination to interfere with mortgagor's possession prior to foreclosure. In this respect it is consistent with § 4.1. The mortgaged real estate must be inadequate to satisfy the mortgage obligation. Moreover, actual rather than "threatened" waste is required. On the other hand, the waste definition of § 4.3(b) will not only be satisfied by "voluntary" or active waste, which entails affirmative destruction or alteration of the real estate, but also by mortgagor failure to make reasonable repairs or to pay real estate taxes or insurance premiums. There is judicial authority for such an inclusive definition of waste. See, e.g., First National Bank v. Dual, 15 Alaska 542 (1955); Title Insurance & Trust Co. v. California Development Co., 127 P. 502 (Cal.1912); Baugh v. District Court of the County of El Paso, 442 P.2d 408 (Colo.1968); Wellman Savings Bank v. Roth, 432 N.W.2d 697 (Iowa.Ct.App.1988); Lincoln National Life Ins. Co. v. Brack, 265 N.W. 290 (Minn.1936); Larson v. Orfield, 193 N.W. 453 (Minn.1923); Nielsen v. Heald, 186 N.W. 299 (Minn.1922); American Medical Services, Inc. v. Mutual Federal Savings & Loan Association, 188 N.W.2d 529 (Wis.1971); Little Earth of United Tribes, Inc. v. United States Department of Housing and Urban Development, 584 F.Supp. 1301 (D.Minn. 1983); Annot., 55 A.L.R.3d 1041 (1974).

Some cases suggest that mortgagor-insolvency may be a condition precedent to a receivership. See, e.g., Chase Manhattan Bank v. Turabo Shopping Center, Inc., 683 F.2d 25 (1st Cir.1982); Mutual Benefit Insurance Co. v. Frantz Klodt & Son, Inc., 237 N.W.2d 350 (Minn.1975); Minnesota Building & Loan Association v. Murphy, 222 N.W. 516 (Minn.1928); Brown v. Muetzel, 358 N.W.2d 725 (Minn.Ct.App.1984); Annot., 55 A.L.R.3d 1041, 1044-45 (1974). Cf. Travelers Insurance Company v. Tritsch, 438 N.W.2d 863 (Iowa.Ct. App.1989) (insolvency not required for receivership where mortgage contained a mortgage of rents and profits). This section does not impose a mortgagor insolvency requirement. Such a requirement is clearly unjustifiable where, as is common in contemporary commercial financing transactions, the mortgage obligation is "non-recourse." In such a setting, the mortgagee has no right to look to the personal solvency of the mortgagor to collect the obligation and thus mortgagor's financial status should be irrelevant for receivership purposes. Neither, however, should insolvency be required where mortgagor is personally liable on the debt. Proving mortgagor insolvency is often a difficult and complex process, and would impose an unfair burden on the mortgagee in situations where the timely appointment of a receiver is crucial. In any event,

> [t]he creditor who takes security is entitled to rely upon it exclusively

for the payment of the entire debt without resorting to other assets of the mortgagor because that is why mortgagee took it in the first place. It is quite true that a solvent mortgagor will pay the debt to save the property if it is worth more than the mortgage debt. And it is equally true that a solvent mortgagor usually will pay the debt even though the property is worth less than the mortgage debt, at least to the extent that he or she would face a deficiency judgment for the difference. Consequently, it would be a relatively uncommon case in which the question of receivership would arise unless the mortgagor is insolvent. Nonetheless it arguably ought to be no part of the mortgagee's case to have to establish insolvency as a condition to relief.

1 G. Nelson and D. Whitman, Real Estate Finance Law 240 (3d ed. 1993).

While this section makes the appointment of a receiver relatively difficult in the absence of a receivership agreement or a mortgage on the rents, when either type of agreement is present, a receiver will be appointed simply upon establishing that the mortgage is in default. In this connection, receivership agreements and mortgages on rents are both treated as affording the mortgagee a security interest in the rents and a judicial remedy for gaining access to them.

As to receivership agreements, courts take a variety of approaches. Some courts simply refuse enforcement when, in the absence of such an agreement, they would deny appointment of a receiver. See, e.g., Dart v. Western Savings & Loan Association, 438 P.2d 407 (Ariz.1968); Chromy v. Midwest Federal Savings & Loan Assn. of Minneapolis, 546 So.2d 1172 (Fla.Dist.Ct.App.1989); Sazant v. Foremost Investments, N.V., 507 So.2d 653 (Fla.Ct.App. 1987) (receivership clause "is not operative where, as here, the mortgagor is committing no acts of waste on the mortgaged property and its defaults, if any, on the mortgage do not place the mortgaged fee at serious risk"); Gage v. First Federal Savings & Loan Association of Hutchinson, Kansas, 717 F.Supp. 745 (D.Kan.1989); Barclays Bank, P.L.C. v. Davidson Avenue Assoc., Ltd., 644 A.2d 685 (N.J. Super. 1994) ("A contractual provision for the appointment of a rent receiver upon mortgage default usurps the judicial function and thereby contravenes public policy."); 2 Glenn, Mortgages § 175.1 at 929 (1943) ("The answer is that no such contract provision should force a court of equity to exercise its discretion in favor of a party who stands in no need of aid.... If the security is plainly adequate, a receiver will not be appointed, despite the presence, in the mortgage, of a rent pledge or receivership clause, or both.").

On the other hand, some courts are inclined to enforce receivership agreements irrespective of whether a receivership would be justified in their absence. See Bank of America National Trust and Savings Association v. Denver Hotel Association Limited Partnership, 830 P.2d 1138 (Colo. Ct.App.1992) (trial court did not abuse discretion in appointing receiver where deed of trust language authorized appointment after default without regard to adequacy of security or solvency of debtor); Fleet Bank of Maine v. Zimelman, 575 A.2d 731 (Me.1990) ("Any advantage gained by the [mortgagee] by having a receiver was freely bargained for at the time the agreement was reached. Accordingly, there is no reason not to enforce the unambiguous language of the mortgage, entitling the [mortgagee] to the appointment of a receiver"); Metropolitan Life Insurance Co. v. Liberty Center Venture, 650 A.2d 887 (Pa.Super.1994) (receivership clause binding on the parties); Federal Home Loan Mortgage Corp. v. Nazar, 100 B.R. 555 (D.Kan.1989) (under Kansas law, receivership agreement was enforceable).

Where the receivership agreement is incident to a federally insured mortgage, federal courts often hold that receivership clauses alone justify the appointment of a receiver in situations where the mortgagee is unable to meet the traditional requirements for appointment. See, e.g., United States v. Berk & Berk, 767 F.Supp. 593 (D.N.J.1991); United States v. Drexel View II, Limited, 661 F.Supp. 1120 (N.D.Ill.1987); United States v. Baptist Towers II, Limited, 661 F.Supp. 1124 (N.D.Ill.1987); United States v. American National Bank & Trust Co. of Chicago, 573 F.Supp. 1317 (N.D.Ill.1983); United States v. Mountain Village Co., 424 F.Supp. 822 (D.Mass.1976). These cases are the product of the application of a "federal common law" instead of the substantive law of the forum state. See Drexel View, supra ("Thus, whether or not HUD makes an appropriate showing for the appointment of a receiver under state law is irrelevant. The issue is simply whether HUD, pursuant to federal law, is entitled to the appointment of a receiver under the circumstances of this case.").

While some courts do not automatically enforce receivership agreements, they appear to be favorably disposed toward them. See Barclays Bank of California v. Superior Court, 137 Cal.Rptr. 743 (Cal.Ct.App.1977) ("although a recital that upon default the [mortgagee] shall be entitled to the appointment of a receiver is not binding upon the courts, such a recital nevertheless has some evidentiary weight.... It reasonably follows that it presents a prima facie, but rebuttable, evidentiary showing of the [mortgagee's] entitlement to appointment of a receiver"); Riverside Properties v. Teachers Ins. and Annuity Assn., 590 S.W.2d 736 (Tex. Ct. App. 1979); Okura & Co. v. Careau Group, 783 F.Supp. 482 (C.D.Cal.1991). See also Wellman Savings Bank v. Roth, 432 N.W.2d 697 (Iowa.Ct.App.1988).

In several states, statutes make receivership clauses enforceable upon mortgagor default without the necessity of establishing the normal equitable conditions precedent. See Ill. Rev. Stat. ch. 110, pars. 15–1101 to 15–1706 (as to nonresidential mortgages, where mortgage so provides, mortgagee may take possession where there is a reasonable probability mortgagee will prevail on a final hearing; "whenever a mortgagee entitled to possession so requests, the court shall appoint a receiver"); Mellon Bank, N.A. v. Midwest Bank & Trust Co., 638 N.E.2d 640 (Ill.Ct.App. 1993); Home Life Insurance Company v. American National Bank and Trust Company, 777 F.Supp. 629 (N.D.Ill.1991); West's Ann. Ind. Code § 34–1–12–1(4)(c) (receiver may be appointed if "either the mortgagor or owner of property has agreed in the mortgage or in some other writing to the appointment of a receiver" and property is not occupied by mortgagors as principal residence); Farver v. DeKalb County Farm Bureau, Co-op Credit Union, 576 N.E.2d 1361 (Ind.Ct.App.1991) (receivership clause mandates appointment of receiver where mortgagor does not occupy as principal residence); Minn. Stat. Ann. § 559.17 (subd. 2) (as to mortgages of $500,000 or more); New York Life Ins. Co. v. Bremer Towers, 714 F.Supp. 414 (D.Minn.1989) (mortgagee entitled to receivership pursuant to contract and Minnesota statute); McKinney's N.Y. Real Prop. Law § 254(10) (where mortgage so provides, the mortgagee may have a receiver appointed on default as a matter of right); East New York Savings Bank v. 924 Columbus Associates, L.P., 628 N.Y.S.2d 642 (N.Y.App.Div.1995); 366 Fourth Street Corp. v. Foxfire Enterprises, Inc., 540 N.Y.S.2d 489 (N.Y. App. Div. 1989) (no showing of need required where mortgage contains receivership clause); Febbraro v. Febbraro, 416 N.Y.S.2d 59 (N.Y. App. Div. 1979) (no showing of need required of mortgagee proceeding under such mortgage language); F.D.I.C. v. Vernon Real Estate Investments, Ltd., 798 F.Supp. 1009 (S.D.N.Y.1992) ("where the mortgagor has defaulted, mortgagee has accelerated the entire debt pursuant to the mortgage, and full payment has not been tendered, proof of the necessity of a receiver is not required"). But compare Federal Home Loan Mortgage Corp. v. Jerwin Realty Associates, 1992 WL 390264 (E.D.N.Y. 1992) ("[T]he Court has the discretion as a matter of equity to deny appointment of a receiver under appropriate circumstances even though the mortgage provides the mortgagee with a specific right to an appointment."); 12 Okla. Stat. Ann. § 1551(2)(c) (receiver may be appointed where "a condition of the mortgage has not been performed and the mortgage instrument provides for the appointment of a receiver."); MIF Realty L.P. v. Duncan Development Co., 892 P.2d 664 (Okla. Ct. App. 1995) (receivership clause enforceable under statute where mortgagor in default on a condition in the mortgage).

There is relatively little authority on whether, absent a receivership clause, a mortgage on the rents alone suffices to justify the appointment of a receiver against a mortgagor in default. This is because a mortgage on rents is rarely utilized without a receivership clause. However, for cases suggesting that a receivership should be granted based on a mortgage on rents clause, see Mines v. Superior Court, 16 P.2d 732 (Cal.1932); Federal Land Bank of Omaha v. Haworth, 414 N.W.2d 650 (Iowa.Ct.App.1987). But see 2 Glenn, Mortgages § 175.1 (1943).

It may be argued that in allowing automatic appointment of a receiver on default where either a receivership clause or a mortgage on rents exists, § 4.3(d) largely defeats the purpose of § 4.3(c) which makes receivership difficult to obtain when such provisions are absent. After all, most contemporary commercial mortgage forms and many residential counterparts routinely include one or both of these provisions. However, receiverships will only become commonplace under § 4.3(b) where the mortgage is on rental real estate. This is because § 4.3(d) usually prohibits a receiver from interfering with a mortgagor who actually occupies the mortgaged real estate or from collecting imputed rent or any other occupancy charge in connection with that occupation. Thus, homeowners and other mortgagors who themselves use the real estate for either residential or nonrental business purposes will almost always be protected in that continued use.

Moreover, any mortgagor of rental real estate who either consents in advance to a receivership or mortgages the rents is typically commercially sophisticated. Consequently, there seems to be little policy justification, other than a highly conceptual and strained interpretation of the lien theory of mortgages, for allowing such mortgagors to avoid the impact of such agreements.

Scope of the receivership, Comment c. In general, a receiver is appointed "for the purpose of conserving the mortgaged property and applying rents and profits of the property to the satisfaction of the debt secured by the mortgage." Keith County Bank & Trust Co. v. Wheat Belt Public Power District, 415 N.W.2d 459 (Neb.1987). See Bank of Tokyo Trust Co. v. Urban Food Malls, 650 N.Y.S.2d 654 (App.Div.1996) ("the right of a receiver to compel attornment and collect rent in the context of a foreclosure proceeding is well established."); Federal Home Loan Mortgage Corporation v. Spark Tarrytown, Inc., 829 F.Supp. 82 (S.D.N.Y.1993) ("A receiver acts 'as an officer of the court and has the duty to preserve and protect the property pending the outcome of the litigation. As a result, [the receiver's] authority is wholly determined by the order of the appointing court.'"). There is authority that a receiver cannot collect accrued rental arrearages unless there is a mortgage on the rents. See Stewart v. Fairchild-Baldwin Co., 108 A. 301 (N.J. Err. & App. 1919); Coleman v. Mulcahey, 165 N.E. 189 (Ill.1929). According to one commentator, however, the receiver should have the right, notwithstanding the absence of a mortgage on the rents, to collect "not only ... rent later to mature, but also rent that is due at the date of his appointment." 2 Glenn, Mortgages 944 (1943). See also N.Y. Life Ins. Co. v. Fulton Development Corp., 193 N.E. 169 (N.Y.1934) ("... the receiver appointed in foreclosure may be authorized to collect such rents as have theretofore accrued but have not yet come into the hands of the owner of the equity of redemption."). For further analysis of the right of a receiver to rent that accrues prior to the receivership, see 1 G. Nelson and D. Whitman, Real Estate Finance Law § 4.38 (3d ed. 1993).

A receiver's right to collect rents terminates if the full amount of the mortgage obligation is satisfied at the foreclosure sale. See Federal Land Bank of Omaha v. Dunkelberger, 499 N.W.2d 305 (Iowa.Ct.App.1993). On the other hand, where a deficiency judgment is entered against the mortgagor, the receiver may apply accumulated rents to satisfy that deficiency. See Rhoden v. Federal Deposit Insurance Corp., 619 So.2d 480 (Fla.Dist.Ct.App.1993).

For an instructive consideration of the role and scope of a mortgage receiver, see Turner v. Superior Court, 140 Cal.Rptr. 475 (Cal.Ct.App. 1977). *Turner* illustrates the problems that arise where receivers attempt to exercise jurisdiction over the mortgagor's business as well as the real estate and its rents. The court emphasized the limited role of the mortgage receiver:

> We have been cited to no authority for the proposition that a court has the power to authorize the receiver in the course of the performance of his duties to reach out and latch onto the appropriate property to the use of the receivership which is not properly a part of the receivership estate. On the con-

trary, what authority there is on the subject points unerringly to a contrary result.

Id. at 480.

In this regard, the words of Mr. Justice Cardozo in Duparquet Huot & Moneuse Co. v. Evans, 297 U.S. 216, 221, 56 S.Ct. 412, 414, 80 L.Ed. 591, 594 (1936), are instructive. In that case the court held that the appointment of a rents and profits receiver pursuant to a mortgage foreclosure action was not an act of bankruptcy because such a receiver is not a full equity or general receiver within the meaning of law:

> A receivership in a foreclosure suit is limited and special. The rents and profits are impounded for the benefit of a particular mortgagee to be applied upon the debt in the event of a deficiency.... The corporation retains its other property, if it has any, unaffected in its power of disposition by the decree of sequestration. The creditors retain their remedies except against the income subjected to the lien. There is neither winding up of the business nor attempt to reorganize it and set it going anew....
>
> But the situation is very different if the receivership in view is one for the foreclosure of a mortgage. In its normal operation such a receivership does not connote possession of all the property of the debtor or even all the property within the appointing jurisdiction. The mortgage may be a lien upon one parcel or a few, leaving other property of abundant value for payment of the debts.

Accord: Castlebrook, Limited v. Dayton Properties Limited Partnership, 604 N.E.2d 808 (Ohio.Ct.App.1992) (because tenant security deposits are not "rents, issues and profits" under Ohio law, mortgage foreclosure receiver has no power to collect them because "the receiver ... does not have the all-encompassing powers of a general receiver of all property of the debtor, but is instead limited to taking those actions 'with respect to' the property covered by the mortgage that is being foreclosed"); Great American First Savings Bank v. Bayside Developers, 284 Cal.Rptr. 194 (Cal. Ct. App. 1991) ("[mortgagee's] complaint was for specific performance of the rents, issues and profits clause by appointment of a receiver only. The complaint did not pray for a general receiver who would have the power to sell all or part of the receivership estate. Sale of the town homes was beyond the power of the court to authorize"). See also Cal-American Income Property Fund VII v. Brown Development Corporation, 187 Cal. Rptr. 703 (Cal.Ct.App.1982). See 2 Glenn, Mortgages § 185 at 960 (1943):

> The rents of land are available to a foreclosing mortgagee because they spring from the land itself, and are the direct fruit and offspring thereof. As incidental to the collection of such an income, the receiver ... takes over the business activities that every landlord assumes, billing the tenants, collecting the rents, evicting for non-payment, making repairs, keeping up insurance and keeping down taxes. There is no difference in this respect, between a cottage and an apartment house; hence, when the premises are occupied by a building of that description, the appointment of a mortgage receiver is quite proper; and the same thing is true as to premises used as a garage or parking lot.

But such instances do not justify the statement that whenever the mortgagor operates a business on the premises, the receiver may take over the business and operate it. The proper question is, what is covered by the mortgage? If it covers the real estate alone, then the only business the receiver can properly operate is the business of a landlord.

See also 1 G. Nelson and D. Whitman, Real Estate Finance Law § 4.41 (3d ed. 1994) ("[I]t is clear that a mortgage foreclosure receiver cannot take into his possession or control property not covered by the mortgage, and a 'mortgage covers the land and building not the business enterprise housed.'").

While this section does not deal with the personal liability of mortgage receivers, traditionally, they have enjoyed broad immunity from personal liability for actions that are within the scope of their authority. See, e.g., Federal Deposit Insurance Corp. v. J.D.L. Assoc., 866 F.Supp. 76 (D.Conn.1994) ("Because receivers are entitled to protection against unnecessary and oppressive litigation, 'consent to sue will not be granted where the receiver has kept clearly within the scope of his authority and acted wholly under the direction of the court.'"); Federal Home Loan Mortgage Corp. v. Tsinos, 854 F.Supp. 113 (E.D.N.Y.1994); Federal Home Loan Mortgage Corp. v. Spark Tarrytown, Inc., 829 F.Supp. 82 (S.D.N.Y.1993). Indeed, some courts have suggested, albeit in the general receivership context, that receivers are entitled to absolute derivative judicial immunity. See, e.g., New Alaska Development Corp. v. Guetschow, 869 F.2d 1298 (9th Cir.1989).

Receiver may not collect imputed rent from mortgagor who is personally liable on the mortgage obligation, Comment d. The primary focus of a receivership created pursuant to this section is on the mortgagor who is a landlord. Illustrations 7–14 emphasize that a receiver may neither evict a mortgagor who is occupying the premises nor hold him or her for their reasonable rental value unless authorized to do so by the loan documents and those documents make the loan nonrecourse. This prohibition applies whether the mortgagor resides on the premises or uses them for non-rental commercial purposes. There are cases that deny a receiver of rents the right to collect from mortgagor a reasonable rent for mortgagor's continued occupation of the premises, notwithstanding a mortgage clause authorizing the appointment pending foreclosure of a receiver "of rents, issues, and profits" of the mortgaged real estate. See Holmes v. Gravenhorst, 188 N.E. 285 (N.Y.1933) ("There are no rents and profits. To authorize the receiver to evict the mortgagor and take possession of the premises in order to create rents and profits, or to compel the mortgagor to pay rent, would be to deprive the mortgagor of a vested right to possession which she had not contracted away"); Carlin Trading Corp. v. Bennett, 264 N.Y.S.2d 43 (N.Y.App.Div.1965) ("We do not believe that a provision in the mortgage * * * that allows a receiver to collect rent from a mortgagor in possession of a residence, allows him to obtain possession of the premises by eviction. There is a marked distinction between the right to collect rent and the right to obtain possession, and the yielding of one does not imply the cessation of the other"); Grusmark v. Echelman, 162 F.Supp. 49 (S.D.N.Y.

1958) ("Clearly, if the mortgagor is in total possession of the premises as in the case of a dwelling house, there are not rents and profits and therefore there is no occasion for the appointment of a receiver to collect them. The same is true if he is in possession of mortgaged premises on which he is conducting a business. On the other hand, an apartment house that is occupied by tenants produces rents in the form of payments by the tenants which are compensation primarily for the use of the property although they may cover also incidental services such as heat, gas and electricity"). Accord, Rehberger v. Wagener, 152 A. 700 (N.J. Eq. 1930); First Trust Co. v. Bauer, 260 N.W. 194 (Neb.1935); Crosby v. Keilman, 239 N.W. 431 (Wis.1931). But see Wellman Savings Bank v. Roth, 432 N.W.2d 697 (Iowa.Ct.App.1988); Union Dime Savings Bank v. 522 Deauville Associates, 398 N.Y.S.2d 483 (N.Y. App. Div. 1977) ("The contention of [mortgagor] that as an owner of the premises he cannot be required to pay rent completely overlooks the provisions of ... the mortgage which specifically requires the mortgagor to pay a receiver the reasonable value of the use and occupation of any portion of the premises occupied by the mortgagor after the appointment of a receiver"); 2 Glenn, Mortgages § 184 at 958–59 (1943). Cf. McKinney's N.Y. Real Prop. Law § 339–aa ("In any ... foreclosure [of a condominium's lien for unpaid common charges] the unit owner shall be required to pay a reasonable rental for the unit for any period prior to sale pursuant to judgment of foreclosure and sale, if so provided by the by-laws.").

Mortgagee may serve as receiver, Comment e. A court is authorized under this section to appoint the mortgagee as receiver in appropriate circumstances. Traditionally, of course, receivers have been judicially appointed third parties. Mortgagees in both lien and title jurisdictions may prefer this arrangement because it affords them the advantages of possession without imposing on them the strict accounting and tort and related landowner-type liabilities that normally are associated with "mortgagee-in-possession" status. See § 4.1, Comment c and Reporters' Note; 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 4.24–4.33 (3d ed. 1993). On the other hand, there sometimes are problems with both the qualifications and costs of third-party receivers. As one commentator has noted, "a receiver is too often chosen by the court because of his political connections or friendship rather than his managerial ability and real estate knowhow. And the award for a receiver's fee can eat up a good part of the property's income." Lifton, Real Estate in Trouble: Lender's Remedies Need An Overhaul, 31 Bus. Lawyer 1927, 1934 (1976).

A few jurisdictions prohibit by statute the appointment of an interested party as receiver. See, e.g., Ind. Code § 34–1–12–2. On the other hand, mortgagees apparently serve as receivers in some other states. See First Interstate Bank of Lea County v. Heritage Square, Ltd., 833 P.2d 240 (N.M.1992). Moreover, case law indicates that it is not uncommon for the United States government to act as receiver or its equivalent where it also is the mortgagee. See, e.g., United States v. Drexel View II, Limited, 661 F.Supp. 1120 (N.D.Ill.1987) ("Since the language of the mortgage, equitable considerations and policies of the [National Housing Act] favor the appointment of a receiver, and [mortgagor] does not specifically object to placing HUD in possession of the premises in lieu of appointing a receiver, the government's motion is granted"); United States v. Baptist Towers II, Limited, 661 F.Supp. 1124 (N.D.Ill.1987) (same); United States v. American National Bank & Trust Co. of Chicago, 573 F.Supp. 1317 (N.D.Ill.1983) (appointment of United States as receiver permissible where mortgagor does not object); United States v. St. Paul Missionary Public Housing, Inc., 575 F.Supp. 867 (N.D.Ohio 1983) (court grants request of United States to be put into possession as "mortgagee in possession" after applying law governing receiverships as the basis for its action).

The Uniform Land Security Interest Act (ULSIA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1985, encourages the mortgagee to take possession pending foreclosure rather than obtaining a receiver. Under § 504, a "court may appoint a receiver after default only upon a showing that a secured creditor cannot take possession or that possession by a secured creditor will not adequately take into account the interests of persons having a claim to the real estate involved, unless the court in its discretion finds the appointment of a receiver appropriate." ULSIA § 504. Section 502(a) permits the mortgagee, except in certain limited residential mortgage transactions, to take possession of the mortgaged real estate upon mortgagor's default without resort to judicial process, if such action is authorized by the mortgage instrument and can be accomplished without a breach of the peace. Absent such an authorization, the mortgagee has the right to obtain possession upon mortgagor default in non-residential transactions by judicial action. See ULSIA § 502(b). Because this Restatement adopts the lien theory of mortgages, mortgagees will rarely be in possession qua mortgagee pending foreclosure. See § 4.1. Moreover, since this section encourages the use of the receivership, it is facially inconsistent with the ULSIA approach. On the other hand, since this section authorizes the appointment of the mortgagee as receiver, its practical effect may be similar to that achieved by ULSIA.

§ 4.4 Appointment of a Receiver—Effect on Existing Leases

(a) Except as provided in Subsections (b) and (c) of this section, the appointment of a receiver confers no authority on the reeeiver to disaffirm a lease in existence at the time of the appointment.

(b) A receiver may disaffirm any lease or related agreement between the mortgagor and a tenant that contravenes a provision of a prior recorded mortgage.

(c) A receiver may disaffirm any lease or related agreement between the mortgagor and a tenant, made while the mortgagor is in default under the mortgage, that was not commercially reasonable when it was consummated.

Cross-References:

Section 4.1, Mortgage Creates Security Interest Only; § 4.2, Mortgaging Rents; § 4.3, Appointment of a Receiver.

Comment:

a. Receiver generally may not disaffirm leases. In states that follow the "title" theory of mortgages, receivers often have the authority to disaffirm preexisting leases. This is clearly so when the lease is junior to the mortgage under which the receiver is appointed. Under this section, however, the receiver may not invalidate a bona fide lease or other agreement entered into by the mortgagor and tenant prior to the appointment of a receiver unless Subsection (b) or (c) applies. This is true without regard to whether the lease is senior or junior to the mortgage. See Illustrations 1–2. Such an approach is consistent with the lien theory of mortgages which this Restatement adopts. See § 4.1, supra. Indeed, receivers often will spend most of their efforts in leasing vacant space and only infrequently will desire to terminate existing leases.

Illustrations:

1. Lessor and Tenant enter into a long-term lease with Tenant for a part of the building on Blackacre. Thereafter, lessor gives a mortgage to Mortgagee on Blackacre. The mortgage is promptly recorded. Several years later, Mortgagor defaults under the mortgage and a receiver is appointed. The receiver believes the lease to be too advantageous to Tenant. The receiver may not disaffirm the lease.

2. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is promptly recorded. Thereafter, Mortgagor, as lessor, enters into a long-term lease with Tenant for a part of the building. Several years later Mortgagor defaults under the mortgage and a receiver is appointed. The receiver believes the lease to be too advantageous to Tenant. The receiver may not disaffirm the lease.

b. Lease that contravenes provision of a prior recorded mortgage. Where a recorded mortgage is senior to a lease, a tenant under the lease is on constructive notice of its contents and is bound by its provisions. Thus, for example, if the mortgage specifically provides that the mortgagee must approve any leases consummated by the mortgagor, a lease entered into without that consent may be disaffirmed by the mortgagee and its receiver. See Illustration 3. Moreover, if a mortgage on rents is part of the original loan transaction, it, by necessary implication, prevents a mortgagor from consummating a valid lease that requires tenant to pay little or no rent. A receiver should therefore be able to disaffirm it. See Illustration 4.

Illustrations:

3. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage, which is recorded immediately, contains a provision that "no lease shall be entered into by Mortgagor and any tenant without the approval by the mortgagee of its terms and conditions." Thereafter, Mortgagor and Tenant, without the approval of Mortgagee, enter into a two-year lease. Mortgagor defaults under the mortgage and a receiver is appointed. The receiver may disaffirm the lease.

4. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage, which is recorded immediately, contains a mortgage on the rents. Thereafter, Mortgagor and Tenant enter into a five-year lease that requires Tenant to pay $1 per month as rent. The Mortgagor subsequently goes into default under the mortgage and a receiver is appointed. Because a lease that requires the payment of little or no rent substantially impairs the effectiveness of the mortgage on rents, the receiver may disaffirm it.

c. The "sweetheart" lease problem. When mortgagors sense the inevitable loss of the building to foreclosure, they frequently are tempted to "milk" the property or to enter into "sweetheart" arrangements with related parties. Schemes for milking the real estate are legion. They include the following: (1) entering into leases on vacant space that demand all or a substantial part of the rent to be paid in advance; (2) negotiating a significant reduction in rent under an existing lease in exchange for a large "prepayment" of rent; (3) the cancellation of existing long-term leases that are highly favorable to the landlord in exchange for substantial lump-sum cash payments to the mortgagor; and (4) the transfer of future rents to a third person. Alternatively, the mortgagor may be tempted to lease space to related parties or friends at little or no rent. Of course, because foreclosure destroys junior interests, any new leases or modifications of existing junior leases will be terminated by the pending foreclosure and will not pose a significant problem for the foreclosure purchaser. Nonetheless, the mortgagee may suffer significant damage from such "sweetheart" arrangements consummated during this post-default interim period. Consequently, Subsection (c) gives the receiver ample authority to deal with such "milking" or "sweetheart" arrangements consummated after mortgagor defaults under the mortgage. An arrangement entered into at that point must be commercially reasonable. Where the mortgagor and tenant enter into an agreement for an amount below the reasonable commercial value of like property, it is commercially unreasonable unless there is a plausible business justification for it apart from benefiting the mortgagor. This is the case even as to an agreement that modifies a senior lease where the tenant has actual knowledge of the existence of the mortgage. Actual fraud or collusion need not be established. So long as the tenant is on notice of the mortgage, any agreement between the mortgagor and tenant that is not commercially reasonable is presumed to be consummated in bad faith. Actual "fraud" need not be established because such a requirement would put the burden of proof on the mortgagee, often to a "clear and convincing" standard. This is too heavy a burden for one who has advanced money and is trying to protect it from conduct that prima facie represents dissipation of the security.

Thus, prepayments of rent that are not authorized by the original lease will be treated as presumptively not commercially reasonable and, accordingly, not binding on the receiver. See Illustration 5. Similarly, a receiver is not bound by cancellations, significant rental reductions or other substantial modifications of existing leases that were favorable to the landlord-mortgagor. See Illustration 6. Moreover, leases of vacant space to the mortgagor's family members or other related parties for less than a market rental are likewise not deemed to be consummated in good faith. See Illustrations 8–9.

On the other hand, the receiver may not invalidate all post-default leases or agreements with tenants. For example, where the lease is senior to the mortgage, it would be inappropriate to invalidate a modification of that lease unless the tenant had actual knowledge of the mortgage. See Illustrations 10–11. Moreover, the receiver may not disaffirm any post-default lease or modification agreement to which the mortgagee has consented. Thus, if a mortgagee enters into a nondisturbance agreement with a tenant after the tenant and mortgagor have executed a post-default lease the mortgagee has, in effect, approved the lease and stipulated that it is commercially reasonable. Consequently, a receiver would have no power to disaffirm it under Subsection (b) or (c). Moreover, it may be commercially reasonable to reduce rent or otherwise change the terms of the lease upon the request of a tenant who is in financial distress and where doing nothing may mean the tenant will be unable to continue in business. While such an agreement may result in a below-market rent, it may be preferable to vacant rental space and its accompanying dislocations. Thus, it should be incapable of being disaffirmed. See Illustration 12. Of course, a shrewd tenant, hearing of the mortgagor's financial distress and attempting to take economic advantage of it, may sometimes initiate negotiations for a lease modification. The fact that the tenant was the initial moving party does not protect the modification from being disaffirmed by a receiver. See Illustration 13.

Illustrations:

5. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. Thereafter, Mortgagor and Tenant enter into a long-term lease for part of the building, with rent payable annually. After Mortgagor defaults under the mortgage, Mortgagor offers to allow Tenant to prepay the rent that would otherwise accrue over the term of the lease in a substantially reduced amount. Mortgagor and Tenant agree to such a modification of the lease and Tenant makes the prepayment. A receiver is then appointed. The receiver may disaffirm the lease modification, treat the prepayment as invalid, and hold Tenant to the terms of the original lease.

6. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. Thereafter, Mortgagor and Tenant enter into a long-term lease for part of the building. The lease is economically highly advantageous to Mortgagor. After Mortgagor defaults under the mortgage, Mortgagor offers to allow Tenant to terminate the lease upon payment by Tenant of a lump-sum payment to Mortgagor. Tenant makes the payment to Mortgagor and the latter terminates the lease. A receiver is then appointed. The receiver may disaffirm the lease termination and hold Tenant to the terms of the original lease.

7. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. Thereafter, Mortgagor and Tenant enter into a five-year lease for part of the building. After Mortgagor defaults under the mortgage and the lease is close to expiration, Mortgagor offers Tenant and Tenant accepts a five-year extension on the lease for a significant lump-sum payment to Mortgagor. Tenant is obligated to pay only nominal rent during the extension period. A receiver is then appointed. The receiver may disaffirm the lease extension.

8. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. After Mortgagor defaults under the mortgage, Mortgagor leases space in the building to a family member on a five-year lease at a nominal monthly rental. A receiver is then appointed. The receiver may disaffirm the lease.

9. The facts are the same as Illustration 8 except that instead of leasing space in the building to a family member, Mortgagor enters into the lease with Mortgagor's attorney at a

nominal rent. A receiver is then appointed. The receiver may disaffirm the lease.

10. Mortgagor as lessor and Tenant enter into a long-term lease with rent payable annually for space on Blackacre, an office building. Thereafter, Mortgagor gives a mortgage on Blackacre to Mortgagee. After Mortgagor defaults under the mortgage, Mortgagor offers to allow Tenant to prepay the rent that would otherwise accrue over the term of the lease in a substantially reduced amount. Mortgagor and Tenant agree to such a modification of the lease and Tenant makes the prepayment. At the time of the modification agreement, Tenant has actual knowledge of the existence of the mortgage. A receiver is then appointed. The receiver may disaffirm the lease modification, treat the prepayment as invalid and hold the Tenant to the terms of the original lease.

11. The facts are the same as Illustration 10 except that at the time of the modification agreement, Tenant had no actual knowledge of the existence of the mortgage. A receiver may not disaffirm the modification of the lease.

12. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. Thereafter, Mortgagor and Tenant enter into a long-term lease for part of the building, with rent payable annually. Mortgagor defaults under the mortgage. Thereafter, Tenant experiences severe financial difficulties in the business conducted on the leased premises. As a result, Tenant notifies Mortgagor that unless the terms of the lease can be negotiated to achieve a lower annual rental, Tenant may be unable to continue in business. Mortgagor consents to a substantial rent reduction and Mortgagor and Tenant enter into a modification of the lease that reflects the reduction. A receiver is then appointed. A receiver may not disaffirm the modification of the lease.

13. Mortgagor gives Mortgagee a mortgage on Blackacre, an office building. The mortgage is immediately recorded. Thereafter, Mortgagor and Tenant enter into a long-term lease for part of the building. Mortgagor thereafter defaults under the mortgage. Tenant hears of Mortgagor's financial distress and offers to pay a significant lump sum to Mortgagor in return for a substantial reduction in the rent and the number of years remaining on the lease. Mortgagor agrees to a lease modification incorporating the Tenant's offer. A receiver is then appointed. The receiver may disaffirm the modification of the lease.

Once a lease has been disaffirmed under this section, the receiver may choose to enter into a new, albeit "commercially reasonable" lease with the former tenant. However, the receiver is under no obligation to do so. Nevertheless, even where the parties fail to reach a new understanding, the former tenant who relied detrimentally on the disaffirmed lease may not be totally without recourse against the receiver. If, for example, the tenant previously made improvements to the real estate that substantially increased its value, recovery may be available for the enhanced value on an unjust enrichment or related restitutionary theory.

REPORTERS' NOTE

Receiver generally may not disaffirm leases, Comment a. Where the lease is senior to the mortgage in a "lien" theory jurisdiction,

> both theory and practice are fairly clear.... [S]uch leases are superior to the mortgage and will not be affected by the foreclosure. The purchaser at the foreclosure sale is bound by them. 'It is entirely clear that if a lease is prior to a mortgage, a sale under the latter is but a sale of the reversion.' It follows that tbe receiver has no power to disaffirm such leases; all she can do is to collect the rents from the tenants.

1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.38 (3d ed. 1993). As to leases that are junior to the lien theory mortgage, "[a]s a general rule, a receiver of rents and profits in a mortgage foreclosure action is bound by the agreement between the tenant and the mortgagor landlord, and notwithstanding that the amount fixed as rent under the terms of the lease is less than the fair and reasonable rental value of the premises, the tenant may not be required to pay to the receiver a greater amount, even though the lease is subordinate to the lien of the mortgage." New York City Community Preservation Corp. v. Michelin Associates, 496 N.Y.S.2d 530 (N.Y.App.Div.1985). See Prudence Co. v. 160 W.73rd St. Corp., 183 N.E. 365 (N.Y.1932) ("Though, during the pendency of the action, a court of equity has power to issue interlocutory orders for protection of an asserted lien, such orders cannot deprive any part of a title or a right, which, though subordinate to the lien of the mortgage, survive and are valid until the lien is foreclosed.... Until the lien of the mortgage is foreclosed, the mortgagee has no paramount title which would justify eviction of the occupants or the abrogation of the agreements. The order of the court directing the occupants to vacate the premises or pay to the receiver the reasonable value of the use and occupancy deprives the occupants of a right which they have obtained by agreement. It does more than protect the security of the mortgage debt. It gives to the mortgagee a security beyond the stipulations of the mortgage and deprives the occupants of their enjoyment of rights secured by contract.").

Under the Uniform Land Security Interest Act (ULSIA), promulgated by the National Conference of Commissioners on Uniform State Laws in

1985, the mortgagee typically has the right to take possession after default in nonresidential mortgage transactions. See ULSIA § 503. Receiverships, on the other hand, are discouraged. See ULSIA § 504; § 4.3, supra, Reporters' Note.

Once in possession, the ULSIA mortgagee has broader inherent power to terminate leases than does its receiver counterpart under this section. As the commentary to ULSIA § 207 stresses, "[i]f under priority rules the lease between a debtor as landlord and a tenant is superior to the security interest, the right to take possession is basically a right to manage the collateral and to collect rent of the lessee who cannot be ousted.... If the lease is junior to the security interest then the present section is applicable. Under Subsection (a) the creditor may exercise his possessory right by ousting the lessee." ULSIA § 207, Comment 1. The inherent right of a mortgagee in possession under ULSIA to terminate junior leases is consistent with the "title" theory of mortgages rather than the "lien" theory adopted by this Restatement. See § 4.1, supra. See 1 G. Nelson & D. Whitman, Real Estate Finance Law 4.39 (3d ed. 1993) ("In title states there is no doubt that the receiver may disaffirm all leases subsequent to the mortgage and collect from the tenant the reasonable rental value of the premises for occupancy after the receiver's appointment.").

Lease that contravenes provision of a prior recorded mortgage, Comment b. See Dime Savings Bank of New York, FSB v. Montague Street Realty Associates, 645 N.Y.S.2d 533 (N.Y.App.Div.1996) (mortgagor's lease extension agreement with tenant requiring tenant to pay one year's rent in advance contravened provision in senior mortgage that prohibited any prepayment of rent without mortgagee's written consent; tenant therefore held liable to receiver for the advance rent previously paid to mortgagor); Crossland Federal Savings Bank v. Pekofsky, 641 N.Y.S.2d 406 (N.Y.App.Div.1996) (receiver entitled to disaffirm lease termination agreement entered into in violation of language in a senior mortgage requiring mortgagee consent for termination of any lease and to recover from mortgagor lump sum rent payment collected pursuant to that agreement); New York City Community Preservation Corp. v. Michelin Associates, 496 N.Y.S.2d 530 (N.Y.App.Div.1985) ("[E]ven in the absence of fraud or collusion, an agreement by the mortgagor with respect to the mortgaged premises is not conclusive upon the mortgagee, or the receiver, where such agreement contravenes an express covenant or the necessary implications of a prior recorded mortgage.").

Moreover, the conflict between the lease or other agreement and the lease or other agreement and the mortgage need not be direct. In Bank of Manhattan Trust Co. v. 571 Park Ave. Corp., 188 N.E. 156 (N.Y.1933), the mortgage contained a mortgage on the rents and language prohibiting impairment of the mortgage lien by the mortgagor. The Court of Appeals held that the mortgagor could neither contractually assign the rents to a general creditor or eliminate its right to collect rent, because such an agreement would impair the mortgage on the rents. The court stated:

> It is not necessary to find any collusion in making such an arrangement; it was simply beyond the power of the parties either to ap-

propriate the pledged rents to a different indebtedness, or to defeat the pledge by granting use of the premises rent free. This was not only expressly forbidden by the mortgage, but it seems a necessary consequence of the assignment of rents contained in it. These rents were expressly made security for the mortgage indebtedness in the event of default, and the scope of the contracts the mortgagor or its successors might make was necessarily limited to that extent. The pledge of these rents could not subsequently be rendered worthless either by another assignment of rents to be received, or by contracting away the right to collect any rent.

Id. at 159. Accord, Colter Realty, Inc. v. Primer Realty Co., 27 N.Y.S.2d 850 (N.Y.App.Div.1941) (in invalidating a prepayment arrangement under a lease junior to the mortgage containing a pledge of rents, the court stated: "The building was a new one when the lease was made, and [tenant] concedes that he knew that the mortgagor had difficulty in completing the building on time. He states that the mortgagor had suffered financial losses, was embarrassed financially, and admits that it was because of this financial situation that the mortgagor asked [tenant] and other tenants to pay the rent in advance.... While we think that the circumstances here warrant a finding that the agreement was made in anticipation of a possible foreclosure, we do not think it was necessary that actual fraud be established."). But see Grether v. Nick, 215 N.W. 571 (Wis. 1927) (prepayment of rent by a junior lessee was valid against a receiver in spite of pledge of rents; however, the prepaid rents were used to improve the mortgaged property and thus improved the value of the mortgagee's security).

Illustration 4 is based in part on New York Community Preservation Corp. v. Michelin Associates, 496 N.Y.S.2d 530 (N.Y.App.Div.1985), where the court stated:

Like the mortgage in the Bank of Manhattan Trust Co., ... the mortgage in question contained an assignment of rents as security for the mortgage indebtodness. Therefore, the agreement by [mortgagor] to lease an apartment to Walker for 20 years at a stipulated rent of only one dollar per month was in clear contravention of the mortgage, regardless of whether that agreement had been made with a fraudulent intent. Simply put, [mortgagor] lacked the power to defeat its pledge of the rents as security by granting use of the premises at a nominal rent.

Id. at 534.

The "sweetheart" lease problem, Comment c. For a general consideration of "milking" and related problems, see 1 G. Nelson & D. Whitman, Real Estate Finance Law 267 (3d ed. 1993):

When a mortgagor becomes resigned to the eventual loss of the mortgaged real estate, he frequently attempts to squeeze as much money out as possible before surrendering it. This process is often referred to as 'milking.' The chief devices by which such mortgagors attempt to 'milk' the property are leases which require payment in advance for the entire term, the execution of a lease at an inadequate rental in return for a cash consideration, the assignment of future rents to a third person, and the cancellation of a long-term lease favorable to the lessor in exchange for cash payment to the mortgagor.

See also Kratovil, Mortgages Problems in Possession, Rents, and Mortgagee Liability, 11 DePaul L. Rev. 1, 13 (1961) (such devices are used by mortgagors to "pocket the future earning capacity of the land and deliver to the mortgagee the empty shell of the mortgaged asset").

There is "lien" state authority that a court has broad power "to prevent frustration of an order appointing a receiver of rents 'by a collusive or fraudulent lease for an inadequate rental or advance payment of rent in anticipation of a foreclosure action.'" New York City Community Preservation Corp. v. Michelin Associates, 496 N.Y.S.2d 530 (N.Y.App.Div.1985); Prudence Co. v. 160 West 73rd St. Corp., 183 N.E. 365 (N.Y.1932). Cf. Chemical Bank v. Evans & Hughes Realty, L.P., 613 N.Y.S.2d 239 (N.Y.App.Div.1994) (receiver not permitted to recover advance collection of rent by mortgagor in the absence of proof that it "was fraudulent or motivated by the anticipation of foreclosure and the appointment of a receiver"). Under Subsection (c), actual fraud or collusion need not be established. Any agreement between the mortgagor that is not commercially reasonable may be disaffirmed by the receiver. The following analysis supports this approach:

> Where the lease is executed prior to the mortgage, if it provides for prepayment, then prepayment in accordance with the terms of the lease is binding on the mortgagee for the simple reason that he took his mortgage subject to that very provision. However, prepayments not in accordance with the terms of the lease, if made with notice of the mortgage, will not be binding on the mortgagee or receiver even in the absence of proof of an actual fraudulent intent by the mortgagor or participation in it by the lessee. This is true even though put in the form of an agreement altering the terms of the original lease. Indeed such cases in most instances might well rest upon a theory generally more difficult to establish factually, that of setting aside a collusive agreement to defraud the mortgagee.... [A]ny arrangement for prepayment of the rent for the whole term or large portion of it is abnormal and, if made after a mortgage has attached to the property, clearly indicates a design to defeat the mortgagee's assertion of claim to it on default and foreclosure. Since this is so, the tenant who agrees to such an arrangement must be charged with collusive acquaintance with the scheme and, on this ground, the courts are justified in giving no validity to the prepayment, provided, of course, the tenant knows of the existence of the mortgage at the time.

1 G. Nelson & D. Whitman, Real Estate Finance Law 268 (3d ed. 1993). Professor Glenn took a similar approach to the prepayment problem, and his analysis supports a commercial reasonableness standard:

> An arrangement by which rent is paid in advance for the whole term, or for many months, is abnormal on its face. It discloses an anticipation of default and foreclosure; and it shows a design, on the mortgagor's part, to divert into his own pocket, by this discount arrangement, money that otherwise would be available to the mortgagee, as security, when the foreclosure ac-

> tually eventuated that was thus foreseen. The tenant, on his part, cannot assert innocence of the mortgagor's designs. He is really a participant in the plan, because his payment makes it possible of fulfillment, and the abnormality of the thing charges him with notice of the mortgagor's purpose and object.... Since that prepayment was a fraud on the mortgagee, it constitutes no defense in the tenant's behalf.
>
> To this rule, however, there are two qualifications. One is whether the tenant had notice of the mortgage at the time of the prepayment. If the mortgage had not been recorded, and he had no actual notice of it, the tenant should be protected as to his prepayments....
>
> The other qualification of the rule is really a part of its texture. If mortgagor applies the prepaid rent to improvement of the premises that are subject to the lien, then the mortgagee should not be allowed to hold the tenant for a payment all over again.

2 Glenn, Mortgages 951–52 (1943). See Webber v. King, 218 N.W. 282 (Iowa 1928).

A similar analysis is justifiable where the receiver is confronted with a lease cancellation, a lease for a nominal rent, or other significant lease modifications:

> The cancellation of a favorable lease antedating the mortgage, or a reduction in the rent of such leases for a cash payment to the mortgagor might also be treated as fraudulent conveyances, if, in fact, such was the case. Here, however, there is not present the abnormality of the transaction to charge the tenant with collusion as in the prepayment case, and difficulties of proof would make it an ineffective remedy. However, such acts do constitute a clear injury to the mortgagee's security because they deprive the mortgagee or his receiver of the rents they would be able to collect on entry into possession or on appointment.... Notice to the tenant of the existence of the mortgage on the reversion should be sufficient to restrict his ability to enter into agreements with the mortgagor that will reduce the value of the security....
>
> Further, since the mortgagee may preserve favorable leases subsequent to the mortgage and have them sold as part of his security on foreclosure sale, cancellation of such leases can be regarded as an impairment of the mortgagee's security on the same reasoning as in the case of a lease prior to a mortgage, and the same consequences should attend it. In other words, notice of the mortgagee's rights should suffice to prevent a valid agreement being made even though no fraudulent design to defeat his claim can be adduced.

1 G. Nelson and D. Whitman, Real Estate Finance Law 268–269 (3d ed. 1993). See also 2 Glenn, Mortgages 954 (1943) ("Now of course we may find a case where, on the facts, a nominal rent was justified by good business considerations, and the same thing can happen in the case of a rent reduction.... But when no such honest reason appears, the mortgagee may join the tenant as a defendant, and have meanwhile a cancellation of the lease as effectuating a fraudulent diversion of his security.").

While a tenant under a disaffirmed lease will be unable to enforce the lease or compel the receiver to enter into a new one, restitutionary relief may nevertheless sometimes be available to that tenant. Such relief is sometimes granted to those who confer benefits under contracts that are either unenforceable or illegal. See generally 3 D. Dobbs, Law of Remedies §§ 13.1–13.6 (2d ed. 1993); II G. Palmer, Law of Restitution §§ 6.1–6.12, 8.1–8.9 (1978).

Once a receiver is appointed, it is extremely common for the mortgagor-lessor to file a Chapter 7 or Chapter 11 bankruptcy petition. This section is consistent with and complements treatment of leases in a mortgagor-lessor bankruptcy. Section 365(h) of the Bankruptcy Code limits the impact of a rejection of a lease in the mortgagor-lessor setting:

> Section 365(h), in effect, gives the lessee a choice when the lessor files for bankruptcy and elects to reject the lease. Under § 365(h)(1), the lessee can, at its option, treat the lease as terminated by the rejection. The lessee vacates the premises and asserts a claim against the estate for any damages it has incurred from the rejection of the lease. This will be a general unsecured claim.
>
> Alternatively, under § 362(h)(2), the lessee can elect to remain in the leased premises even though the lessor has filed for bankruptcy and rejected a lease. The lessee may so remain in the premises for the balance of the term of the lease plus any renewals or extension rights it would have a right to assert under the lease. If the lessee remains in possession of the leasehold, it must continue to pay rent to the trustee.
>
> While a debtor lessor cannot use rejection to force the lessee to leave the premises, the debtor lessor can use rejection as a means for avoiding some of its contractual obligations under a lease such as repairs and maintenance. The lessee may then offset the amount of rent it pays by the damages caused by the debtor lessor's nonperformance. This right of offset is the sole remedy against the estate for damages arising after the rejection.

D. Epstein, S. Nickles & J. White, Bankruptcy § 5–7(b) (1993). As articulated by the foregoing analysis, the trustee has no general authority to force a recalcitrant lessee to accept termination of a lease. This is consistent with the receiver's powers under this section in that, like the bankruptcy trustee, the receiver has no general authority to disaffirm pre-appointment leases.

On the other hand, when a mortgagor-lessor files a bankruptcy petition, a trustee or creditors' committee may well be able to set aside lease prepayments, cancellations of pro-lessor leases, leases for nominal rent, and similar transactions as being transfers for other than "reasonably equivalent value" and thus constructively fraudulent under §§ 548 and 544(b) of the Bankruptcy Code. See 11 U.S.C.A. §§ 548, 544(b). See generally, D. Epstein, S. Nickles & J. White, Bankruptcy §§ 6–49, 6–60 (1993). Similarly, under this section a state court receiver may invalidate post-default transactions between lessor-mortgagor and tenants that were not consummated in good faith because they were not commercially reasonable. Since these standards are not dissimilar, the receiver's power under this section is largely consistent with and complementary to that exercised by the bankruptcy courts in the fraudulent-transfer context.

§ 4.5 Priorities Between Competing Receivers

(a) Where more than one mortgagee qualifies for the appointment of a receiver under § 4.3, a receivership request by a senior mortgagee has priority over a receivership request by a junior mortgagee unless:

(1) the senior mortgage and any accompanying agreement contains neither a mortgage on the rents nor an authorization for the appointment of a receiver upon mortgagor default; and

(2) the junior mortgage or an accompanying agreement contains either such a mortgage on rents or receivership authorization.

This priority for the senior mortgage applies even though a court has previously appointed a receiver under a junior mortgage.

(b) When a junior mortgagee obtains the appointment of a receiver, that receiver has the right, until a receiver is appointed under a senior mortgage, to collect rents from the mortgaged real estate and, after first using them to pay real estate taxes and other reasonable expenses associated with the maintenance and repair of the real estate, to apply the balance to the junior mortgage obligation.

Cross-References:

Section 4.1, Mortgage Creates Security Interest Only; § 4.2, Mortgaging Rents; § 4.3, Appointment of a Receiver; § 4.4, Appointment of a Receiver—Effect on Existing Leases.

Comment:

a. Competing requests for receivership. Frequently, where multiple mortgagees are contemplating the appointment of a receiver, they will join in seeking a single receivership to represent their interests and agree as to such important matters as the disposition of rental income and the receiver's rights and responsibilities. Where such is the case, such an agreement is controlling. However, where such a consensus is absent, a court can be confronted with competing requests for a receivership from mortgagees who otherwise satisfy the criteria for appointment spelled out in § 4.3. Here mortgage priority, with one minor exception, is the overriding consideration. Thus, a senior mortgagee will prevail if the mortgage or an accompanying agreement contains either a mortgage on the rents or language authorizing the appointment of a receiver upon mortgagor default. Even if the senior mortgage has the benefit of neither of these latter collateral agreements, a junior mortgagee will prevail only it can claim the benefit of at least one of them. See Illustrations 1–4. These priority rules apply not only where multiple mortgagees are seeking a receivership initially, but also where a senior mortgagee requests appointment of a receiver to replace a previously appointed junior receiver.

Illustrations:

1. A senior mortgage on Blackacre, on which is located an office building, also contains a mortgage on the rents. A junior mortgage on Blackacre likewise contains a mortgage on the rents. Both mortgagees qualify for the appointment of a receiver under § 4.3. The receivership will be for the benefit of the senior mortgagee.

2. The facts are the same as Illustration 1, except that the senior mortgage contains language authorizing the appointment of a receiver upon mortgagor default, but there is no mortgage on the rents. The receivership will be for the benefit of the senior mortgagee.

3. The facts are the same as Illustration 1, except that neither mortgagee has the benefit of either a mortgage on the rents or an agreement authorizing the appointment of a receiver upon mortgagor default. The receivership will be for the benefit of the senior mortgagee.

4. The facts are the same as Illustration 1, except that the senior mortgage has neither a mortgage on the rents nor language authorizing the appointment of a receiver upon mortgagor default. The junior mortgage contains a mortgage on the rents. The receivership will be for the benefit of the junior mortgagee.

b. Rights of junior mortgage receiver when succeeded by senior receivership. A junior mortgagee who obtains a receiver is entitled to the rents collected by the receiver prior to the time that a senior mortgage receiver is appointed. However, the junior receiver must first apply those rents to the payment of real estate taxes and other reasonable expenses associated with the maintenance and repair of the real estate. This is because the junior receiver, like any person in possession of real estate, has the duty to avoid waste. See § 4.6, infra. It is only the excess, after the foregoing expenditures, that may be applied to the junior obligation. See Illustration 5. Of course, the junior receiver has the option, but not the obligation, to apply that excess to the senior obligation.

This preference for the junior mortgagee applies even though the junior mortgagee has neither a mortgage on the rents nor language authorizing the appointment of a receiver upon mortgagor default. This result rewards the diligent junior mortgagee. Had the latter not sought the appointment of receiver, the rents that accrued prior to the appointment of the senior mortgage receiver would have gone to the mortgagor and not to the senior lienholder. Thus, allowing the junior mortgagee to reap the benefit of those rents places the senior mortgagee in no worse a position than would have been the case had the junior mortgagee failed to act.

There are several important limitations on the rights of the junior receiver upon being superseded by a senior receivership. First, where the senior mortgagee has a mortgage on the rents and, prior to or during the junior receivership, the senior mortgagee takes the steps necessary under § 4.2 to collect the rents, the intervening senior receiver has a prior claim as to any of those rents collected by the junior receiver after the foregoing steps were carried out by the senior mortgagee. See Illustration 6. In such a situation, the senior mortgagee should be viewed as acting promptly to protect its rights and thus should not be prejudiced simply because it initially opted for a non-receivership remedy. Second, any rent that accrues, but which is uncollected during the junior receiver's tenure, belongs to the senior receiver for the benefit of the senior mortgagee. See Illustration 7. In addition, the junior receiver is responsible to the successor receiver for prepayments of rent that were not authorized by leases on the mortgaged real estate. This latter rule is intended to discourage attempts by the junior receiver to enter into prepayment arrangements with tenants that would deprive a senior mortgagee of rents which would otherwise accrue after the appointment of a senior receiver. See Illustration 8. Finally, a junior receiver who foresees early replacement by a senior receivership may be tempted to enter into a variety of "sweetheart" leases and other agreements to maximize the cash flow available to reduce the amount of the junior mortgage. To discourage such conduct, a successor receiver may disaffirm any transaction of the prior receiver that, had it been entered into by a mortgagor and tenant, would be avoidable under § 4.4. See Illustration 9.

Illustrations:

5. Junior Mortgagee obtains the appointment of a receiver to take possession of Blackacre, on which is located an office building. The receiver collects $50,000 in net rents after paying

taxes and making reasonable expenditures for the maintenance and repair of the real estate. Senior Mortgagee then obtains the appointment of a receiver and the latter takes possession of Blackacre. The original receiver is entitled to retain the $50,000 for the benefit of the Junior Mortgagee.

6. The facts are the same as Illustration 5, except that after the junior receivership becomes effective, Senior Mortgagee takes the steps required by § 4.2 to commence collection of rents under its mortgage on rents. The junior receiver is accountable to senior receiver for any of the rent collected after Senior Mortgagee took such steps.

7. The facts are the same as Illustration 5, except that when the junior receiver surrenders possession to the senior receiver, there is $20,000 in accrued rent outstanding that junior receiver was unable to collect. The senior receiver is entitled to collect that $20,000 for the benefit of Senior Mortgagee.

8. The facts are the same as Illustration 5, except that in addition to collecting $50,000 of accrued rent, the junior receiver also collects prepayments of rent totaling $25,000. These prepayments were not authorized by any of the leases on the mortgaged premises. The junior receiver is accountable to senior receiver for any of the rent prepayments that covered any time period after the appointment of the senior receivership.

9. Junior mortgagee obtains the appointment of a receiver to take possession of Blackacre, on which is located an office building. The receiver enters into a two-year lease with a tenant for vacant space in the building. The rent is payable in a lump sum at the inception of the lease and is substantially below the fair-rental value of the premises. The lease is not commercially reasonable for purposes of § 4.4. A month thereafter, senior mortgagee obtains the appointment of a receiver and the latter takes possession of Blackacre. The senior receiver may disaffirm the lease entered into by the prior receiver.

REPORTERS' NOTE

Competing requests for receivership, Comment a. The rationale and policy justification for Subsection (a) has been articulated as follows:

The general rule is clear that a first mortgagee, even without a rents and profits clause, who obtains a receiver ... will prevail as to all rents thereafter to the exclusion of any other claimant whether junior mortgagee, judgment creditor or general creditor. This includes accruing and uncollected back rents. This rule is understandable because, after all, to the extent that the rents reduce the senior lien, the status of the junior lienors often improves. To be sure, there can be situations where the total value of the liens against the property is so high in relation to the value of the property that reduction of a senior lien will have little economic meaning to junior lienors. Even in that situation, however, there seems to be no compelling reason to depart from the consequences of normal priority rules.

1 G. Nelson & D. Whitman, Real Estate Finance Law 272 (3d ed. 1993). For supportive cases, see Last v. Winkel, 97 A. 961 (N.J. 1916), affirmed, 99 A. 1070 (1916); Metropolitan Life Insurance Co. v. Jash-Lap Realty Corp., 245 N.Y.S. 281 (N.Y. App. Div. 1930).

Under Subsection (a) the only time a junior mortgagee seeking a receivership will prevail against a senior mortgagee is in the extremely rare setting where the senior has the benefit of neither a mortgage on rents nor language authorizing a receivership upon mortgagor default and the junior mortgagee is the beneficiary of at least one of those provisions. This result is consistent with the policy of § 4.2 of this Restatement that real estate and the rents it produces are separately mortgageable. Under this approach, if a senior mortgagee has a mortgage on the real estate only, but a junior lienor takes a mortgage on the rents, the junior mortgagee has priority as to the rents until the senior mortgage is foreclosed. See § 4.2, Comment *b* and Illustration 4.

Rights of junior mortgage receiver when succeeded by senior receivership, Comment b. Subsection (b) is supported by substantial case law. See Stevens v. Blue, 57 N.E.2d 451 (Ill.1944) ("[W]hen [the junior lienor] procured the appointment of ... a receiver, to collect rents to be applied to her claim, she had a right to receive the rents and profits unless and until appellant applied to the circuit court for enforcement of her senior lien.... [Until the] order was made extending the receivership for the benefit of appellant, the receiver paid, as he had a right to do, the income from the property to ... the junior lienholder."); Depan, Eichenberger & Knowles Inc. v. Greenbriar Properties I, 607 N.Y.S.2d 177 (N.Y.App. Div.1994); Vecchiarelli v. Garsal Realty, Inc., 443 N.Y.S.2d 622 (N.Y. Misc. 1980) ("A receiver appointed at the instance of one mortgagee acts on behalf of that mortgagee and not generally on behalf of all lienholders.... Therefore the senior mortgagee must either obtain the appointment of his own receiver or an extension of the junior receivership before rents may be collected for his benefit"); Federal Deposit Insurance Corp. v. Briarwood Holding Corp., 387 N.Y.S.2d 712 (N.Y.App.Div.1976) (junior mortgagee who takes possession will prevail as to rents collected prior to the appointment of a senior mortgage receiver); Yoelin v. Kudla, 24 N.E.2d 67 (Ill.Ct.App.1939); Detroit Properties Corp. v. Detroit Hotel Co., 242 N.W. 213 (Mich.1932); Sullivan v. Rosson, 119 N.E. 405 (N.Y.1918); N.Y. Life Insurance Co. v. Fulton Development Corp., 193 N.E. 169 (N.Y. 1934); Goddard v. Clarke, 116 N.W. 41 (Neb. 1908); Bermes v. Kelley, 154 A. 860 (N.J. Eq. 1931). See Notes, 50 Yale L.J. 1424 (1945); 43 Yale L.J. 107 (1933). Nevertheless, there is some authority that even though the junior mortgagee first obtains the appointment of a receiver, when the senior mortgagee intervenes, all of the rents collected by the junior receiver will be allocated in the order of priorities of the mortgages and the junior mortgagee will lose its advantage as to the part already collected. See Bergin v. Robbins, 109 Conn. 329, 146 A. 724 (1929); Wolkenstein v. Slonim, 355 Ill. 306, 189 N.E. 312 (1934) (receiver was ordered to pay over all rents collected by the receiver appointed incident to a foreclosure action by second mortgagee. However, the first mortgagee began its own foreclosure action on the day the receiver was appointed in the earlier action and the facts do not indicate that any rents had been collected by the receiver before the first mortgagee moved to have the junior receiver turn over all of the rents.); N.J. Title & Guarantee Co. v. Cone & Co., 53 A. 97 (N.J. 1902).

Sound policy considerations support the rule of Subsection (b):

> This result rewards the diligent junior mortgagee for had it not been for his action, the rents up to the time the senior mortgage asserted his rights, would have gone to the mortgagor-landlord. To put the matter differently, a senior mortgagee who has done nothing to capture the rents arguably should be in no better position than he would have been in had the mortgagor continued in possession.

1 G. Nelson & D. Whitman, Real Estate Finance Law 256 (3d ed. 1993). See Vecchiarelli v. Garsal Realty, Inc., 443 N.Y.S.2d 622, 623 (N.Y.Sup.Ct.1980):

> In this area of the law diligence is the byword. Following default in their respective mortgages both lienholders had the opportunity to have a receiver appointed and rents collected. In this case the junior mortgagee ... availed himself of the opportunity forthwith whereas ... the senior lienholder, delayed several months before establishing its own receivership. There is no question that once [senior lienholder] established its own receivership ... its superior interest must be recognized. Once established, the [senior] receivership became entitled to collect rents on its own behalf, including those that accrued but were uncollected prior thereto.

See also Sullivan v. Rosson, 119 N.E. 405 (N.Y.1918) ("[Senior mortgagee's] failure to take any action would, or might have been as serious to him if the receiver had never been appointed as he now claims it will be if the money in the hands of the receiver is not paid to him as mortgagee. He is not now entitled to appropriate the proceeds of the diligence of a junior mortgagee.").

Some state statutes require that a mortgage receiver apply rents and profits to real estate taxes as a priority claim. See, e.g., Iowa Code §§ 654.14, 680.7; Presidential Realty Corp. v. Bridgewood Realty Investors, 498 N.W.2d 694 (Iowa 1993).

Support for Illustration 6 and its accompanying commentary may be found in Presidential Realty Corp. v. Bridgewood Realty Investors, 498 N.W.2d 694 (Iowa 1993) (where first mortgagee of real estate also took an "absolute assignment" of rents, it had a prior claim to rents collected by receiver appointed under second mortgage); Paramount Building & Loan Association v. Sacks, 152 A. 457 (N.J. Eq. 1930); John McMenamy Investment & Real Estate Co. v. Dawley, 165 S.W. 829 (Mo.Ct.App.1914); Harris v. Taylor, 56 N.Y.S. 1108 (N.Y.App.Div.1899).

Support for Illustration 7 and its accompanying commentary may be found in Vecchiarelli v. Garsal Realty, Inc., 443 N.Y.S.2d 622 (N.Y. Misc. 1980).

§ 4.6 Waste

(a) Waste occurs when, without the mortgagee's consent, the mortgagor:

(1) physically changes the real estate, whether negligently or intentionally, in a manner that reduces its value;

(2) fails to maintain and repair the real estate in a reasonable manner, except for repair of casualty damage or acts of third parties not the fault of the mortgagor;

(3) fails to pay before delinquency property taxes or governmental assessments secured by a lien having priority over the mortgage;

(4) materially fails to comply with covenants in the mortgage respecting the physical care, maintenance, construction, demolition, or insurance against casualty of the real estate or improvements on it; or

(5) retains possession of rents to which the mortgagee has the right of possession under § 4.2.

(b) The following remedies for waste by the mortgagor are available to the mortgagee as necessary to give complete redress:

(1) foreclosure or the exercise of other remedies available under the mortgage for default on the secured obligation, if the waste has impaired the mortgagee's security;

(2) an injunction prohibiting future waste or requiring correction of waste already committed, but only to the extent that the waste has impaired or threatens to impair the mortgagee's security; and

(3) recovery of damages, limited by the amount of the waste, to the extent that the waste has impaired the mortgagee's security.

(c) If the mortgage relationship has ended at the time the mortgagee claims waste, an impairment of security exists if the value of the real estate is less than the sum of the mortgage obligation and the obligations se-

cured by any liens senior to the mortgage. If the mortgage relationship continues to exist at the time the mortgagee claims waste, an impairment of security exists if the ratio of the mortgage obligation to the real estate's value is above its scheduled level. In such cases, the mortgagee may restore the ratio of the mortgage ohligation to the real estate's value to its scheduled level by obtaining an order compelling correction of the waste or by recovery of damages, limited by the amount of the waste.

(d) Waste occurs when a person other than the mortgagor physically changes the real estate, whether negligently or intentionally, in a manner that reduces its value. Such a person may he held liable for damages and may be subjected to an injunction prohibiting future waste or requiring correction of waste already committed. If the waste was committed with the mortgagor's consent, liability exists only if the person committing it had actual knowledge of the existence of the mortgage.

(e) Persons who acquire possessory estates other than leaseholds in the real estate subject to the mortgage are liable for waste on the same basis as the mortgagor.

Cross-References:

Section 2.2, Expenditures for Protection of the Security; § 4.3, Appointment of a Receiver; § 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability.

Comment:

a. Introduction. Originally the common-law concept of waste applied only to conduct by a person with a limited possessory interest in the land, such as a life tenant or leasehold tenant. When such a person damaged the real estate, the holder of the future interest could recover in damages or enjoin further waste. In modern American law, the doctrine of waste has been adapted to the mortgagor-mortgagee relationship, and recognizes that a mortgagor has a responsibility to protect the value of the real estate against loss that might endanger its usefulness as security. Waste traditionally involved intentional physical damage to the property. Under modern law, however, the concept has been broadened to include the mortgagor's failure to make reasonable repairs or to keep prior tax and assessment liens on the property current. Nearly all well-drafted mortgages impose these burdens on mortgagors in any event, but under this Restatement they are imposed whether mentioned in the mortgage or not. Such obligations are virtually universally accepted as reasonable; in the rare cases in which the parties to a mortgage do not wish to impose them on the mortgagor, they can include language that specifically exculpates the mortgagor to the extent desired.

Waste does not depend on the presence of covenants in the mortgage. It is in the nature of a tort, a breach of a duty arising from the mortgage relationship. As noted below, however, the parties may insert covenants in the mortgage refining or expanding the definition of waste.

b. Conduct that constitutes waste. Physical damage to improvements on the real estate is the most obvious form of waste. A mortgagor who causes such damage is liable, whether acting negligently or intentionally. The term "mortgagor" here includes successors in ownership of the original mortgagor (other than leasehold tenants) and persons acting as the mortgagor's agents. See § 4.6(e). Thus non-assuming grantees of the mortgaged real estate are personally liable for waste, even though they are not liable for payment of the obligation secured by the mortgage. Compare § 5.2.

The common-law distinction between "voluntary" (intentional) and "permissive" (negligent) waste is no longer followed. See Illustrations 1 and 2. The concept of waste embraces a duty on the part of the mortgagor to make reasonable repairs in order to correct ordinary wear and tear, and to repair damage caused by the mortgagor or persons under his or her control. However, the mortgagor is not responsible for repair or reconstruction of damage caused by natural casualties such as hurricane, earthquake, or lightning, and need not repair the consequence of such casualty loss, such as damage caused to the interior of a building by rain after a hurricane has destroyed the roof. See Illustration 3. In the face of such damage, however, the mortgagor continues to be liable for failure to carry out reasonable maintenance, which may include securing the property within a reasonable time to prevent further deterioration.

Similarly, the mortgagor has no liability for damage caused by third persons if their acts were not attributable to the mortgagor. See Illustration 5. Here again, however, the mortgagor must still provide reasonable maintenance, which may include efforts te stabilize and protect the property against additional harm.

Even natural disasters or acts of third parties may give rise to mortgagor liability if the mortgagor was at fault. Thus, if the mortgagor installs a building on the mortgaged premises without anchoring it to its foundation in a reasonable manner, the mortgagor may be liable if a hurricane destroys it. The mortgagee may hedge the risk of casualty by requiring the mortgagor to carry casualty insurance, and in that event failure of the mortgagor to insure will constitute waste.

The mortgagor has no duty under the law of waste to repair defects in the property that existed at the time the mortgage was given. In most cases such defects could have been discovered by the mortgagee, and must be considered to have been taken into account by the mortgagee in appraising the security. Even if the defect in question was latent or nonobvious, and even if the mortgagor was aware of it, the mortgagor has no liability unless the circumstances amount to fraud on the mortgagee. See Illustration 4.

Persons other than the mortgagor are liable for waste under Subsection (d) if they cause physical damage to the mortgaged real estate. Both negligent and intentional acts of third parties may give rise to liability, and it is generally immaterial whether the third party knows of the existence of the mortgage. However, the remedies available to the mortgagee against third parties are limited; the mortgagee may recover damages or obtain an injunction, but may not assert foreclosure or other remedies under the mortgage itself. It would be unjust to force the mortgagor into foreclosure because of the actions of a person beyond the mortgagor's control. See Illustration 5. The mortgagee might also obtain a receiver on account of waste being committed by a third party, if the mortgagor were shown to be unable or unwilling to prevent the third party's actions.

Waste encompasses default on senior tax and assessment liens. The mortgagee has a reasonable and legitimate expectation that the mortgagor will not place a governmental entity in a position to destroy the mortgage. See Illustration 6.

Illustrations:

1. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, a heavily wooded tract. Thereafter Mortgagor, without Mortgagee's consent, cuts the timber from Blackacre and sells it to a sawmill. Mortgagor has committed waste, giving Mortgagee the remedies mentioned in this section.

2. Mortgagee makes a loan te Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. As a result of natural wear and tear the roof of the house on Blackacre develops a leak, and Mortgagor does not repair it. The roof timbers rot and the roof collapses. Mortgagor has committed waste, giving Mortgagee the remedies mentioned in this section.

3. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. An earthquake damages the house on Blackacre, and Mortgagor does not repair the damage. Neither the occurrence of the

earthquake nor Mortgagor's failure to repair the damage constitute waste.

4. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. A house on Blackacre, previously constructed by a contractor, contains serious but hidden structural defects, but Mortgagor was unaware of them at the time the mortgage was given. The defects subsequently cause the house to develop large cracks in the foundation, and Mortgagor does not repair them. Mortgagor has not committed waste.

5. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. While Mortgagor is in possession of Blackacre, but without Mortgagor's consent or involvement, T, a trespasser, sets fire to the house on Blackacre and destroys it. Mortgagor does not repair the damage. T has committed waste, but Mortgagor has not. Mortgagee may recover damages from T and may obtain an injunction against any further waste by T.

6. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. Blackacre is subjected to an assessment lien by the county government for street improvement. By law the assessment lien has priority over all mortgages. Mortgagor fails to make a payment when due on the assessment. The failure to pay constitutes waste.

In Illustration 2, Mortgagor's obligation is one of reasonable and not perfect maintenance. For example, Mortgagor is not bound to make the repairs unless and until Mortgagor knows or has reason to know of the defect. Likewise, Mortgagor is not bound to correct minor or trivial defects that would have no significant impact on the value of the real estate.

c. Expansion or reduction of duties by mortgage covenant. Mortgages frequently contain covenants that redefine or expand the concept of waste. For example, they may require the mortgagor to maintain the property in a certain manner or to a certain level of quality. They may require that specific improvements be constructed, modified, or removed. Nearly all mortgages of improved real estato require the mortgagor to insure the premises against fire and other casualties. Under this Restatement no distinction is made between such covenants and the common-law duty to refrain from waste, except that relief for breach of a covenant is available only against the mortgagor and his or her successors, but not third parties.

In the same manner, covenants in the mortgage may reduce the mortgagor's duties with respect to the property's condition, repair, maintenance, or payment of prior liens. Such covenants are likewise enforceable, and may diminish or eliminate the mortgagor's liability for waste.

d. Waste of rents. Under § 4.2, a mortgagee may take a mortgage on the rents from real estate. If the mortgagor defaults on the secured obligation, the mortgagee may then acquire the right to collect and possess the rents, by complying with any conditions in the mortgage and demanding the rents from the mortgagor and the mortgagor's successors. Once the mortgagee has met these conditions, the mortgagor or any other person who intercepts the rents and fails to deliver them to the mortgagee has committed waste. This principle may assume great importance in a case in which the mortgagor is not personally liable on the debt, for such a person may still be liable for waste.

e. Remedies for waste. A mortgagee may pursue three remedies for waste: enforcement of the mortgage by foreclosure or other appropriate means (such as interception of the rents if the mortgage covers the rents); an injunction; and recovery of money damages. In general, the mortgagee is free to select among these remedies, and has no duty to seek one before another. However, when the waste is committed by a person other than the mortgagor, the mortgagee may not treat the waste as a default on the mortgage obligation and foreclose; te do so would attribute to the mortgagor the actions of a person who is not controlled by the mortgagor. On the other hand, if the mortgagor's agents or employees commit the waste, it can be charged to the mortgagor.

In addition to the remedies described in this section, waste committed by the mortgagor may also warrant the appointment of a receiver. See § 4.4. Further, reasonable expenditures by the mortgagee to correct or repair waste may be added to the obligation secured by the mortgage, treated as a future advance, and recovered by way of foreclosure or an action on the debt. See § 2.2.

f. Limitations on recovery of damages. The mortgagee may seek money damages for waste without first foreclosing the mortgage; cases holding the contrary are rejected here. While this approach may seem onerous to mortgagors, it is likely to work in their favor, since a rule that required the mortgagee to foreclose first would probably result in more foreclosures.

The determination of damages resulting from acts of waste is governed by general principles of damages measurement and depends on the circumstances of the case. The diminution of value of the real estate is usually the appropriate formula, but a court may also consider the cost of repairing the property or replacing items damaged, removed, or destroyed.

Any damages recovered by the mortgagee must be applied toward the balance owing on the secured obligation. That balance comprises a ceiling on damage recovery, for the mortgagee can never recover more than is owed on the mortgage debt, including appropriate interest, attorneys' fees, and other costs as provided in the mortgage itself and recognized by local law.

There is a further limitation: the mortgagee may recover only so much of the damages as are necessary to correct the impairment of security, with the amount of the waste itself forming a ceiling on the recovery. Under § 4.6(c), whether there has been an impairment of security depends on whether the mortgage relationship is continuing or has ended. The reason for the different treatment of these two situations is that, if the mortgage relationship will extend into the future, the mortgagee is entitled to have continuing protection of its margin of security. If the relationship has ended (typically because the mortgage has been foreclosed or the mortgagee has accepted a deed in lieu of foreclosure) the mortgagee has no more need for a margin of security. The effect of a foreclosure and its associated proceedings is to fix the amount (if any) of the deficiency owed to the mortgagee, and this amount becomes a ceiling on the mortgagee's post-foreclosure recovery of waste.

On the other hand, if the mortgage relationship is continuing the mortgagee may recover damages if the waste has deprived the mortgagee of the margin of security for which it bargained when the mortgage was given. Under § 4.6(c), this determination is based on a simple formula: Security is impaired if the loan-to-value ratio has risen above its scheduled value, that is, the ratio that would have prevailed if the real estate's value had remained constant and all scheduled payments on the mortgage obligation had been timely made. This approach differs from that found in some of the cases, which regard security as impaired only if the value of the real estate has fallen below the amount of the mortgage obligation. These cases unfairly disregard the fact that most mortgage loans are made for an amount well below the property's value, and the further fact that loans providing for amortization payments are expected to become more secure over time as the principal balance declines. In effect, they refuse to permit recovery of damages or an injunction unless the mortgagee's loan-to-value ratio has increased to 100 percent, a position for which very few mortgagees bargain and which few would willingly accept.

Numerous other approaches have been used. For example, a few courts have endorsed use of the "reasonable" or "customary" loan-to-value ratio employed by conservative lenders, such as 70 percent or 75 percent. Others have held that the mortgagee should recover if the market value of the debt (in the secondary mortgage market) has declined as a result of the waste. Several commentators have recommended a rule under which security is considered impaired if the loan-to-value ratio after the commission of the waste is lower than before the waste.

The approach taken by § 4.6(c) is similar to that just mentioned, except that under § 4.6(c) impairment of security is based on the scheduled rather than the actual loan-to-value ratio at the time of the waste. The mortgagor is thus given the benefit of any increases in market value of the real estate as an offset against the waste, but is penalized (in terms of the likelihood of having to pay damages for waste) if the market value has declined. See Illustrations 7 and 8. This rule is reasonable because the mortgagee obviously did not bargain for increases or decreases in the market value after taking the mortgage; such fluctuations in value are inherently unpredictable. However, the mortgagee is entitled to the protection (in the form of margin of security) for which it bargained when the mortgage was given, including improvements in that protection resulting from the scheduled amortization of the balance owing on the obligation.

This measure of impairment of security, like the others mentioned above, requires an appraisal of the property after the waste has occurred. It also requires knowledge of value at the time the mortgage was created. The latter requirement will rarely impose any additional burden, since virtually all institutional lenders routinely obtain appraisals when making mortgage loans and retain those appraisal reports in their loan files.

Illustrations:

7. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. During the ensuing five years, Mortgagor makes scheduled payments of amortization and interest, reducing the balance on the loan to $70,000, while Blackacre's value increases to $120,000. Mortgagor then commits waste, reducing Blackacre's value by $10,000, to $110,000. The scheduled loan-to-value ratio at the time of the waste is $70,000 divided by $100,000, or 70 percent, while the actual loan-to-value ratio is $70,000 divided by $110,000, or 63.6 percent. Mortgagor is not liable for waste, since Mortgagee's security has not been impaired.

8. The facts are the same as Illustration 7, except that Mortgagor commits more severe waste, reducing Blackacre's value by $30,000, to $90,000. The actual loan-to-value ratio is about 77.8 percent, while the scheduled loan-to-value ratio, as indicated in Illustration 7, is 70 percent. Mortgagor is liable for damages for waste, since Mortgagee's security has been impaired.

In cases in which the mortgage relationship is continuing, the measure of damages for waste should ordinarily be the amount necessary to restore the mortgagee to its scheduled loan-to-value ratio. Changes in the mortgagee's loan-to-value ratio over time generally result from two distinct factors. One is the pay-down of the principal balance of the debt, resulting from any scheduled amortization payments and sometimes from unscheduled prepayments. The other is the fluctuation in value of the real estate resulting from market conditions. Both of these factors often result in improvement of the loan-to-value ratio over time as the debt is amortized and the real estate appreciates in value. Improvement resulting from scheduled amortization belongs to the mortgage lender as a matter of right; the schedule is built into the promissory note or other evidence of the obligation, and the mortgagee is entitled to rely upon the greater security that it produces over time. Increases and decreases in the real estate's value, on the other hand, are unpredictable; no mortgagee can be certain at the inception of the mortgage of whether such changes will make the loan more or less secure over time. Hence the only fair assumption, for purposes of computing damages, is that the property value would remain static.

The measure of damages should give the mortgagee the benefit of the first factor but not the second. It should permit the mortgagee to recover a sum which, when credited against the mortgage debt, will be sufficient to produce the same loan-to-value ratio that the mortgagee would have experienced, at the same point in time, if the property had remained stable in value and the loan had been amortized as scheduled. See Illustrations 9 and 10. Under this approach, no additional recovery te reflect appreciation in the property's value is permitted. In essence this approach is a compromise between the "debt equivalency" and "pre-take ratio" tests discussed above.

Illustrations:

9. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. During the ensuing five years, scheduled amortization payments reduce the loan balance to $70,000 while Blackacre's value increases to $120,000.

Mortgagor then commits waste, reducing Blackacre's value by $30,000 to $90,000. Since the scheduled loan-to-value ratio at the time of the waste was $70,000/$100,000, or 70 percent, Mortgagee is entitled to a restoration of that loan-to-value ratio. The value of Blackacre now being reduced to $90,000, the damages recovery should reduce the debt balance to 70 percent of $90,000, or $63,000. Mortgagee may recover (and upon recovery must credit against the debt balance) damages of $70,000 minus $63,000, or $7,000.

10. The facts are the same as Illustration 9, except that Blackacre's value falls from $100,000 to $90,000 during the five years after the mortgage is given. Mortgagor then commits waste, reducing Blackacre's value by $30,000, to $60,000. As in Illustration 9, the actual balance owing on the mortgage loan is $70,000, and the scheduled loan-to-value ratio at the time of the waste is 70 percent. The value of Blackacre now being reduced to $60,000, the damages recovery should reduce the debt balance to 70 percent of $60,000, or $42,000. Mortgagee may recover (and upon recovery must credit against the debt balance) damages of $70,000 minus $42,000, or $28,000.

Sometimes mortgagors make unscheduled voluntary partial prepayments of the mortgage debt. Such prepayments give the mortgagee a windfall in increased margin of security, placing the mortgagor ahead of schedule in terms of amortization. If a mortgagor who makes such a payment subsequently commits waste, the prepayment may, in effect, "cover" the waste and reduce or eliminate the mortgagee's recovery of damages. See Illustration 11.

On the other hand, mortgagors sometimes fall behind in making scheduled payments and fail to amortize the debt balance in accordance with the terms of their obligation. Similarly, late payments by mortgagors may result in the accrual of unpaid interest and late charges against the debt balance. In such cases, the mortgagee's recovery of damages for waste should place the mortgagee in the same position as if the debt balance had been amortized and reduced as scheduled. See Illustrations 12 and 13. The actual amount of the waste always constitutes a ceiling on the recovery of damages.

Illustrations:

11. The facts are the same as Illustration 9, except that immediately prior to committing the waste, Mortgagor makes a voluntary prepayment of $10,000, reducing the debt balance to $60,000. Mortgagor then commits waste of $30,000, reducing the

value of Blackacre to $90,000. Since the scheduled loan-to-value ratio is 70 percent, and since Mortgagee's actual loan-to-value ratio is $60,000/$90,000 or 66.6 percent, which is below 70 percent, Mortgagee is not entitled to recover any damages for the waste.

12. The facts are the same as Illustration 9, except that Mortgagor has failed to make some scheduled amortization payments, with the result that at the time of the waste the debt balance is $80,000, although it would have been $70,000 if all payments had been made as scheduled. Mortgagor then commits waste of $30,000, reducing the value of Blackacre to $90,000. Since the scheduled loan-to-value ratio is 70 percent, and the value of Blackacre has now been reduced to $90,000, the damages recovery should reduce the debt balance to 70 percent of $90,000, or $63,000. Mortgagee may recover (and upon recovery must credit against the debt balance) damages of $80,000 minus $63,000, or $17,000.

13. The facts are the same as Illustration 9, except that Mortgagor has made no amortization payments, and has made only partial payments of interest, with the result that at the time of the waste the debt balance, including accrued and unpaid interest, is $110,000, although it would have been $70,000 if all payments had been made as scheduled. Mortgagor then commits waste of $30,000, reducing the value of Blackacre to $90,000. Since the scheduled loan-to-value ratio is 70 percent, and the value of Blackacre has now been reduced to $90,000, Mortgagee might wish to recover damages of $47,000, bringing the debt balance down to $63,000 and restoring a loan-to-value ratio of 70 percent. However, such a recovery would exceed the amount of the waste. Mortgagor is liable only for $30,000, the amount of the waste.

When a mortgage loan is made to enable the mortgagor to construct improvements on land, the mortgagee ordinarily appraises the real estate on the basis of the completed improvements, even though the mortgage is given before construction starts. In such cases the value at the time of the mortgage must be understood to include the value of the improvements the mortgagor has agreed to construct. Similarly, the scheduled loan-to-value ratio must be calculated on the basis of the value of the completed improvements. When the mortgage in question is not the first lien on the real estate, its scheduled loan-to-value ratio must be understood as taking into account the senior liens. In effect, the "value" available for satisfaction of the mortgage in such a case is the property's market value less the amount of the obligations secured by the senior liens. Of course, the balance owing on such senior liens will depend on whether their holders have already recovered damages for waste, since they must apply any such recovery against the debts they hold. See Illustration 14.

Illustration:

14. Mortgagee-1 makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee-1 secured by a mortgage on Blackacre, which has a value of $100,000. Mortgagee-2 then makes a loan of $10,000 to Mortgagor, secured by a second mortgage on Blackacre. During the ensuing five years, Mortgagor makes all scheduled amortization payments on both loans, reducing the first loan balance to $70,000 and the second loan balance to $5,000. Blackacre's value remains at $100,000. Mortgagor then commits waste, reducing Blackacre's value by $20,000 to $80,000. Since the scheduled loan-to-value ratio on the first loan at the time of the waste was $70,000 divided by $100,000, or 70 percent, Mortgagee-1 is entitled to a restoration of that loan-to-value ratio. The value of Blackacre now being reduced to $80,000, Mortgagee-1's damages recovery should reduce the debt balance to 70 percent of $80,000, or $56,000. Mortgagee-1 may recover (and upon recovery must credit against the debt balance) damages of $70,000 minus $56,000, or $14,000.

The real estate value available to Mortgagee-2 at the time of the waste was scheduled to be $100,000 minus $70,000, or $30,000, giving Mortgagee-2 a scheduled loan-to-value ratio of $5,000 divided by $30,000, or 16.67 percent. As a result of the waste, the value available to Mortgagee-2 has been reduced to $80,000 minus the balance owing on the first mortgage loan. If Mortgagee-1 does not in fact recover for waste before Mortgagee-2's action for waste must be decided, the balance owing on the first mortgage loan will still be $70,000, leaving only $10,000 in value available for Mortgagee-2. Hence, Mortgagee-2 can recover damages in an amount necessary to restore Mortgagee-2's loan-to-value ratio to 16.67 percent of $10,000, or $1,667. Mortgagee-2 may recover (and upon recovery must credit against the debt balance) damages of $5,000 minus $1,667, or $3,333.

However, if Mortgagee-1 actually recovers $14,000 from Mortgagor in a waste action before Mortgagee-2's action for waste must be decided, Mortgagee-1's recovery will, as noted above, reduce the balance owing on the first mortgage to $56,000. In this situation the value available to Mortgagee-2 will have been reduced to $80,000 minus $56,000, or $24,000. Mortgagee-2 can recover damages in an amount necessary to restore Mortgagee-2's loan-to-value ratio to 16.67 percent of $24,000, or $4,000.

Mortgagee-2 may recover (and upon recovery must credit against the debt balance) damages of $5,000 minus $4,000, or $1,000.

The "impairment of security" limitation may be waived by language in the mortgage or a subsequent agreement of the parties. There is no public policy in opposition to such a waiver. Even if the mortgagee recovers damages for the entire amount of the waste, the full recovery must be applied against the debt balance, thus benefiting the mortgagor; in effect, the recovery is a prepayment that the mortgagor is compelled to make on account of the waste. Likewise, if the parties have waived the "impairment of security" limitation and the mortgagee obtains an injunction requiring a complete repair of the waste, the mortgagor is benefited by the increased value of the real estate.

g. Limitations on the remedies of injunction and foreclosure. The "impairment of security" test is employed not only in actions for damages against the mortgagor, but also when the mortgagee wishes to foreclose the mortgage or obtain an injunction. The premise is that waste that does not impair security has done the mortgagee no significant harm, and does not warrant the imposition of these remedies. A court, in fashioning injunctive relief, may in its discretion order that the waste be corrected only to the extent necessary to restore the mortgagee to the scheduled loan-to-value ratio, by analogy to the computation of damages discussed above. However, complete correction of the waste might be necessary in order to avoid leaving the real estate in a condition that would impair its marketability. Likewise, a receiver appointed to manage the real estate may expend rent money on repairs that correct the waste completely rather than partially, if in the receiver's judgment such repairs are appropriate to enhance the property's attractiveness to tenants. See § 4.3.

While waste that is too slight to impair security will not ordinarily warrant foreclosure, a mortgage may provide that specific acts or defaults by the mortgagor will lead to acceleration and foreclosure. For example, if the mortgage contains specific covenants requiring the mortgagor to care for the improvements in a certain manner, or to insure the premises, defaults on these covenants may lead to acceleration and foreclosure whether they impair security or not.

h. Liability of third parties for damages for waste. The "impairment of security" limitation on the recovery of damages is not applicable in actions against third parties—that is, persons other than the mortgagor and those who stand in the mortgagor's place by virtue of having succeeded to a possessory interest in the real estate (see § 4.6(e)). The mortgagee's right to recover the full damages from a third party who commits waste is based on considerations of judicial efficiency. If full recovery were not allowed, third parties would more often be subject to two suits, one by the mortgagee and the other by the mortgagor, each seeking a portion of the damages. Moreover, there is no unfairness to the mortgagor in permitting the mortgagee to preempt the entire claim against the third party. The mortgagee must credit the entire recovery to the mortgage debt, or under the principles of § 4.7 must give the mortgagor access to the funds for purposes of repair or reconstruction of the property if doing so is economically feasible and the property's value will be increased by at least the amount so expended.

Third parties often commit waste at the request or with the consent of the mortgagor. Such parties may be completely innocent of any desire to harm the mortgagee, and may not even know that a mortgage exists on the real estate. They may simply have been engaged to perform demolition or removal of some improvements on the land, or may have contracted to cut timber or remove other natural resources. They cannot reasonably be expected to examine title before doing their work. Hence, they are not liable for damages unless they have actual knowledge that the mortgage exists. The mortgagor who hires them, on the other hand, is liable for waste if an impairment of security results.

Illustration:

15. Mortgagee makes a loan to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre. Mortgagor employs Contractor to demolish a garage located on Blackacre. Mortgagee is not informed of this action and does not consent to it, and demolition of the garage reduces the value of the real estate below its value at the time the mortgage was given. However, Contractor has no actual knowledge of the mortgage at the time the garage is demolished. Contractor is not liable for damages, but Mortgagor is liable to the extent that the demolition impairs Mortgagee's security.

i. Liability for waste of persons not personally liable on the mortgage obligation. In some circumstances a person who owns the mortgaged real estate, or some interest in it, may have no personal liability on the mortgage obligation. An antideficiency statute may preclude such liability; the mortgage or note may contain a "nonrecourse" clause freeing the owner of personal liability; or the owner may be a grantee of the original mortgagor who did not assume the obligation (see § 5.2).

In each of these settings, the question may arise whether the owner is personally liable for waste, even though there is no liability on the mortgage obligation itself. If the absence of personal liability is predicated on an antideficiency statute, liability for waste presents an issue of construction of the statute. The mortgagor who is in financial straits may make timely payments on the mortgage debt but be unable to repair the property, or may use the same funds to repair the property but consequently be unable to make the debt payments. Hence, it is arguable that, if the statute bars personal liability for the missed payments, it should similarly exclude personal liability for the failure to make repairs; the impact of either choice on the mortgagee is essentially identical. The California courts have adopted this view of that state's antideficiency statute, and have held that where a deficiency judgment is barred, no action for waste will lie unless committed in bad faith—that is, recklessly or maliciously. Because this question turns on the language and policy of the specific statute in question, this Restatement takes no position on whether the California view or some similar limitation on waste recovery should be adopted in other jurisdictions with antideficiency statutes.

If the mortgagor lacks personal liability because of nonrecourse language in the mortgage or related documents, the question of liability for waste is a matter of construction of that language. A nonrecourse clause may or may not exclude personal liability for waste, or it may exclude liability for some types of waste but not others. The parties are free to bargain on the issue. Because the language chosen by the parties will vary from case to case, this Restatement takes no general position on whether nonrecourse clauses preclude liability for waste.

j. Liability of the mortgagor's successors for waste. When the mortgaged real estate is transferred to a new owner, that person becomes liable for waste occurring during the period of his or her ownership, and is subject to the mortgagee's exercise of all of the remedies set forth in this section, including a personal action for damages. For waste of the types mentioned in § 4.6(a)(1), (2), (3), and (5), the basis of liability is the tortious nature of waste. For waste consisting of a breach of a mortgage covenant concerning the real estate, § 4.6(a)(4), the basis of liability is that the covenant is a servitude that runs with the mortgagor's estate, burdening future owners. Compare Restatement Third, Property (Servitudes) § 2.2 et seq. (Tentative Draft No. 1, 1989). Neither of these theories requires that the successor owner have assumed the mortgage obligation or undertaken a contractual duty to refrain from waste; hence, both "assuming" and "subject-to" grantees are personally liable for waste occurring while they own the real estate. See § 5.2(d).

Since only successors of the mortgagor's possessory interest are in a position to prevent waste, persons who acquire nonpossessory interests in the real estate subject to the mortgage, such as holders of subordinate mortgages, mechanics' liens, or easements, are not personally liable for waste unless they physically damage the real estate under Subsection (d). Likewise, tenants in possession under leasehold estates are liable to mortgagees for waste only for affirmative physical damage they commit under Subsection (d); they are not liable for the other forms of waste unless their leases so provide. This approach avoids undue interference with the landlord-tenant relationship.

REPORTERS' NOTE

Introduction, Comment a. For general treatments of waste, see Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086 (1976); Comment, Remedies for Waste in Missouri, 47 Mo. L. Rev. 295 (1982); 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 4.4–4.11 (3d ed. 1993); R. Powell, Real Property ¶ 453[2] (1987); E. Durfee, Cases on Mortgages 70–90 (1951); G. Glenn, Mortgages §§ 34–34.3, §§ 194–202.1 (1943).

Recovery for waste does not depend on a showing that the mortgagor is insolvent. See Turrell v. Jackson, 39 N.J.L. 329 (1877); Ogden Lumber Co. v. Busse, 86 N.Y.S. 1098 (N.Y.App.Div.1904); 2 G. Glenn, Mortgages § 196.1 (1943) (waste will be enjoined even if mortgagor is solvent).

Likewise, recovery of damages for waste does not depend on the mortgagee's having first foreclosed. See Jaffe-Spindler v. Genesco, Inc., 747 F.2d 253 (4th Cir.1984); Arnold v. Broad, 62 P. 577 (Colo.Ct.App.1900); Martin v. Fairburn Banking Co., 463 S.E.2d 507 (Ga.Ct.App.1995); Smith v. Frio County, 50 S.W. 958 (Tex. Ct. Civ. App. 1899). Cf. Rainbow Venture Assoc., L.P. v. Parc Vendome Assoc., Ltd., 633 N.Y.S.2d 478 (N.Y.App.Div. 1995) (if a foreclosure order is pending, the mortgagee may pursue a separation action for damages for negligent maintenance of the premises without special leave of court).

Conduct that constitutes waste, Comment b. In general, the removal of fixtures or improvements from the land is waste if it causes substantial reduction in the land's value. See Byrom v. Chapin, 113 Mass. 308, 311 (1873). Cf. Houle v. Guilbeault, 40 A.2d 438 (R.I.1944), noted in 25 B.U. L. Rev. 149 (1945) (junior mortgagee in a title state may not recover damages against a third party for removal of fixtures without joining the first mortgagee). The mortgagee may employ replevin to recover the removed items in specie, or trover for their value. Dorr v. Dudderar, 88 Ill. 107 (1878); Gill v. Weston, 1 A. 921 (Pa. 1885); Waterman v. Matteson, 4 R.I. 539 (1857); contra, see Kircher v. Schalk, 39 N.J.L. 335 (1877). Considerable authority also permits the mortgagee to assert a separate lien upon the severed items. See Federal Land Bank v. Davis, 152 So. 226 (Ala. 1934); Johnson v. Bratton, 70 N.W. 1021 (Mich.1897); Hamlin v. Parsons, 12 Minn. 108, 90 Am.Dec. 284 (1866); Mills v. Pope, 4 P.2d 485 (Mont.1931); Turner v. Mebane, 14 S.E. 974 (N.C.

1892); Dakota Loan & Trust Co. v. Parmalee, 58 N.W. 811 (S.D.1894); Partridge v. Hemenway, 50 N.W. 1084 (Mich.1891). Whether a bona fide purchaser should take free of the mortgage lien is disputed. Compare Hamlin v. Parsons, 12 Minn. 108 (1866) (lien enforced against BFP) with Betz v. Verner, 19 A. 206 (N.J. Eq. 1890) (BFP is free of mortgage lien).

However, demolition of buildings or removal of fixtures is not actionable waste if the mortgagor replaces them with items of equal or greater value as part of a program of improvement of the property. Heller v. Gerry, 364 N.Y.S.2d 615 (N.Y.App.Div.1975).

The mortgagor's cutting and removal of timber on the real estate has proven problematic in the courts. If the nature of the land and the cutting is such that the activity can be considered "good husbandry" there is no liability for waste. See Manke v. Prautsch, 401 P.2d 680 (Nev.1965) (removal of diseased and dying tress is not waste). An analogy may be drawn to the harvesting of crops, which is clearly not waste. See Judkins v. Woodman, 17 A. 298 (Me.1889) (mortgagor privileged to remove a reasonable amount of wood). Land in use as a tree nursery would he similarly treated. But waste will be found if the removal was not "good husbandry" under the circumstances. See Waterman v. Matteson, 4 R.I. 539 (1857); Searle v. Sawyer, 127 Mass. 491 (1879) (the question is whether "the assent of the mortgagee could fairly be presumed"). In Kruger v. Horton, 725 P.2d 417 (Wash.1986), vendors sold land by real estate installment contract. Upon purchasers' default, they forfeited the contract and retook possession. The purchasers had cut timber on the land, and vendors sued for damages for waste. However, the court denied their claim on the ground that they had not proved that the cutting of the timber had decreased the value of the land. Compare Bremerton Central Lions Club, Inc. v. Manke Lumber Co., 604 P.2d 1325 (Wash.Ct.App.1979) (cutting of timber by installment contract vendee was waste where the contract specifically prohibited it). See also Ga. Code Ann. § 51-12-51, permitting the cutting of timber "for firewood or other necessary uses in and around said farm."

There is substantial authority that failure to carry out reasonably necessary repairs or maintenance will constitute waste. See Travelers Insurance Co. v. 633 Third Associates, 14 F.3d 114 (2d Cir.1994) (New York law); Finley v. Chain, 374 N.E.2d 67 (Ind.Ct.App.1978); Gardner v. W. M. Prindle & Co., 185 Minn. 147 (1932); Damiano v. Bergen County Land Co., 180 A. 489 (N.J. Eq. 1935); Cottle v. Wright, 251 N.Y.S. 699 (N.Y.Sup.Ct. 1931); Vogel v. Pardon, 444 N.W.2d 348 (N.D.1989); Whistler v. Hyder, 879 P.2d 214 (Or.Ct.App.1994).

In In re Evergreen Ventures, 147 B.R. 751 (Bankr.D.Ariz.1992), the mortgagor, a partnership that owned an apartment building, permitted it to deteriorate by failing to repair roof leaks, damaged windows and doors, and sewer leaks. The court held the general partner liable in damages to the mortgagees. It refused to recognize the Arizona anti-deficiency statute as a defense, noting that the waste statute specifically stated that damages for waste were available even if a deficiency judgment was not, and further that the mortgagor had the financial capacity to make the needed repairs and was guilty of bad faith in failing to do so.

In Prudential Insurance Co. v. Spencer's Kenosha Bowl, Inc., 404 N.W.2d 109 (Wis. Ct. App. 1987), the mortgagee sought damages against a non-assuming grantee who had failed to maintain and repair the roof of the building. The court awarded damages, rejecting the grantee's argument that doing so was tantamount to the granting of a deficiency judgment. It also rejected the argument that damages could be recovered only for active or voluntary waste.

Illustration 3 is based on Morton v. Park View Apartments, 868 S.W.2d 448 (Ark.1993) (mortgagors not liable for damage caused by hailstorm and freeze). See also Krone v. Goff, 127 Cal.Rptr. 390 (Cal.Ct.App.1975) (failure of mortgagor to repair damage caused by earthquake and fire was not waste).

Cases holding that failure of the mortgagor to pay property taxes constitutes waste include Travelers Insurance Co. v. 633 Third Associates, 14 F.3d 114 (2d Cir.1994) (under New York law, failure to pay taxes is waste if intentional or fraudulent); North American Sec. Life Ins. Co. v. Harris Trust & Sav. Bank., 859 F.Supp. 1163 (N.D.Ill.1994) (Illinois law); Osuna v. Albertson, 184 Cal. Rptr. 338 (Cal.Ct.App.1982); Nielsen v. Heald, 186 N.W. 299 (Minn.1922); Abernathy v. Orton, 71 P. 327 (Or. 1903). Cf. Bank of America v. 203 North LaSalle St. Partnership, 195 B.R. 692 (N.D.Ill.1996) (inadvertent failure to pay one installment of taxes was not waste, where the failure was cured and the mortgagee suffered no harm).

Cases holding that failure to pay taxes does not constitute waste include Krone v. Goff, 127 Cal.Rptr. 390 (Cal.Ct.App.1975); Camden Trust Co. v. Handle, 26 A.2d 865 (N.J. Eq. 1942); Merchants' Union Trust Co. v. New Philadelphia Graphite Co., 83 A. 520 (Del.Ch.1912); Union Mortg. Co. v. Nelson, 82 N.Y.S.2d 268 (N.Y.Sup. Ct.1948). See Chetek State Bank v. Barberg, 489 N.W.2d 385 (Wis. Ct. App. 1992), in which the mortgagor on a nonrecourse mortgage failed to pay the property taxes. The mortgagee foreclosed, and a large deficiency resulted. The nonrecourse language precluded a deficiency judgment, but the mortgagee brought an action for waste in the amount of the delinquent taxes and interest. The court rejected this claim on the basis that (1) failure to pay the taxes was not "unreasonable conduct," and (2) that no physical damage to the land resulted.

An unusual use of the waste concept is illustrated by Application of Busse, 464 N.E.2d 651 (Ill. App. Ct. 1984). Mortgagors purchased land from mortgagees, paying in part by means of a purchase-money mortgage. The contract of sale stated that the purchase-money mortgage would contain a subordination clause. However, the mortgagor altered the subordination clause before recording the mortgage; the altered version subordinated the mortgage to a specific mortgage for $225,000 in favor of another lender. The court found that the alteration was fraudulent, was "in the nature of waste," and (since the mortgage obtaining priority under the subordination clause had been foreclosed) had the effect of entirely impairing the mortgagors' security. It awarded the mortgagees both actual and punitive damages.

Another unusual form of waste was found to exist in Duncan v. First American Title Co., 648 F.Supp. 296 (D.Nev.1986). The mortgaged real estate was a ranch that had associated grazing rights in adjacent government land under leases from the Bureau of Land Management. The mortgagor was found to have repeatedly violated BLM regulations, eventually causing the cancellation of the leases to the detriment of the ranch's value. The court concluded that this action constituted waste and imposed damages on the mortgagor.

The concept of waste may be either expanded (see Subsection (a)(4)) or contracted by the terms of the mortgage itself. See North American Sec. Life Ins. Co. v. Harris Trust & Sav. Bank., 859 F.Supp. 1163 (N.D.Ill. 1994) (Illinois law) (mortgage language did not effectively narrow the definition of waste).

Waste of rents, Comment d. Once a mortgagee's right to possession of rents has been actuated, a mortgagor who intercepts or diverts the rents to other purposes is liable for waste. See Taylor v. Brennan, 621 S.W.2d 592 (Tex.1981), in which the court recognized in principle that diversion of the rents could be waste, but refused to award damages because the mortgagee had never taken the necessary action to acquire a right of possession of the rents; Ginsberg v. Lennar Florida Holdings, Inc., 645 So.2d 490 (Fla.Dist.Ct.App.1994) (same).

Remedies for waste, Comment e. The mortgagee may recover for waste from the proceeds of the foreclosure sale if it has advanced funds to repair or correct the waste. See South Amboy Trust Co. v. McMichael Holdings, Inc., 56 A.2d 437 (N.J. Eq. 1947) (unpaid taxes recovered). See also Whistler v. Hyder, 879 P.2d 214 (Or.Ct.App.1994) (vendor may declare forfeiture of installment contract if purchaser does not carry out reasonable maintenance). See § 2.2, dealing with the mortgagee's right to include in the secured debt expenditures made to protect the security. Cf. Brayton v. Pappas, 383 N.Y.S.2d 723 (N.Y.App.Div.1976) (mortgagee may not foreclose for waste, where waste was not included as a ground for acceleration in the mortgage, but may nonetheless recover damages).

Cases allowing recovery of damages include President & Directors of Manhattan Co. v. Mosler Safe Co., 284 N.Y.S. 145 (N.Y.App.Div.1935); Hummer v. R.C. Huffman Construction Co., 63 F.2d 372 (7th Cir.1933); Toledo v. Brown, 200 N.E. 750 (Ohio 1936); Arnold v. Broad, 62 P. 577 (Colo.Ct.App.1900). Contra, see State ex rel. Watson v. White, 408 S.E.2d 66 (W.Va.1991), refusing to grant either damages or an injunction to a mortgagee on account of the mortgagor's cutting timber on the land in violation of a covenant in the mortgage, and relegating the mortgagee to the remedy of foreclosure.

The following cases support the right of the mortgagee to an injunction against waste: Travelers Insurance Co. v. 633 Third Associates, 973 F.2d 82 (2d Cir.1992); Owings Lumber Co. v. Marlowe, 76 So. 926 (Ala. 1917); Moriarty v. Ashworth, 44 N.W. 531 (Minn.1890). See Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1090–91 (1976).

Limitations on recovery of damages, Comment f. Any damages recovered for waste must be applied against the balance owing on the mortgage debt. See Jaffe–Spindler v. Genesco, Inc., 747 F.2d 253 (4th Cir. 1984); Barron, Meade & Co. v. Paulling, 38 Ala. 292 (1862); Gooding v. Shea, 103 Mass. 360 (1869); Randolph v. Simpson, 500 S.W.2d 289 (Mo.Ct. App.1973); Guthrie v. Kahle, 46 Pa. 331 (1864); Houle v. Guilbeault, 40 A.2d 438 (R.I.1944); Note, 10 Tex. L. Rev. 475 (1932).

In measuring damages, the mortgagee may claim either the diminution in value of the real estate or the cost of repair, at the mortgagee's option. See Atlantic Coast Line R. Co. v. Rutledge, 165 So. 563 (Fla.1935) (diminution in value awarded); Byrom v. Chapin, 113 Mass. 308, 311 (1873) (for removal of fixtures, mortgagee may recover diminution in value of real estate, though it exceeds the value of the items removed); Bell v. First Columbus National Bank, 493 So.2d 964, 970 (Miss.1986) (plaintiff's choice will be enforced unless defendant shows it would result in unjust enrichment; even cost of replacing old fixtures with new may be recoverable); Meyer v. Hansen, 373 N.W.2d 392 (N.D.1985) (same); Jowdy v. Guerin, 457 P.2d 745 (Ariz.Ct. App.1969) (plaintiff's choice will be enforced unless defendant shows that an alternate measure of damages would produce a lower figure). Cf. Ogden Lumber Co. v. Busse, 86 N.Y.S. 1098 (N.Y.App.Div.1904) (mortgagee may recover diminution in value of land unless mortgagor proves that cost of repair is less).

Virtually all "lien" theory states hold that impairment of security must be shown in order for the mortgagee to recover damages. See Manke v. Prautsch, 401 P.2d 680 (Nev.1965). Most title theory states allow the mortgagee to recover the full amount of the waste without regard to impairment of security. See Delano v. Smith, 92 N.E. 500 (Mass.1910); Sturges & Clark, Legal Theory and Real Property Mortgages, 37 Yale L.J. 713 (1928). Cf. Jaffe-Spindler v. Genesco, Inc., 747 F.2d 253 (4th Cir. 1984) (permitting recovery of the full amount of the waste under South Carolina law, despite the fact that South Carolina follows the "lien" theory).

The following "lien" theory cases determine whether the security has been impaired simply by asking whether the real estate is worth, after commission of the waste, less than the balance owing on the obligation (the "debt equivalency" rule): Freeman v. Lind, 226 Cal.Rptr. 515 (Cal. Ct.App.1986) (for purposes of the accrual of a right in the mortgagee to accelerate and foreclose); Ginsberg v. Lennar Florida Holdings, Inc., 645 So.2d 490 (Fla.Dist.Ct.App.1994); Schalk v. Kingsley, 42 N.J.L. 32, 33 (1880); Turrell v. Jackson, 39 N.J.L. 329 (1877); Monte Enterprises, Inc. v. Kavanaugh, 303 S.E.2d 194 (N.C.Ct. App.1983); Lieberman v. Knight, 283 S.W. 450 (Tenn.1926); Frio Investments, Inc. v. 4M-IRC/Rhode, 705 S.W.2d 784 (Tex. Ct. App. 1986); Payne v. Snyder, 661 S.W.2d 134 (Tex. Ct. App. 1983), error refused n.r.e. (1984); Carroll v. Edmondson, 41 S.W.2d 64 (Tex.Com.App.1931), commented on in Note, 10 Tex. L. Rev. 475 (1932). See Denton, Right of a Mortgagee to Recover Damages from a Third Party, 3 Ohio L.J. 161, 164 (1936).

There is, however, authority rejecting the "debt equivalency" rule and requiring maintenance of the pre-waste loan-to-value ratio or some other reasonable margin of security. See Duncan v. First American Title Co., 648 F.Supp. 296 (D.Nev.1986) (damages assessed in an amount sufficient to restore the mortgagee's loan-to-value ratio to its amount at the inception of the mortgage); Finley v. Chain, 374 N.E.2d 67 (Ind.Ct.App. 1978) (in action for damages, the test was "whether the value of the realty had been reduced to the extent that the remaining debt was rendered unsafe"); Moriarty v. Ashworth, 44 N.W. 531 (Minn.1890) (mortgagee should have the margin of security that a prudent lender would expect); Lawton v. Lincoln, 191 P.2d 926 (Okla.1948) (no recovery for waste, where the value of the mortgaged property, despite removal of buildings, was "greatly in excess of the amount of the mortgage debt"); Atlantic Coast Line R. Co. v. Rutledge, 165 So. 563 (Fla.1935) (full diminution in value awarded, where mortgagee had already foreclosed and had apparently obtained an uncollectible deficiency judgment for more than that amount); Stevensen v. Goodson, 924 P.2d 339 (Utah 1996) (no recovery if the debt is "adequately secured"). See Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1099 (1976); Note, 10 Tex. L. Rev. 475, 482 (1932).

Miller v. Waddingham, 91 Cal. 377 (1891), adopted, as a test for impairment of security, that the waste has reduced the value of the real estate below its value at the time of the mortgage. The vendor under a real estate installment contract (which the court treated as the equivalent of a mortgage) sought to enjoin the removal of two houses that the purchaser had constructed on the land. In refusing the injunction, the court noted:

> Nor is it alleged or found that the land is less valuable than it was at the date of the contract of sale.... In the absence of any allegation or finding to the contrary, it must be assumed that the land is fully as valuable as at the date of the contract, and that the vendee is not only able to comply with his obligations, but that he will fully and promptly meet them as they mature.

Id. at 381.

When the waste is assessed in a foreclosure action or after foreclosure, so that the debtor-creditor relationship no longer exists, it is unnecessary to give the mortgagee the benefit of any margin of security; in such a case, the recovery is limited to the deficiency or the unpaid debt, even if the loss of value of the real estate is much greater. See Finley v. Chain, 374 N.E.2d 67 (Ind.Ct.App. 1978); Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1098–99 (1976).

If the mortgagor tenders the full amount of the debt, there can be no recovery for waste since the mortgagee's security has obviously not been impaired. See Oles v. Plummer, 444 N.E.2d 879 (Ind.Ct.App.1983), in which the purchasers under a real estate installment contract, although in default, tendered the full remaining balance of the price into court and sued for specific performance. The vendors counterclaimed for forfeiture of the contract and for waste. The court held that, in light of the availability of the full contract price to the vendors, they could not possibly have been injured by any waste committed by the purchasers. Since there was no impairment of their security, their claim for waste was denied. To the same effect is Lett v. Grummer, 300 N.W.2d 147 (Iowa 1981).

Similarly, if the mortgagee or a third party bids in the full amount of the debt at a foreclosure sale, the debt is satisfied and no further recovery for waste is possible. Allstate Finance Corp. v. Zimmerman, 272 F.2d 323 (5th Cir.1959); Sloss–Sheffield Steel & Iron Co. v. Wilkes, 165 So. 764 (Ala.1936), noted 109 A.L.R. 385; Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975); King v. Bangs, 120 Mass.

514 (1876); Band Realty Co. v. North Brewster, Inc., 398 N.Y.S.2d 724 (N.Y.App.Div.1977); Monte Enterprises, Inc. v. Kavanaugh, 303 S.E.2d 194 (N.C.Ct.App.1983). See § 4.8.

For a similar result in a case involving an installment sale contract, see Kruger v. Horton, 725 P.2d 417 (Wash.1986). In *Kruger*, vendors sold land on a real estate installment contract. Upon purchasers' default, they forfeited the contract and retook possession. The purchasers had cut timber on the land, and vendors sued for damages for waste. However, the court denied their claim on the ground that they had not proven that the cutting of the timber had decreased the value of the land. The opinion seems further to suggest that, by declaring a forfeiture, the vendors had elected their remedy and could not have recovered additional damages on any theory.

The most complete case discussion of impairment of security is found in People v. Redwood Baseline, Ltd., 149 Cal.Rptr. 11 (Cal.Ct.App.1978). However, the case did not involve waste, but rather the right of real estate mortgagees to an eminent domain award resulting from the taking of a portion of the property for flood control purposes. Under California law, as under § 4.7 of this Restatement, the mortgagees were entitled to share in the award only to the extent that their security was impaired by the taking. The court discussed all of the approaches mentioned in the Comment, supra. It generally favored the "pre-taking ratio" method, but upheld the trial court's award to the mortgagees based on the ratio of the acreage taken to the total acreage subject to the mortgage.

See also Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1097-1100 (1976).

The "impairment of security" test is not applied to actions for damages against parties other than the mortgagor, and the mortgagee can recover the full loss (up to amount of the secured debt) from them. See Ga. Code Ann. § 51-12-51, noted in 53 Harv. L. Rev. 503 (1940), and applied in Southern Land & Cattle Co. v. Simmons, 415 S.E.2d 329 (Ga.Ct.App. 1992).

Limitations on the remedies of injunction and foreclosure, Comment g. The following cases hold the "impairment of security" test applicable to actions to enjoin waste: Coker v. Whitlock, 54 Ala. 180 (1875); Miller v. Waddingham, 27 P. 750 (Cal. 1891); Eisenberg v. Javas, 134 A. 769 (N.J. Eq. 1926).

Liability of third parties for damages for waste, Comment h. Cases sustaining imposition of damages on third parties who commit waste include Atlantic Coast Line R. Co. v. Rutledge, 165 So. 563 (Fla.1935); McCorristin v. Salmon Signs, 582 A.2d 1271 (N.J. Super. Ct. 1990) (mortgagee permitted to recover for waste against a third party who caused damage while installing billboard on mortgaged premises); In re Braddock Avenue, 297 N.Y.S. 301 (N.Y.App.Div.1937) (public body condemning an easement is liable for damages to the extent mortgagees' security is impaired); Heath v. Haile, 24 S.E. 300 (S.C.1896). See Denton, Right of a Mortgagee to Recover Damages from a Third Party, 3 Ohio L.J. 161 (1936); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.5 (3d ed. 1993). Cf. Stevensen v. Goodson, 924 P.2d 339 (Utah 1996) (third party not liable for waste if acts were committed with owner's permission).

If waste is committed by a third party, the mortgagor may be liable for having employed, invited, or conspired with the third party. However, in the absence of such involvement, the mortgagor is not liable merely for failing to prevent the third party's actions. See Garliner v. Glicken, 196 N.Y.S.2d 784 (N.Y.Sup.Ct.1960).

Some authority holds that third parties are liable only for intentional, and not negligent, damage, but the better view rejects this limitation. See U.S. Financial v. Sullivan, 112 Cal.Rptr. 18 (1974); Denton, Right of a Mortgagee to Recover Damages from a Third Party, 3 Ohio L.J. 161 (1936).

Third parties are liable for waste only if they had notice of the existence of the mortgage. See Tomlinson v. Thompson, 27 Kan. 70 (1882). Whether constructive notice from the recordation of the mortgage is sufficient notice, or whether actual knowledge is required, is disputed in the cases. Compare Johnson v. Bratton, 70 N.W. 1021 (Mich.1897), apparently adopting constructive notice, with Betz v. Verner, 19 A. 206 (N.J. Eq. 1890), apparently rejecting constructive notice; the position of both decisions on the point is somewhat obscure. See Ga. Code Ann. § 51-12-51, apparently adopting constructive notice in cases of the cutting of timber on the land. See also U.S. Financial v. Sullivan, 112 Cal.Rptr. 18 (Cal.Ct. App.1974): "It is common knowledge that the development of residential subdivisions is accomplished financially by means of loans secured by deeds of trust on the real property involved. Therefore, it was not only reasonably foreseeable that the alleged negligence of respondents would result in impairment of plaintiff's security, such a result was substantially certain to occur."

In First South Prod. Credit Ass'n v. Georgia-Pacific, 585 So.2d 545 (La. 1991), the mortgagee sought damages against timber companies that had cut wood from the land with the consent of the mortgagor, but without the consent of the mortgagee. The court refused to find the timber companies liable for treble damages under the Louisiana waste statute, La. Rev. Stat. § 9:5382, which gives the mortgagee "the same rights, privileges, and actions as the mortgagor" to recover for waste. The mortgagor's consent to the cutting was held to exclude application of the statute. However, the court remanded the case for consideration of the mortgagee's claim for damages on other nonstatutory theories.

Liability for waste of persons not personally liable on the mortgage obligation, Comment i. In Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975), the mortgagor of a house sold it to a non-assuming grantee who allegedly committed gross physical waste. The mortgagee foreclosed, bid in the amount of the debt, and acquired the property. The mortgagee then sued the grantee for damages for the waste. The grantee raised as defenses (1) the antideficiency statute (which plainly barred any deficiency judgment in connection with the mortgage) and (2) the absence of personal liability because of the mortgagor's non-assumption. The court held that to hold the grantee liable for damages for waste would defeat the policy of the antideficiency statute unless the waste was committed "in bad faith," defined as reckless or malicious, rather than as a result of "economic pressures." It reached a similar conclusion with respect to the defendant's posture as a nonassuming grantee.

In Travelers Insurance Co. v. 633 Third Associates, 973 F.2d 82 (2d Cir. 1992), the mortgagor failed to pay the property taxes, but distributed $4 million in cash to its partners. The mortgagee sued to set aside the cash distribution as a fraudulent conveyance. The mortgage contained a nonrecourse clause that precluded a money judgment on the mortgagor's liability "to perform and observe and make good the obligations contained in this Note and the Mortgage." Since the mortgage also contained a clause prohibiting waste, the court held that the nonrecourse language was broad enough to prevent an action for damages for waste, but did not bar an injunction. See the further opinion in the case at 14 F.3d 114 (2d Cir.1994). Contra, see Jaffe-Spindler v. Genesco, Inc., 747 F.2d 253 (4th Cir.1984) (waste is a tort, and hence not within the scope of a mortgage clause excluding personal liability on the debt and other covenants in the mortgage; non-recourse mortgagor held liable for damages).

In U.S. v. Haddon Haciendas Co., 541 F.2d 777 (9th Cir.1976), the mortgage prohibited the mortgagee from seeking "any judgment for a deficiency in any action to foreclose this" mortgage. A "regulatory agreement" executed by the mortgagor and mortgagee also provided that the individual partners of the mortgagor partnership would not be personally liable for payments under the note or "for matters not under their control," but would be liable "for their own acts and deeds." The court held that none of this language barred an action by the mortgagee after foreclosure for damages for waste. The court also declined to follow, as a matter of federal law, the rule of Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975); hence, it held the mortgagor and its partners liable irrespective of any finding that their waste was committed in "bad faith."

In In re Mills, 841 F.2d 902 (9th Cir.1988), the mortgagor committed serious failures of maintenance of the real estate, a transient hotel. After foreclosing, the mortgagee sought damages for waste, and the mortgagor defended on the basis of Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975). It was undisputed that the antideficiency statute applied. Hence, the issue before the court was whether the mortgagor's failure to maintain was "bad faith." The evidence indicated that he had made minimal efforts at maintenance, but had diverted most of the revenues from the hotel to other properties he owned. The court concluded that the waste was due to his "financial difficulties," and hence that he had not acted in "bad faith" and was protected from liability by the antideficiency statute. The dissent argued that only a general depression in the real estate market, and not the mortgagor's individual financial difficulties, could justify such a conclusion.

Liability of mortgagor's successors for waste, Comment j. See Jowdy v. Guerin, 457 P.2d 745 (Ariz.Ct.App. 1969) (assignee of vendee under contract for deed was held liable for waste, where the assignee took possession and where the vendor did not know that the property was being abandoned and neglected); Byrom v. Chapin, 113 Mass. 308 (1873) (grantee of mortgagor held liable for waste); Van Pelt v. McGraw, 4 N.Y. 110 (1850); Heath v. Haile, 24 S.E. 300 (S.C.1896) (same); Prudential Insurance Company of America v. Spencer's Kenosha Bowl Inc., 404 N.W.2d 109 (Wis.Ct.App.1987) (mortgagee entitled to assert waste claim against nonassuming grantee). The principle involved here is not limited to grantees; see Wheeler v. Peterson, 331 S.W.2d 81 (Tex. Ct. Civ. App. 1959) (statutory liquidator of insurance company that owned the mortgaged property may be liable for waste). Contra, see Camden Trust Co. v. Handle, 26 A.2d 865 (N.J. Eq. 1942) (grantee of mortgagor is not liable for permissive waste, nor for nonpayment of taxes, though mortgagor covenanted to pay them). See 1 G. Glenn, Mortgages § 34.1 (1943) (non-assuming grantees may be held liable for waste).

§ 4.7 Mortgagee's Right to Funds Paid Under Casualty Insurance or Taking in Eminent Domain

(a) Unless a different disposition is provided in the mortgage, the mortgagee has a right to the following funds paid on account of loss or damage to the mortgaged real estate, to the extent that the mortgagee's security has been impaired by the loss or damage, as defined in § 4.6(c):

(1) the proceeds paid by a casualty insurer due to the occurrence of an insured loss to the real estate, if the mortgagor promised the mortgagee, in the mortgage or otherwise, to purchase the insurance; and

(2) an award resulting from a taking of all or part of the real estate under power of eminent domain, or the proceeds of a sale to a governmental body in lieu of such taking.

(b) Unless the mortgage effectively provides the contrary, if restoration of the loss or damage described in Subsection (a) is reasonably feasible within the remaining term of the mortgage with the funds received by the mortgagee, together with any additional funds made available by the mortgagor, and if after restoration the real estate's value will equal or exceed its value at the time the mortgage was made, the mortgagee holds the funds received subject to a duty to apply them, at the mortgagor's request and upon reasonable conditions, toward restoration. The mortgagee must credit toward the obligation secured by the mortgage any such funds not so applied.

Cross-References:

Section 4.6, Waste; § 4.8, Effect of Foreclosure on Mortgagee's Right to Insurance and Eminent Domain Proceeds.

Comment:

a. Introduction. This section deals with funds that are received in replacement for loss of or damage to the mortgaged real estate. Two types of funds are commonly so received: casualty insurance proceeds and payments made by governmental bodies that acquire part or all of the real estate. Such funds are viewed as substitute collateral, and the mortgagee's claim on them is sometimes described as an "equitable lien." This means simply that the mortgagee is entitled to recover the funds to the extent necessary to compensate for the impairment of security that results from the loss or damage, with a maximum recovery equal to the balance owing on the mortgage debt. This result is required to avoid unfairness to the mortgagee through devaluation of the real estate as a consequence of the loss or damage.

Rights to these funds are governed by the ordinary rules of mortgage priority. Thus a first mortgagee has priority over a second mortgagee in claiming the funds involved here, and may leave nothing for the second mortgagee to recover. Similarly, if a mortgage on a leasehold estate is subordinate to the rights of the lessor, the lease may give the lessor's claim to these funds preference over the mortgagee's claim.

This section presupposes that the loss or damage to the real estate occurs before foreclosure of the mortgage. If it occurs after foreclosure, the real estate belongs to the buyer at the foreclosure sale, and neither the mortgagor nor the mortgagee, as such, has any interest in it. Even when the loss occurs before foreclosure, the mortgagee's right to claim the fund in question may be terminated in whole or part by foreclosure. If the bid at the foreclosure sale is sufficient to discharge the entire debt secured by the mortgage, the debt no longer exists and the mortgagee may make no claim on the funds with which this section is concerned. See § 4.8. If the foreclosure discharges the debt only partially, the lender's claim on these funds is limited to the remainder of the debt.

The principle of Subsection (a) is applicable to other sorts of funds that represent recovery for loss or damage to the mortgaged real estate. For example, if a third party commits waste and the mortgagor sues and recovers damages, the recovery may be regarded as substitute collateral and subjected to the mortgagee's claim. The mortgagor will still benefit indirectly, since the funds must be applied by the mortgagee toward the debt or made available for restoration of the damage under Subsection (b).

b. Impairment of security. Under the principle of "impairment of security," stated in § 4.6, the mortgagee's recovery of the fund in question is limited to the amount necessary to correct the impairment of security the mortgagee has suffered. Under § 4.6(c), this is the amount needed to return the mortgagee's loan-to-value ratio to the scheduled level—that is, the level that would have existed if all debt payments had been made when due and the real estate's original value had remained constant. See Illustrations 1 and 3.

The mortgagee's right to recover the funds described here is subject to modification in the mortgage itself. The mortgage may provide for a lesser recovery, or none at all; alternatively, it may provide for a complete recovery of the funds, even though a smaller recovery would fully cure the impairment of security. See Illustration 2. The effect of such language in the mortgage is significantly mitigated, however, by the right of the mortgagor under § 4.7(b) to require that the funds be applied toward restoration of the loss or damage.

Illustrations:

1. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. The mortgage requires Mortgagor to purchase fire insurance, but contains no provision with respect to disposition of insurance proceeds. Mortgagor purchases and maintains the required insurance. During the ensuing five years Mortgagor makes all scheduled payments of amortization and interest, reducing the mortgage debt balance to $70,000 while Blackacre's value increases to $120,000. A fire occurs, reducing Blackacre's value by $30,000 to $90,000. The fire insurance carrier tenders $30,000. Since the scheduled loan-to-value ratio at the time of the fire was $70,000 divided by $100,000, or 70 percent, Mortgagee is entitled to a restoration of that loan-to-value ratio. The value of Blackacre now being reduced to $90,000, Mortgagee is entitled to so much of the insurance proceeds as are necessary to reduce the debt balance to 70 percent of $90,000, or $63,000. Mortgagee may claim $70,000 minus $63,000, or $7,000 of the fire insurance proceeds, subject to a duty to apply the funds toward restoration of the real estate under § 4.7(b) if the conditions of that subsection are met.

2. The facts are the same as Illustration 1, except the mortgage contains a clause providing that, in the event of an insured casualty, Mortgagee is entitled at its option to the entire insurance proceeds. This clause is enforceable, and Mortgagee is entitled to recover the entire $30,000 insurance payment, subject to a duty to apply the funds toward restoration of the real estate under § 4.7(b). Mortgagee must apply any funds not so applied toward reduction of the mortgage debt balance.

3. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. During the ensuing five years Mortgagor makes all scheduled payments of amortization and interest, reducing the mortgage debt balance to $70,000 while Blackacre's value increases to $120,000. The local government then acquires a portion of Blackacre by eminent domain; the value of the remaining portion of Blackacre is $90,000. The local government pays $30,000 for the part taken. Since the scheduled loan-to-value ratio at the time of the taking was $70,000 divided by $100,000, or 70 percent, Mortgagee is entitled to a restoration of that loan-to-value ratio. The value of Blackacre now being reduced to $90,000, Mortgagee is entitled to so much of the eminent domain award as is necessary to reduce the debt balance to 70 percent of $90,000, or $63,000. Mortgagee may claim $70,000 minus $63,000, or $7,000 of the award, subject to a duty to apply the funds toward restoration of the real estate under § 4.7(b) if the conditions of that subsection are met.

c. Insurance proceeds. Both mortgagor and mortgagee have independent insurable interests in the real estate, and it is well established that either of them may insure that interest without the other's acquiring any right to proceeds of the policy. However, it is very common for the parties to enter into an agreement that one of them will purchase insurance but that both will be protected by it. Most often the mortgage will require that the mortgagor obtain and pay for the insurance, but that the mortgagee be named as a loss payee. The mortgagee's right to the proceeds of insurance purchased by the mortgagor arises only if that purchase was made under a promise by the mortgagor to do so. The promise may be found in the mortgage, the promissory note, or some other agreement, and may or may not be contemporaneous with the mortgage.

Even if the mortgage is silent on the mattor, the mortgagee's right to insurance proceeds may also be evidenced by a provision in the insurance policy naming the mortgagee as a loss payee. However, the principle discussed in the preceding paragraph applies whether or not the mortgagee is not so named.

d. Application of funds toward restoration. The mortgagee's right to funds under § 4.7(a) is not absolute; rather, it is limited by the mortgagee's duty, under § 4.7(b), to permit use of the funds for restoration of the loss or damage to the real estate.

The principle of this subsection is that the mortgagee must cooperate with the mortgagor in restoration of the real estate if it is feasible to do so. It is common for real estate lenders to refuse such cooperation, particularly when market interest rates are higher than the rate on the mortgage loan in question. In this context, lenders are often tempted to seize upon the casualty loss or governmental taking as a basis for compelling a prepayment of the loan. Such a position may be extremely harsh from the borrower's viewpoint. Often the borrower cannot continue to occupy the real estate without first restoring the damage; hence, if the lender retains the funds paid in compensation for the damage, the borrower will have to find alternative financing for the property's restoration, either by way of a junior mortgage loan or by refinancing of the existing mortgage. Either of these alternatives will often result in a much higher interest cost to the borrower than use of the funds held by the lender. If restoration is feasible and involves no impairment of the lender's security, it is unreasonable for the lender to refuse to cooperate. See Illustration 4.

If the remaining term of the mortgage is very short, it is possible that restoration of the premises could not reasonably be accomplished within that term. In such a case the mortgagee is relieved of the duty to apply the funds toward restoration. The adverse impact to the mortgagor of the mortgagee's retention of the funds is likely to be minimal in such cases.

Restoration of the mortgaged premises is not always feasible and, if it is not, this subsection has no application. For example, a complete taking in eminent domain leaves none of the real estate in the mortgagor's hands, and thus with no location for restoration to take place. In other cases, restoration may be impossible for legal reasons. If the improvements on the mortgaged land were a nonconforming use under the local zoning ordinance, it may be impermissible to reconstruct them after they are destroyed by fire. In such cases, the mortgagee is entitled to retain the entire fund, up to the limit imposed by the outstanding balance on the debt itself.

Even if restoration is legally and technically feasible, it may be infeasible on financial grounds. Changes in market conditions and patterns of land use may be such that restoration of the property with the funds available will not restore its value to the level at the time the mortgage was made. For example, tenants may have terminated their leases on account of the loss or damage, and because of market conditions it may not be possible to replace them at adequate rents even if the property is fully restored.

In any case in which the funds held by the lender are insufficient to accomplish the restoration of the property, the mortgagor may, for personal or business reasons, wish to supplement those funds. Under § 4.7(b), if the combination of the funds held by the lender and any additional funds the mortgagor wishes to contribute will permit a restoration of the property's original value at the time the mortgage was made, the lender has no legitimate basis for objection and must permit the use of the funds it holds for that purpose. See Illustrations 5 and 6.

If the mortgage debt is delinquent at the time the mortgagor requests use of the funds for restoration, the mortgagee is entitled to retain so much of the funds as necessary to cure the default, and the test described in the preceding paragraph must be met with the remainder of the funds. Moreover, the delinquency will ordinarily give rise to the usual mortgagee's remedies of acceleration and foreclosure; the fact that the loss or damage has occurred, or that the mortgagor wishes to restore the property, will not preclude the mortgagee's exercise of these remedies. Once the mortgagee has properly accelerated the debt, it no longer has a duty to release any funds for restoration of the real estate. See Illustration 7.

Illustrations:

4. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. The mortgage requires Mortgagor to purchase fire insurance. Mortgagor purchases and maintains the required insurance. During the ensuing five years Mortgagor makes all scheduled payments of amortization and interest, reducing the mortgage debt balance to $70,000 while Blackacre's value remains constant. A fire occurs, reducing Blackacre's value by $20,000 to $80,000. The fire insurance carrier tenders $20,000. Since the scheduled loan-to-value ratio at the time of the fire was $70,000 divided by $100,000, or 70 percent, Mortgagee is entitled to a restoration of that loan-to-value ratio. This can be accomplished by reducing the balance on the mortgage loan to 70 percent of $80,000, or $56,000. Mortgagee may therefore recover $70,000 minus $56,000, or $14,000 of the fire insurance proceeds.

However, Mortgagor requests that these funds be made available for restoration of the real estate, and agrees to devote the remaining $6,000 of the fire insurance proceeds to the same purpose. The evidence shows that restoration is reasonably feasible, and that the expenditure of $20,000 will be sufficient to return the value of the real estate te $100,000. Mortgagee has a duty to permit the use of the $14,000 for purposes of restoration, subject to reasonable conditions.

5. The facts are the same as in Illustration 4, except that the evidence shows that $25,000 will be required to restore the

value of the real estate to $100,000. If Mortgagor tenders an additional $5,000 for this purpose, Mortgagee has a duty to permit the use of the entire $20,000 in insurance proceeds for purposes of restoration, subject to reasonable conditions.

6. The facts are the same as in Illustration 5, except that Mortgagor declines to make the additional $5,000 available for restoration. Mortgagee may retain $14,000 of the insurance proceeds, and has no duty to permit the use of those funds for restoration. Mortgagee must credit the mortgage debt by $14,000, reducing its balance to $56,000.

7. The facts are the same as in Illustration 4, except that Mortgagor is delinquent in payments on the mortgage debt which, as a result of accrued but unpaid interest and late charges, has an outstanding balance of $80,000 rather than the scheduled balance of $70,000. Mortgagee may accelerate the mortgage debt if the mortgage so authorizes and if Mortgagor fails to cure the delinquency before acceleration. If Mortgagee accelerates, it may retain the entire $20,000 fire insurance proceeds and has no further duty to permit the use of any of those proceeds for restoration.

The mortgagee is entitled to impose reasonable conditions on the process of restoration of the real estate. For example, the mortgagee may reserve a power to review and approve the plans and specifications for the work to be done. Such a power is recognized if it is reasonably exercised. Likewise, the mortgagee may require reasonable provisions for the disbursal of the funds to ensure that they will in fact be used for restoration and not diverted to other purposes. If the mortgagee is experienced in construction lending, it may wish to administer the disbursal itself; alternatively, the mortgagee may require use of some external service, such as an escrow company, to disburse the funds and inspect the progress of the restoration. In either case, the reasonable administrative cost of these procedures may be charged against the funds.

While § 4.7(b) specifically addresses only casualty insurance proceeds and the proceeds of government acquisitions of the mortgaged real estate, the mortgagor may have an equitable claim to the application of other types of funds toward restoration of the real estate as well. For example, if a third party committed waste and the mortgagee recovered damages, a court could properly find that the funds so recovered were held subject to a duty to apply them to the restoration of the real estate if the conditions set out in § 4.7(b) were met. The same result would follow if the mortgagor recovered the damages, but was required to turn the funds over to the mortgagee under the principle of § 4.7(a).

e. Mortgagor's waiver of right to use funds for restoration. It is common to find mortgage clauses that purport to give the mortgagee the right to casualty insurance and eminent domain awards without mentioning any corresponding duty to permit use of the funds for restoration of the premises, or that expressly negate any such duty. While such a provision may be construed to preclude the mortgagor's right to use of the funds for restoration under Subsection (b), it may also be disregarded by the courts. For example, in jurisdictions following the Restatement, Second, of Contracts the provision might be considered unenforceable on the ground that it is an unconscionable term of the contract (see Restatement, Second, Contracts § 208) or that enforcement would violate the mortgagee's duty of good faith and fair dealing (see Restatement, Second, Contracts § 205). Application of these principles depends on the facts of the case. See Illustration 8.

Illustration:

8. The facts are the same as in Illustration 4, except that a provision in the mortgage states that in the event insurance proceeds are paid out, the mortgagee at its election may either apply them toward the mortgage debt or toward restoration of the real estate. When Mortgagor requests that the funds be released for the purpose of restoration, Mortgagee refuses and advises Mortgagor that they will be applied toward the mortgage debt instead. Since restoration is reasonably feasible and will return the value of the real estate to its original amount, a court may be warranted in ordering Mortgagee to permit use of the funds for restoration on the grounds that refusal to do so is a breach of Mortgagee's duty of good faith and fair dealing, or that the mortgage clause permitting Mortgagee to retain the funds is an unconscionable contract term. Additional facts which will tend to support this result include: (1) Mortgagee drafted the mortgage; (2) Mortgagor was unaware, at the time the mortgage was entered into, of the provision allowing the mortgagee to retain the funds; (3) Mortgagee is in the mortgage lending business; (4) the real estate is Mortgagor's residence; and (5) Mortgagor will be able to finance restoration of the real estate only by borrowing other funds at an interest rate significantly higher than the rate on the present mortgage debt.

REPORTERS' NOTE

Introduction, Comment a. Authorities holding that an eminent domain award is substitute collateral under the mortgage include Swanson v. U.S., 156 F.2d 442 (9th Cir.1946), cert. denied, 329 U.S. 800, 67 S.Ct. 492, 91 L.Ed. 684 (1947); Carson Redevelopment Agency v. Adam, 186 Cal.Rptr. 615 (Cal.Ct.App.1982); People v. Redwood Baseline Limited, 149 Cal.Rptr. 11 (Cal.Ct.App.1978); Department of Transportation v. New Century Engineering & Development Corp., 454 N.E.2d 635 (Ill. 1983); City of Chicago v. Salinger, 52 N.E.2d 184 (Ill.1943); In re Dillman, 267 N.W. 623 (Mich.1936); Boutelle v. City of Minneapolis, 61 N.W. 554 (Minn. 1894); Silverman v. State, 370 N.Y.S.2d 234 (N.Y.App.Div.1975); Cyllene Corp. v. Eisen, 4 N.E.2d 431 (N.Y.1936); Wynnewood Bank v. State, 767 S.W.2d 491 (Tex. Ct. App. 1989). See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.12 (3d ed. 1993); Miller, Valuation of the Mortgagee's Interest upon Partial Condemnation, 15 Loy. L.A. L. Rev. 227 (1982); Leipziper, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1097 (1976); Teague, Condemnation of Mortgaged Property, 44 Tex. L. Rev. 1535 (1966).

Casualty insurance proceeds are regarded as substitute collateral if the mortgagor covenanted to insure the property, even if the mortgagee was not named as a loss payee, under the following authorities: Weiner v. Sentinel Fire Ins. Co., 87 F.2d 286, 288 (2d Cir.1937); In re Natale, 174 B.R. 362 (Bankr.D.R.I.1994); Hatley v. Payne, 751 S.W.2d 20, 22 (Ark.Ct. App.1988); Le Doux v. Dettmering, 43 N.E.2d 862, 867 (Ill. App. Ct. 1942); Loving v. Ponderosa Systems, Inc., 479 N.E.2d 531 (Ind.1985); Lakeshore Bank v. United Farm Bureau Mut. Ins. Co., 474 N.E.2d 1024 (Ind.Ct. App.1985); Giberson v. First Fed. Sav. & Loan Ass'n, 329 N.W.2d 9 (Iowa 1983); Rollins v. Bravos, 565 A.2d 382 (Md. Ct. Spec. App. 1989); Warner v. Tarver, 405 N.W.2d 109 (Mich.Ct.App.1986); Jeffreys v. Boston Ins. Co., 162 S.E. 761, 762–63 (N.C.1932); Willis v. Nowata Land & Cattle Co., 789 P.2d 1282 (Okla.1989); Knapp v. Victory Corp., 302 S.E.2d 330 (S.C.1983); Anchor Mortgage Services, Inc. v. Poole, 738 S.W.2d 68 (Tex. Ct. App. 1987); Shelton v. Providence Washington Ins. Co., 131 S.W.2d 330, 332 (Tex. Ct. Civ. App. 1939). See 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 4.13–4.14 (3d ed. 1993). Cf. Ziello v. Superior Court, 42 Cal.Rptr.2d 251 (1995) (where mortgage did not require mortgagor to carry earthquake insurance, mortgagee was not entitled to the proceeds of an insurance claim for earthquake damage); Midland Lumber & Supply, Inc. v. J.P. Builders, 626 A.2d 89 (N.J. Super. Ct. 1993) (mortgagee's claim to fire insurance proceeds had priority over mechanics lien claimant). Even though the mortgagee has a claim to the insurance proceeds, if it is not named as a loss beneficiary of the insurance policy it may have difficulty collecting the proceeds; see Rosario–Paolo, Inc. v. C & M Pizza Restaurant, Inc., 599 N.Y.S.2d 628 (N.Y.App.Div.1993) (insurer has no duty to issue joint check to mortgagor and mortgagee, and no duty to mortgagee to investigate the validity of mortgagor's claim).

Numerous older cases consider that the proceeds of a casualty insurance policy purchased by the mortgagor are free of any claim by the mortgagee, if the latter is not shown as a loss payee on the policy. See, e.g., Columbia Ins. Co. v. Lawrence, 35 U.S. (10 Pet.) 507 (1836); Plimpton v. Farmers' Mut. Fire Ins. Co., 43 Vt. 497 (1870). See Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1097 (1976).

The following authorities hold that, where the mortgagor recovers from a third party for waste, the fund so recovered is regarded as substitute collateral under the mortgage: American Sav. & Loan Ass'n v. Leeds, 68 Cal.Rptr. 453, 440 P.2d 933 (Cal. 1968); Garrow v. Brooks, 196 A. 460 (N.J. 1938); Delaware Tel. Co. v. Elvins, 43 A. 903 (N.J. 1899). See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.9 (3d ed. 1993); 1 G. Glenn, Mortgages § 27.1 (1943); Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1086, 1095–96 (1976).

All recoveries by the mortgagee under this section are limited to the amount of the debt. See, e.g., Allstate Ins. Co. v. James, 779 F.2d 1536, 1540 (11th Cir.1986):

> The insurer should not complain if the mortgagees pursue first the foreclosure, then proceed against the insurance policy. The amount recoverable by the mortgagees from the insurer is limited to the amount of the secured debt, fixed at the time of loss, less the proceeds from the foreclosure sale, plus statutory interest from the time of loss until the money was deposited with the court.

Impairment of security, Comment b. The majority view holds that the mortgagee may exercise its equitable claim to the funds under discussion by taking them in their entirety, up to the full amount of the debt, irrespective of any measure of impairment of security. In eminent domain cases, see, e.g., City of Chicago v. Salinger, 52 N.E.2d 184 (Ill.1943); In re Dillman, 267 N.W. 623 (Mich.1936); In re Forman, 240 N.Y.S.718 (N.Y. Sup. Ct. 1930), noted 44 Harv. L. Rev. 1142 (1931).

However, a substantial body of authority holds that the mortgagee is entitled to the award only to the extent necessary to compensate for the impairment of security it has suffered. See, e.g., Swanson v. U.S., 156 F.2d 442 (9th Cir.1946), cert. denied, 329 U.S. 800, 67 S.Ct. 492, 91 L.Ed. 684 (1947); Milstein v. Security Pac. Nat. Bank, 103 Cal.Rptr. 16 (Cal.Ct. App.1972); Harwell v. Georgia Power Co., 298 S.E.2d 498 (Ga.1983). There is a wide range of opinion as to how the impairment of security should be measured. The following cases are illustrative.

People v. Redwood Baseline, Ltd., 149 Cal.Rptr. 11 (Cal.Ct.App.1978), contains the most thorough discussion of the measure of impairment of security. The real estate in question was encumbered by two mortgages, and a portion was taken in eminent domain for flood control purposes. The court noted that, under California law, the mortgagees were entitled to share in the award only to the extent that their security was impaired by the taking. It then discussed a number of possible methods for determining whether impairment of security had occurred. The landowner had argued for the "debt equivalency" rule, which would give the mortgagees only an amount that would reduce their indebtedness to the post-taking value of the land. The court found that this approach was appropriate only in cases in which the debt would be paid off in full in the court proceeding, or the mortgage was in the process of being foreclosed. On the other hand, in situations in which the debtor-creditor relationship was expected to continue into the future, the "debt equivalency" rule would be unjust to the mortgagee, since it would leave no margin or "cushion" of security value in excess of the debt balance.

The court then discussed formulas that would give the mortgagee a margin of security. They included the "pre-take ratio" rule, which gives the mortgagee the same loan-to-value ratio it had immediately prior to the taking; the "original ratio" rule, which awards the mortgagee enough of the award to restore it to the loan-to-value ratio that existed at the inception of the mortgage; a rule comparing the market value of the mortgage debt on the secondary market before and after the taking; and a rule awarding the mortgagee enough to bring its loan-to-value ratio to the level that a "conservative lender" would consider reasonable.

The court declined to adopt any of these as a fixed rule, but observed that the "pre-take ratio" approach would achieve an equitable result in many cases. It commented:

> But we think it is also accurate to say that in either case both the debtor and the creditor generally expect the margin of security to increase with time. Where the debt is to be repaid in periodic installments of principal and interest this is obviously so.... The important point, however, is that the parties do not bargain for maintenance of the margin of security existing at the inception of the security transaction. The bargain is that the whole parcel of land, whatever its value, will be security for the debt, and that in the event of default and foreclosure the entire property, at its increased value if that expectation has materialized, will be available for satisfaction of the debt.

Id. at 25. The approach taken in § 4.7(b) of this Restatement adopts the rationale of the *Redwood Baseline* court quoted above in part, but not entirely. It gives the mortgagee the scheduled loan-to-value ratio, but does not assume that the property's market value was expected to increase or decrease over the term of the mortgage.

See also Carson Redevelopment Agency v. Adam, 186 Cal.Rptr. 615 (Cal.Ct.App.1982) (security impairment "is normally a question of fact [which] is to be determined in light of the circumstances of the particular case considering all of the relevant factors").

In Buell Realty Note Collection Trust v. Central Oak Investment Co., 483 S.W.2d 24 (Tex. Ct. Civ. App. 1972), aff'd per curiam, 486 S.W.2d 87 (Tex.1972), a portion of the land was taken in eminent domain. The court held that the mortgagee's right to the funds was limited to the impairment of security it had suffered. The trial court had found no impairment, and the Court of Appeals held that finding to be conclusive, but it commented as follows on the measure of impairment:

> Whether the security has been or will be impaired or damaged is a fact issue to be resolved in each case by the triers of the facts, taking into consideration all the surrounding circumstances including, but not necessarily limited to, the fact question of whether after the taking or damage the value of the

> remaining property has (and probably will continue to have until the maturity of the secured debt) substantially the same ratio to the debt as the value of the mortgaged property bore to the debt at the time of its creation, or at least a value sufficiently in excess of the debt to give reasonable assurance that the debt will be paid at or before maturity.

Id. at 27. See also FDIC v. Texas Electric Service Co., 723 S.W.2d 770 (Tex. Ct. App. 1986), in which the court purportedly followed *Buell Realty*. It found that the remaining land was seriously inadequate as security for the debt, but rather than merely reducing the debt with a portion of the eminent domain proceeds in order to restore the mortgagee to its original loan-to-value ratio, it allocated the entire proceeds to the mortgagee.

In First Western Financial Corp. v. Vegas Continental, 692 P.2d 1279 (Nev.1984), a partial taking in eminent domain had reduced the value of the real estate from $3.35 million to $3.1 million. The mortgagee sought the entire award, but the court held that it should receive only compensation for the impairment of its security:

> We are of the view that a more reasonable and equitable measure of the impairment of security of a mortgagee or trust deed holder is the extent to which the actual margin of security is affected at the time of the taking.

Id. at 1281. The court then calculated the loan-to-value ratio at the time of the taking and held that the mortgagee should receive so much of the award as necessary to restore it to that same ratio after the taking.

In Kreshek v. Sperling, 204 Cal. Rptr. 30 (Cal.Ct.App.1984), a fire destroyed about 18 percent of the mortgaged building, but the remaining building was worth more than $2 million. The mortgage debt was about $320,000. The mortgagee demanded the insurance proceeds of $420,000. The court held that the mortgagee was entitled to the proceeds only to the extent (if any) of the impairment of its security, and remanded the case for a determination of the amount of any impairment. The court did not discuss how impairment should be computed, but it is significant that it was considered at least conceivable that an impairment had occurred, notwithstanding that the mortgagees' loan-to-value ratio was only about 16 percent.

In State ex rel. Commissioner of Transportation v. Kastner, 433 A.2d 448 (N.J. Super. Ct. 1981), a portion of the mortgaged property was taken in eminent domain. The mortgagors applied to withdraw the award from court, and were opposed by the mortgagees, who sought the entire amount. The value of the remaining real estate was at least twice the balance owed on the mortgage debt. The court rejected the mortgagee's application:

> the lienholder cannot enforce his lien against the condemnation award unless the remaining property is of insufficient value to satisfy the lien. Such has not been shown in the present case.

Id. at 449.

The cases are divided as to whether a clause in the mortgage can effectively override the rule limiting the mortgagee's recovery only to the extent of its impairment of security. Upholding such a clause, see Pima

County v. INA/Oldfather 4.7 Acres Trust #2292, 700 P.2d 877 (Ariz.Ct. App.1984). A portion of the mortgaged real estate was taken in eminent domain, and the mortgagor and mortgagee both claimed the award. The court noted that a division of authority exists as to whether the mortgagee is entitled to the entire award, or only so much as is necessary to compensate for the impairment of security the mortgagee has suffered. However, in this case the mortgage itself gave the mortgagee the right to the entire award, and the court held that this language was conclusive of the issue.

Other authority holds that the mortgagee may be compensated only for the impairment of security, notwithstanding a mortgage clause purporting to give the mortgagee the entire award. See First Western Financial Corp. v. Vegas Continental, 692 P.2d 1279 (Nev.1984).

Insurance proceeds, Comment c. Numerous modern cases give the mortgagee a claim to casualty insurance proceeds even though the insurance policy does not name the mortgagee as a loss payee, provided that the mortgagor has covenanted in the mortgage to insure the property. The following cases are representative.

Arkansas Teacher Retirement System v. Coronado Properties, Ltd., 801 S.W.2d 50, 54 (Ark.Ct.App.1990):

> Where an insurance policy is procured by a mortgagor under an agreement to insure for the mortgagee's benefit, the proceeds recovered by the mortgagor are held in trust for the mortgagee, and the mortgagee has an equitable lien on the proceeds of the insurance for the satisfaction of his mortgage, regardless of whether the policy is made payable to him.

First Federal Sav. & Loan Ass'n v. Stone, 467 N.E.2d 1226, 1233 (Ind.Ct. App.1984):

> Where a mortgage or insurance policy provides for insurance proceeds to be paid to the mortgagee "as its interest appears," the mortgagee is entitled to the insurance proceeds to the extent of the mortgage debt.

Lakeshore Bank v. United Farm Bureau Mut. Ins. Co., 474 N.E.2d 1024, 1026 (Ind.Ct.App.1985):

> In general, a mortgagee has no interest in a policy of insurance upon mortgaged premises unless he is given such interest by some covenant or condition in the policy or in the mortgage. Where a positive duty is imposed upon the mortgagor to insure for the benefit of the mortgagee, the mere existence of the duty is sufficient to impress upon the proceeds of any policy taken out by the mortgagor an equitable lien in favor of the mortgagee.

Giberson v. First Fed. Sav. & Loan Ass'n, 329 N.W.2d 9, 11 (Iowa 1983):

> . . . the mortgagee has an equitable lien on the proceeds of a fire insurance policy procured by the mortgagor pursuant to an agreement to insure for the mortgagee's benefit, although the policy is not made payable to the mortgagee.

Application of funds toward restoration, Comment d. Under the traditional view, which many courts continue to follow, the mortgagor has no right to insist that condemnation and insurance funds held by the mortgagee be applied toward restoration of the property. One of the best recent articulations of this view is found in General G.M.C. Sales, Inc. v. Passarella, 481 A.2d 307, 312 (N.J. Super. Ct. 1984):

> There may be cases in which the mortgagee will be adequately protected by a holding that allows the mortgagor to use the fire insurance proceeds to rebuild. But there will be times when the mortgagee will be placed at risk by having his mortgage on an existing building converted to a construction mortgage for a new building. The holding creates too much potential for dispute and litigation.... The parties could dispute the value of the security after a fire, especially if the property is not insured at full market value. Disagreement could also arise as to the value of the repairs or the replacement structure, the amount of progress payments, and other matters. For example, in the case at hand a question was raised as to the right to reconstruct a nonconforming building. The trial judge said that the mortgagee should not be forced into partnership with the mortgagor in rebuilding the structure, and the mortgage loan should not be converted into a construction loan. We agree with these observations.

Other cases adopting this view include In re Wolf, 77 B.R. 51 (Bankr. E.D.Va.1987) (condemnation award); First Nat. Bank v. Martin, 7 N.E.2d 637 (Ill. App. Ct. 1937); Loving v. Ponderosa Systems, Inc., 479 N.E.2d 531 (Ind.1985); Pearson v. First Nat. Bank, 408 N.E.2d 166 (Ind.Ct.App. 1980); Giberson v. First Fed. Sav. & Loan Ass'n, 329 N.W.2d 9 (Iowa 1983); Kintzel v. Wheatland Mutual Ins. Assoc., 203 N.W.2d 799 (Iowa 1973); Pink v. Smith, 274 N.W. 727 (Mich.1937); Fath v. Cape Girardeau, 132 S.W.2d 1073 (Mo.Ct.App.1939); Savarese v. Ohio Farmers' Ins. Co., 182 N.E. 665 (N.Y.1932); State ex rel. Squire v. Royal Ins. Co., 16 N.E.2d 342 (Ohio.Ct.App.1938); Montgomery v. First Nat'l Bank, 508 P.2d 428 (Or.1973); Meader v. Farmers' Mutual Relief Ass'n, 1 P.2d 138 (Or.1931); and English v. Fischer, 660 S.W.2d 521 (Tex.1983).

One of the most unfortunate cases of this sort is First Federal Sav. & Loan Ass'n v. Stone, 467 N.E.2d 1226 (Ind.Ct.App.1984). There the mortgagee notified the insurance carrier, immediately after the fire, that it elected to apply the insurance proceeds toward payment of the debt, but it failed to notify the mortgagors of that election. The mortgagors proceeded to expend the funds necessary to restore the premises, but the court held that because they did so without any explicit assurance from the mortgagee that the insurance funds would be available to them, they had no right to those funds. Similarly, in Anchor Mortgage Services, Inc. v. Poole, 738 S.W.2d 68 (Tex. Ct. App. 1987), an employee of the mortgagee advised the mortgagors that the insurance funds would be made available for rebuilding. Relying on that assurance, the mortgagors commenced reconstruction work, but were forced to quit when the mortgagee changed its position and refused to release the funds. The court sustained the mortgagee's actions.

Notwithstanding these cases, there is a noticeable trend toward imposing upon the mortgagee a duty to permit use of the funds for rebuilding under reasonable conditions. Cases so holding include Starkman v. Sigmond, 446 A.2d 1249 (N.J. Super. Ct. 1982); Schoolcraft v. Ross, 146 Cal.Rptr. 57

(Cal.Ct.App.1978); Fergus v. Wilmarth, 7 N.E. 508 (Ill.1886); Hatch v. Commerce Insurance Co., 249 N.W. 164, opinion on rehearing, 249 N.W. 824 (1933) (installment contract; no clause governing disposition of insurance proceeds); Cottman Co. v. Continental Trust Co., 182 A. 551 (Md. 1936) (personal property).

Illustrations 4–6 are based on Starkman v. Sigmond, 446 A.2d 1249 (N.J. Super. Ct. 1982). After the fire in that case, the land alone exceeded the amount of the mortgage debt. The court held:

> Since the vacant land remains as full security for the mortgage debt, it is difficult to identify any loss sustained by the mortgagee.... There has never been in this case impairment for purposes of the mortgagees [sic] interest.... Arguably, the mortgagees have suffered a loss by the reduction in the ratio of the debt to the value of the security. But the cost of building probably will be more than the value of the home that was destroyed; hence the mortgagees will have even greater security than the value of the destroyed dwelling.

Id. at 1255, 1256 n.5.

Illustration 7 is based on Manufacturers Hanover Mortgage Corp. v. Kenegos, 831 F.2d 1520 (9th Cir. 1987), in which the fire loss occurred after the mortgagor had defaulted in payment on the mortgage loan. The court held that the default (which had not been cured) warranted the mortgagee in accelerating the debt, and hence in refusing to permit use of the fire insurance proceeds for rebuilding of the improvements.

Mortgagor's waiver of right to use funds for restoration, Comment e. Illustration 8 is based on Schoolcraft v. Ross, 146 Cal.Rptr. 57 (Cal.Ct.App. 1978), which was decided on the basis of the implied covenant of good faith and fair dealing found in every contract under California law. The mortgagors introduced evidence that their home could have been rebuilt with the available insurance proceeds, and upon completion would have had a fair market value far in excess of the mortgage balance. The court refused to enforce a mortgage provision that purported to permit the mortgagee to retain the proceeds, and required that they be made available for rebuilding of the home.

> [T]he purpose of a deed of trust is that the borrower will have the use of funds loaned on specific terms and the lender will have the right to a specified repayment that is secured by the deed of trust.... The lender does not have the right to unilaterally cut off the borrower's right to use the loaned funds unless he can show that his security is impaired.... Here there is no evidence that the security was impaired by the fire nor is there any evidence that plaintiffs were unwilling or unable to continue making payments on the property.... The parties intended that the purchase price would be paid in the ordinary course of events to the end that plaintiffs could enjoy the full use of the house, subject to the required monthly payments. Forcing the buyer to pay off in advance would result in a buyer losing certain property rights contemplated by the parties, among them the benefit of a long-term loan which permits the buyer to spread the purchase price of the property over a long time.

Id. at 59–60. See also People v. Redwood Baseline, Ltd., 149 Cal.Rptr. 11, 16 n.7 (Cal.Ct.App.1978), recognizing the view of the California Law Revision Commission that, under Cal. Civ. Proc. Code § 1265.225, a lienholder is entitled to share in the award only to the extent of the impairment of his security notwithstanding any agreement to the contrary entered into at the time of the creation of the indebtedness on which the lien is based. The court, however, questioned whether any California case law supported this statement.

See also Sessler v. Arshak Corp., 464 So.2d 612 (Fla.Dist.Ct.App.1985), in which the mortgage purported to permit the mortgagee to accelerate the entire indebtedness in the event of any partial taking. The court, however, refused to enforce this term of the mortgage upon a taking of a small portion of the property, loss of which did not materially impair the mortgagee's security. To enforce the acceleration would be "inequitable and unjust," the court held.

§ 4.8 Effect of Foreclosure on Mortgagee's Right to Insurance and Eminent Domain Proceeds

(a) Where a mortgagee has a right to foreclose a mortgage because the mortgage obligation is fully due and payable and the mortgagee has a right to casualty insurance or eminent domain proceeds under § 4.7, the mortgagee may either:

(1) recover from the insurance proceeds or from the eminent domain award, the full amount of the mortgage obligation; or

(2) foreclose on the mortgaged real estate and, to the extent that doing so does not satisfy the mortgage obligation, recover the balance from the insurance proceeds or from the eminent domain award.

(b) When the mortgagee proceeds under Subsection (a)(1), the mortgagee may have further recourse against the mortgaged real estate or the mortgagor only to the extent that the recovery on the casualty policy or from the eminent domain award is less than the mortgage obligation. When the mortgagee proceeds under Subsection (a)(2), the mortgagee may recover from the insurance proceeds or from the eminent domain award only to the extent that the foreclosure proceeds are less than the mortgage obligation.

Cross-References:

Section 4.6, Waste; § 4.7, Mortgagee's Right to Funds Paid Under Casualty Insurance or Taking in Eminent Domain.

Comment:

a. Casualty loss prior to foreclosure sale. This section deals with the rights of the mortgagee to insurance proceeds or a condemnation award where the mortgaged real estate suffers a casualty loss or is partially condemned and the mortgagee has a right to foreclose because the mortgage obligation has become fully due and payable. This Comment deals with insured casualty losses, while Comment *c* deals with condemnation awards.

In the event of an insured casualty loss, the mortgagee may satisfy the mortgage obligation by two different means. It may recover on the insurance policy, up to its limits, the full amount of the mortgage obligation at the time of the loss. If these proceeds are insufficient to satisfy the obligation fully, the deficiency may be recovered by foreclosing on the real estate or, to the extent permitted by local law, proceeding against the mortgagor personally. See Illustrations 1–3. Alternatively, the mortgagee may proceed first to foreclose the mortgage. When this approach is followed, and the foreclosure sale does not yield the full amount of the mortgage obligation, the balance may be recovered under the insurance policy, up to its limits. See Illustration 4.

Note that, if the mortgagee chooses to foreclose and the foreclosure bid is at least equal to the mortgage obligation, that obligation is fully satisfied and the mortgagee shall have no additional recourse against the insurance carrier. This is true whether the foreclosure purchaser is the mortgagee or a third-party. See Illustration 5. Moreover, this result applies in both the "standard" and "loss payable" type casualty policy context and is not altered by the fact that the mortgage contains language that, in the event of foreclosure, the mortgagor's rights in casualty insurance policies pass to the foreclosure sale purchaser.

The foregoing approach may occasionally be harsh on the mortgagee who, having no actual knowledge of the casualty loss, mistakenly bids in the full amount of the mortgage obligation at the foreclosure sale. Indeed, it may be tempting to argue that a mortgagee should at least be relieved from a mistaken foreclosure bid where the mortgagor has actual knowledge of a pre-foreclosure casualty loss and fails to notify the mortgagee of that loss. This concern for the mortgagee, however, is largely misplaced. For purposes of this section, the mortgagee is only bound by a foreclosure bid when its amount becomes final under local law. In some jurisdictions, the foreclosure sale price is not deemed to be final until judicially confirmed. In that setting a court may, in its equitable discretion, order a new sale where a mortgagee establishes that it entered its bid without knowledge of the casualty loss. Even where such relief is unavailable, however, the mortgagee may easily obviate this problem by making an inspection of the real estate immediately prior to the foreclosure sale. Often the simple precaution of an inquiry by telephone will suffice. Thus, a court should be justifiably suspicious of mortgagee attempts to avoid the consequences of its own failure to take reasonable and nonburdensome pre-foreclosure precautions. Moreover, a contrary approach may well encourage inequitable mortgagee conduct. To permit the mortgagee, after using a full credit bid to discourage third-party bidders, to take the real estate and thereafter establish that it was worth less than the mortgage obligation encourages fraud. It also creates uncertainty as to the mortgagor's rights. Most importantly, it deprives the foreclosure process of the competitive impact of third-party bidding.

There may, of course, be rare instances where mortgagor is guilty of such egregious misconduct that a court may be justified in exercising its equitable discretion to relieve a mortgagee of the consequences of a mistaken bid. This may be the case, for example, where, in response to a specific mortgagee inquiry concerning the condition of the mortgaged real estate, a mortgagor with actual knowledge that a casualty loss has occurred, knowingly conceals that loss from the mortgagee.

The principles of this section apply not only when the mortgage obligation becomes fully due and payable prior to a casualty loss, but also where, after such a loss, the mortgagor defaults on the mortgage obligation and, as a result of acceleration by mortgagee, the mortgagee has the right to foreclose for the entire mortgage obligation. See Illustrations 6–7.

Illustrations:

1. An obligation secured by a mortgage on Blackacre becomes fully due and payable. Mortgagee commences foreclosure of the mortgage. Prior to a foreclosure sale, the building on Blackacre is destroyed or damaged by a casualty loss. Mortgagor carries a casualty insurance policy on the building and mortgagee is entitled to proceeds under it under § 4.7. Under the policy, the proceeds payable for the loss are $50,000. The mortgage obligation is then $70,000. Mortgagee may recover the policy proceeds. Upon such a recovery, Mortgagee may collect the remaining $20,000 of the mortgage obligation by foreclosing on the real estate or, to the extent permitted by local law, from Mortgagor personally.

2. The facts are the same as Illustration 1, except that the insurance proceeds payable for the loss are $70,000. Mortgagee may recover the full amount of those proceeds. Upon receipt of those proceeds, the mortgage obligation is satisfied and Mortgagee has no further recourse against either Blackacre or Mortgagor.

3. The facts are the same as Illustration 1, except that the insurance proceeds payable for the loss are $80,000. Mortgagee may recover $70,000 of those proceeds. Upon receipt by Mortgagee, the mortgage obligation is satisfied and Mortgagee has no further recourse against either Blackacre or Mortgagor. Absent a valid claim under § 4.7 by a junior lienholder, the excess insurance proceeds are payable to Mortgagor.

4. An obligation secured by a mortgage on Blackacre becomes fully due and payable. Mortgagee commences foreclosure of the mortgage. Prior to the foreclosure sale, the building on Blackacre is destroyed or damaged by a casualty loss. Mortgagor carries a casualty insurance policy on the building and Mortgagee is entitled to proceeds under it under § 4.7. Mortgagee makes no attempt to collect the insurance proceeds. Rather, the foreclosure process proceeds and Mortgagee purchases Blackacre at the foreclosure sale for $50,000. The mortgage obligation at the time of the sale is $70,000. The mortgagee may recover the remaining $20,000 of the mortgage obligation out of the proceeds of the casualty insurance policy, up to its limits.

5. The facts are the same as Illustration 4, except that Mortgagee purchases at the foreclosure sale for $70,000, the amount of the mortgage obligation. The mortgage obligation is fully satisfied and Mortgagee has no right to collect any of the casualty insurance proceeds. This is true even though Mortgagee had no actual knowledge of the casualty loss when it purchased at the foreclosure sale.

6. The facts are the same as Illustration 1, except that the casualty loss occurs first and thereafter the mortgage obligation becomes fully due and payable as a result of acceleration by Mortgagee after a default in payment by Mortgagor. Mortgagee may recover the policy proceeds. Upon such recovery, Mortgagee may collect the remaining $20,000 by foreclosing on the real estate or, to the extent permitted by local law, from Mortgagor personally.

7. The facts are the same as Illustration 5, except that the casualty loss occurs first and thereafter the mortgage obligation becomes fully due and payable as a result of acceleration by Mortgagee after a default in payment by Mortgagor. The mortgage obligation is fully satisfied and Mortgagee has no right to collect any of the casualty insurance proceeds.

b. Casualty loss after foreclosure purchase by mortgagee. This section does not deal directly with the mortgagee-purchaser's rights to proceeds from a pre-foreclosure casualty policy carried by the mortgagor. Rather, this matter is determined by the statutory and common law of insurance. Under generally recognized statutory and common-law principles, recovery by the mortgagee is permitted. The premise is that the standard mortgage policy specifically protects the mortgagee's interest in the mortgaged real estate and creates an independent contractual claim by the mortgagee against the insurer. Consequently, a change in the mortgagee's status from lienholder to owner, as a result of foreclosure, does not defeat the mortgagee-owner's right to the insurance proceeds because the standard mortgage policy is designed to accommodate the mortgagee's change in status.

c. Condemnation prior to foreclosure sale. This section applies the casualty loss approach described above to pre-foreclosure partial takings of the mortgaged real estate in eminent domain. Where the mortgage obligation is fully due and payable and the mortgagee is entitled to condemnation proceeds under § 4.7, two alternatives are available to it. First, it may recover from the condemnation award an amount sufficient to satisfy the mortgage obligation. If the award is insufficient for this purpose, it may then foreclose on the remaining real estate, if any, or, to the extent permitted by local law, proceed against the mortgagor personally. See Illustrations 8–10. Alternatively, mortgagee may foreclose on the real estate and if the proceeds of foreclosure are insufficient to satisfy the mortgage obligation, recover the balance from the condemnation award. See Illustration 11. However, if the mortgagee or a third party is the purchaser at the sale for the full amount of the mortgage obligation, the obligation is satisfied and mortgagee loses any further recourse against the condemnation award. See Illustration 12. As in the casualty loss situation, a mortgagee is only bound by its foreclosure bid when its amount becomes final under local law.

As in the casualty loss setting, the principles of this section apply not only where the mortgage obligation becomes fully due and payable prior to the commencement of a condemnation proceeding, but also where, after such a proceeding is commenced, the mortgagor defaults on the mortgage obligation and, as a result of acceleration by the mortgagee, the mortgagee has the right to foreclose for the entire mortgage obligation. See Illustrations 13–14.

Illustrations:

8. An obligation secured by a mortgage on Blackacre becomes fully due and payable. Mortgagee commences foreclosure of the mortgage. Prior to the foreclosure sale, a proceeding is commenced to condemn part of Blackacre. Mortgagee is entitled to the condemnation proceeds under § 4.7. The condemnation

award is $50,000. The mortgage obligation is then $70,000. Mortgagee may recover the condemnation award. Upon such recovery, Mortgagee may collect the remaining $20,000 of the mortgage obligation by foreclosing on the remainder of Blackacre or, to the extent permitted by local law, from Mortgagor personally.

9. The facts are the same as Illustration 8, except that the condemnation award is $70,000. Mortgagee may recover the condemnation award. Upon receipt of the award, the mortgage obligation is satisfied and Mortgagee has no further recourse against either the remainder of Blackacre or Mortgagor.

10. The facts are the same as Illustration 8, except that the condemnation award is $80,000. Mortgagee may recover $70,000 of the award. Upon receipt of the $70,000, the mortgage obligation is satisfied and Mortgagee has no further recourse against either the remainder of Blackacre or Mortgagor. Absent a valid claim by a junior lienholder under § 4.7, the remainder of the condemnation award is payable to Mortgagor.

11. An obligation secured by a mortgage on Blackacre becomes fully due and payable. Mortgagee commences foreclosure of the mortgage. Prior to the foreclosure sale, a proceeding is commenced to condemn part of Blackacre. Mortgagee is entitled to the condemnation proceeds under § 4.7. Mortgagee makes no attempt to collect any of those proceeds. Rather, the foreclosure process proceeds and Mortgagee purchases what remains of Blackacre at the sale for $50,000. The mortgage obligation at the time of sale is $70,000. Mortgagee may recover the remaining $20,000 of the mortgage obligation out of the condemnation award.

12. The facts are the same as Illustration 11, except that Mortgagee purchases at the foreclosure for $70,000, the amount of the mortgage obligation. The mortgage obligation is fully satisfied and Mortgagee has no right to any of the condemnation award. This is true even though Mortgagee had no actual knowledge of the condemnation proceeding at the time it purchased at the foreclosure sale.

13. The facts are the same as Illustration 8, except that the condemnation proceeding is commenced first and the mortgage obligation becomes fully due and payable as a result of acceleration by Mortgagee after a default in payment by Mortgagor. Mortgagee may recover the condemnation award. Upon such recovery, Mortgagee may collect the remaining $20,000 by foreclosing on the remainder of Blackacre or, to the extent permitted by local law, from Mortgagor personally.

14. The facts are the same as Illustration 12, except that the condemnation proceeding is commenced first and the mortgage obligation becomes fully due and payable as a result of acceleration by Mortgagee after a default in payment by Mortgagor. The mortgage obligation is fully satisfied and Mortgagee has no right to any of the condemnation award.

REPORTERS' NOTE

Casualty loss prior to foreclosure sale, Comment a. For a general treatment of the issues raised in this section, see Comment, Foreclosure, Loss, and the Proper Distribution of Insurance Proceeds Under Open and Standard Mortgage Clauses: Some Observations, 7 Valparaiso L. Rev. 485 (1973); Note, Fire Insurance Recovery Rights of the Foreclosing Mortgagee: Is His Lien Lost in the Ashes?, 8 Ford. Urb. L. Rev. 857 (1980); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.16 (3d ed. 1993); Annot., 19 A.L.R.4th 778 (1983).

Where a mortgagee has the right to foreclose as a result of the mortgage obligation becoming fully due and payable and also has the right to casualty insurance proceeds, the mortgagee is permitted to choose between recovery on the policy and foreclosure on the mortgage. One court has articulated this choice as follows:

> Where ... the loss precedes the foreclosure, ... the mortgagee has an election as to how he may satisfy the mortgage indebtedness by two different means. He may look to the insurance company for payment as mortgagee under the New York Standard Mortgage clause and may recover, up to the limits of the policy, the full amount of the mortgage debt at the time of the loss. In this event he would have no additional recourse against the mortgagor for the reason that his debt has been fully satisfied.
>
> The second alternative available to the mortgagee is satisfaction of the mortgage debt by foreclosure. If the mortgagee elects to pursue the latter option, and the foreclosure sale does not bring the full amount of the mortgage debt at the time of the loss, he may recover the balance due under the insurance policy as owner. If the foreclosure does fully satisfy the mortgage debt, he, of course, has no additional recourse against the insurance company.

Nationwide Mutual Fire Ins. Co. v. Wilborn, 279 So.2d 460, 463 (Ala. 1973). Accord, Allstate Insurance Company v. James, 779 F.2d 1536 (11th Cir.1986). Moreover, the insurer has no valid objection if the mortgagee follows the second option. As one court stated:

> The insurer should not complain if the mortgagees pursue first the foreclosure, [and] then proceed against the insurance policy. The amount recoverable by the mortgagees from the insurer is limited to the amount of the secured debt, fixed at the time of loss, less the proceeds from the foreclosure sale, plus statutory interest from the time of loss until the money was deposited with the court.

> Allowing the mortgagees to proceed in this fashion would not prejudice the insurer. It would reduce the amount the insurer owes on the policy. No double recovery would be permitted, i.e., the mortgagees would not be permitted to pocket the proceeds from the foreclosure sale and then recover the full amount of secured debt owing at the time of loss from the insurer.

Id. at 1540. See also In re Cayer, 150 B.R. 829 (Bankr.M.D.Fla.1993) (mortgagee that purchases at foreclosure sale for less than mortgage obligation is permitted to recover balance from casualty insurance policy).

However, where the mortgagee purchases at the foreclosure sale for the full amount of the mortgage obligation, a majority of courts hold that the mortgagee loses all entitlement to any casualty insurance proceeds. This section reflects this position. The most persuasive rationale for this result is contained in Whitestone Savings & Loan Ass'n v. Allstate Ins. Co., 270 N.E.2d 694, 696–97 (N.Y. 1971), where the New York Court of Appeals stated:

> The applicable rules of law are simple. Because a mortgagee is entitled to one satisfaction of his debt and no more, the bidding in of the debt to purchase the mortgaged property, thus cutting off other lower bidders, has always constituted a satisfaction of the debt.... The point is that the mortgagee has voluntarily converted the debt into the property and has done so by taking the property in satisfaction of the debt. It could have bid less, thus leaving a deficiency for which the mortgagor would be obligated and from which there would survive an insurable interest. It could have bid more, in which event there would have been a surplus in favor of the mortgagor or subsequent lienors but no insurable interest surviving in the mortgagee as mortgagee. * * *
>
> The theory of recovery by a mortgagee is indemnity. The risk insured against is an impairment of the mortgaged property which adversely affects the mortgagee's ability to resort to the property as a source for repayment. Where the debt has been satisfied in full subsequent to the fire, neither reason nor precedent suggest recovery on the policy by the mortgagee. The fact that a mortgagee may not recover on the insurance does not necessarily mean that an insurer will not be obligated to pay the mortgagor or other person entitled under the policy. Indeed, in the absence of defenses, it will be the mortgagor or his creditors who will recover.
>
> The rule is not harsh and it is eminently practical. None disputes that the mortgagee is entitled to recover only his debt. Any surplus value belongs to others, namely, the mortgagor or subsequent lienors. Indeed, it is not conceivable that the mortgagee could recover a deficiency judgment against the mortgagor if it had bid in the full amount of the debt at the foreclosure sale. To allow the mortgagee, after effectively cutting off or discouraging lower bidders, to take the property—and then establish that it was worth less than the bid—encourages fraud, creates uncertainty as to the mortgagor's rights, and most unfairly deprives the sale of whatever leaven comes from other bidders. Mortgagees have the obvious opportunity to bid only so much of the debt as equals

> the value of the property, and if someone else wishes to bid the same or more, so much the better for every other party concerned with the property.

Accord: Arkansas Teacher Retirement System v. Coronado Properties, Ltd., 801 S.W.2d 50 (Ark.Ct.App. 1990); Caruso v. Great Western Savings, 280 Cal.Rptr. 322 (Cal.Ct.App. 1991); Associates National Mortgage Corp. v. Farmers Insurance Exchange, 266 Cal.Rptr. 56 (Cal.Ct.App. 1990); Rollins v. Bravos, 565 A.2d 382 (Md.Ct.App.1989); Western Employers Insurance v. Bank of Ravenswood, 512 N.E.2d 9 (Ill. Ct. App. 1987); Smith v. General Mortgage Corp., 261 N.W.2d 710 (Mich.1978); Margaretten & Company, Inc. v. Illinois Farmers Insurance Co., 526 N.W.2d 389 (Minn.Ct.App.1995); Emmons v. Lake States Insurance Company, 484 N.W.2d 712 (Mich.App. 1992); Northwestern National Insurance Co. v. Mildenberger, 359 S.W.2d 380 (Mo.Ct.App.1962); Singletary v. Aetna Casualty & Surety Co., 447 S.E.2d 869 (S.C.Ct.App.1994); Beneficial Standard Life Insurance Co. v. Trinity National Bank, 763 S.W.2d 52 (Tex. Ct. App. 1988); Universal Mortgage Co. v. Prudential Ins. Co., 799 F.2d 458 (9th Cir.1986) ("[A]ctual or constructive knowledge [of the property's condition] is irrelevant to the policy or application of the rule. Neither the true value of the subject property nor the conduct of the [mortgagee] controls the impact of a full credit bid. Once the debt was extinguished at the time of the bid, so was (mortgagee's insurable interest)"); Rosenbaum v. Funcannon, 308 F.2d 680 (9th Cir.1962); Altus Bank v. State Farm Fire and Casualty Co., 758 F.Supp. 567 (C.D.Cal.1991) ("Nothing in the policy, or in the California law under which it must be interpreted, suggests that a mortgagee can bid-in property at a mortgage sale for more than it is worth and have any part of the difference between the amount paid and the true worth survive as part of an insurance claim on the mortgage debt."); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.16 (3d ed. 1993).

A few courts reject the foregoing reasoning in favor of relieving the mortgagee who makes a full credit bid without knowledge of an earlier casualty loss. One court has held that:

> The "foreclosure after loss" rule requires an election of remedies. This court has held that when making an election between remedies, a party must make the election with the full and clear understanding of the problem, facts and remedies essential to the exercise of an intelligent choice.... We conclude that implicit in the "foreclosure after loss" rule is the requirement that the mortgagee or purchaser at the sale have knowledge of the loss before making an election. However, the mortgagee or purchaser must diligently seek facts that would enable it to make an informed election.

Ex parte Chrysler First Financial Services Corp., 608 So.2d 734, 737 (Ala.1992). In that case the mortgagee purchased for the full amount of the debt when the house on the property had been destroyed five days earlier. However, because there was "no indication in the record that [mortgagee] knew or should have known of the change in the property," the court concluded that mortgagee was not "dilatory." Id. Consequently, the foreclosure sale was set aside so that mortgagee could make an "informed" election of remedies.

The Alaska Supreme Court used a somewhat different approach in relieving a mortgagee from the consequences of an inadvertent foreclosure bid. See Fireman's Fund Mortgage Corp. v. Allstate Insurance Co., 838 P.2d 790 (Alaska 1992). There a fire destroyed the house on the mortgaged real estate a few hours before mortgagee entered a bid that clearly exceeded the property's post-casualty value. The court rejected the urging of the mortgagee simply to disregard its foreclosure bid because it was made in ignorance of the casualty loss. Nevertheless, the court permitted the mortgagee to seek "reformation" of the foreclosure sale price to replace it "with a price more reflective of the actual market value of the property at the time of sale." Id. at 797. In an action for reformation, the court concluded, the mortgagee has "the burden of showing by clear and convincing evidence that reformation is warranted." Id. at 797. However, the court indicated that unless it was established that mortgagee had actual knowledge of the casualty loss at the time of its bid, reformation should be granted.

Finally, one court has rejected the majority approach without requiring either that the foreclosure sale be set aside or that the mortgagee qualify for reformation of its bid. In Georgia Farm Bureau Mutual Insurance Company v. Brewer, 413 S.E.2d 770 (Ga.Ct.App.1991), the court held:

> We reject the theory that because [mortgagee] subsequently took the property in foreclosure in exchange for the debt, this [insurance] entitlement was extinguished. The principle that a bid by a mortgagee of the full amount of the indebtedness extinguishes the mortgage exists to preclude the mortgagee from pursuing the mortgagor for a deficiency once the debt has been satisfied.... We see no reason for applying the rule to preclude recovery from an insurer, which is contractually obligated to compensate the mortgagee for loss of or damage to the insured property.... Accordingly, we hold [mortgagee] was entitled to the insurance proceeds to the extent of his actual net loss—i.e., the difference between the amount he bid in foreclosure and the value of the damaged property, as established here by its resale value.

Id. at 772. See also Comment, Foreclosure, Loss, and the Proper Distribution of Insurance Proceeds Under Open and Standard Mortgage Clauses: Some Observations, 7 Valparaiso L. Rev. 485, 501 (1973) ("A more desirable solution would be reached if the courts employed their general equity powers to arrive at the fairest possible distribution of proceeds. Rather than distorting the terms of the standard mortgage clause in order to 'punish' the mortgagee for bidding an amount which exceeds the value of the foreclosed property, the courts should attempt to distribute the proceeds in accordance with the parties' proportionate investments.").

A few recent decisions employ especially questionable reasoning to permit mortgagee recovery after a full credit bid. One case holds that even though a full credit bid after the loss normally bars recovery by the mortgagee on the casualty policy, mortgagee nevertheless may recover from the insurer if the mortgage contains language providing that "in the event of foreclosure of this mortgage ... in extinguishment of the debt secured hereby, all right, title, and interest of the Mortgagor in and to any insurance policies then in force shall pass to [the] purchaser or grantee." Melino v. National Grange Mutual Insurance Co., 630 N.Y.S.2d 123, 125 (N.Y.App.Div.1995). This reasoning is flawed, however, because once the full credit bid is entered, the mortgage obligation is satisfied and the mortgage and its provisions are no longer enforceable. As the dissent in the foregoing case emphasizes, the "foreclosure sale and acquisition of the mortgaged premises by the [mortgagee] extinguished the mortgage and effectively nullified the provisions of the mortgage * * *. The provisions of the mortgage are no longer enforceable." Id. at 126. Cf. L.G.H. Enterprises, Inc. v. Kadilac Mortgage Bankers, Ltd., 640 N.Y.S.2d 155 (N.Y.App.Div.1996). Another decision holds that while a full credit bid bars mortgagee recovery on a "loss payable" type of casualty policy, it does not where the policy is of the "standard" or "union" variety. See Wilson v. Glancy, 913 P.2d 286 (Okla.1995).

On balance, the majority approach, as reflected in this section, is preferable from both a practical and policy perspective. Moreover, this is the case irrespective of whether the casualty policy is of the "loss payable" or "standard variety." It is true that the section penalizes the occasional mortgagee who inadvertently makes a full credit bid while unaware of an earlier casualty loss. On the other hand, this problem is avoided with minimal effort. An inspection or telephone inquiry immediately prior to the foreclosure sale will obviate any possible prejudice to the mortgagee. Indeed, it is unlikely that a court would relieve a third-party purchaser from the consequences of bid entered without knowledge that the property was previously destroyed or damaged in a casualty loss. Surely the mortgagee should not be treated more favorably in this regard. More important, the position adopted by this section clearly discourages improper mortgagee manipulation of the foreclosure process. For example, a mortgagee could enter a full credit bid "intending to discourage third party bidders and, ultimately, to collect the insurance proceeds as well." 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.16 (3d ed. 1993). Finally, courts will be able to avoid, except in cases involving allegations of especially egregious mortgagor misconduct, complex inquiries into whether mortgagee knew of the casualty loss at the time of its bid and whether it acted in a reasonable and prudent fashion. Consequently, the approach of this section not only has the virtues of clarity and predictability, but it serves an important judicial economy interest as well.

Casualty loss after foreclosure purchase by mortgagee, Comment b. In the "loss after foreclosure" setting mortgagees uniformly prevail in their attempts to recover on the casualty policy. See Guardian Savings & Loan Association v. Reserve Insurance Co., 276 N.E.2d 109 (Ill.Ct.App.1971) ("[T]he entire tenor of the mortgage clause is to extend coverage under various contingencies to the mortgagee" and the terms of that clause protect mortgagee "irrespective of whatever interest in the [mortgaged real estate] the mortgagee might succeed to after foreclosure"); 495 Corp. v. New Jersey Insurance Underwriting Association, 430 A.2d 203 (N.J.1981); Brindisi v. State Farm Insurance Company, 564 N.Y.S.2d 985 (Misc. 1991); Tech Land Development, Inc. v. South Carolina Insurance Company, 291 S.E.2d 821 (N.C.Ct.App.1982); Shores v. Rabon, 112 S.E.2d 556 (N.C.1960) (mortgagee's acquisition of title by a full credit bid characterized as increased interest rather than change of ownership and did not defeat mortgagee's rights under casualty policy "despite the argument that the word 'mortgagee' in [insurance clause] discloses an intention to benefit one in that capacity only.... "); Union Central Life Insurance Co. v. Codington County Farmers Fire & Lightning Mutual Insurance Co., 287 N.W. 46 (S.D.1939) ("[T]he word 'mortgagee' is a mere matter of convenient description or designation, and was not intended to limit the primary agreement to pay the loss to the beneficiary 'as his interest may appear.' It is held that provisions dealing with change of ownership apply only to strangers of the insurance contract.... "); Disrud v. Arnold, 482 N.W.2d 114 (Wis.Ct.App.1992). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.16 (3d ed. 1993); Annot., 19 A.L.R.4th 778, 783–788 (1983); Comment, Foreclosure, Loss, and the Proper Distribution of Insurance Proceeds Under the Open and Standard Mortgage Clauses: Some Observations, 485, 490–494 (1973).

Condemnation prior to foreclosure sale, Comment c. There are few cases that deal directly with the question of the mortgagee's options when the mortgage obligation is fully due and payable and the mortgagee has the right to condemnation proceeds. What authority that does exist, however, is consistent with the approach of this section. In Fidelity–Philadelphia Trust Co. v. Kraus, 190 A. 874 (Pa.1937), a municipality changed a street grade adjoining mortgaged real estate. A damages action against the city was brought that ultimately resulted in a $6,000 damages award to the owner. Prior to the completion of the damages action, however, the mortgagee foreclosed on the real estate and purchased at the sale for an amount significantly less than the mortgage obligation. Prior to the payment of the damage award to the owner, mortgagee brought suit to impose a constructive trust on the award. The mortgagee's suit was dismissed and that dismissal was affirmed on appeal. The court stated:

> If, before foreclosure, the plaintiff had intervened in the land damage proceeding it would have been entitled to receive the amount awarded (though not more than the debt secured) regardless of whether the mortgaged land was then worth more or less than the debt, and the landowner would have suffered no injury of which he could complain, because the amount so received by his creditor would have been credited on his general obligation; but the plaintiff, by foreclosing and taking the property, brought before the court a different relationship to be considered. If the mortgaged property was damaged by the change of grade so that it was worth less than the debt secured, plaintiff still had a claim against the landowner enforceable in equity against the land damages awarded but unpaid and a bill to construct a trust would be an appropriate remedy. But before equity will decree that the [damages awarded] be held by [defendant] in trust for the benefit of the [mortgagee], the [mortgagee] must show an equitable right to support the decree.... Coming into court with no mortgage lien, and after having taken the property, the [mortgag-

ee] must do equity by showing and allowing credit for the value of what has been received; plaintiff must satisfy the chancellor that it has sustained a loss to be compensated by the trust sought to be established.... As there is no evidence that the value of the land acquired was less than the debt, the bill was properly dismissed.

Id. at 876.

In Los Angeles T. & S. Bank. v. Bortenstein, 190 P. 850 (Cal.Ct.App. 1920), mortgaged real estate was damaged by a flood and the owner-mortgagor sued the City of Los Angeles for damages based on tort. The owner recovered a judgment against the city. Before the award was paid, however, the mortgagee commenced a judicial foreclosure action naming the city as an additional defendant and claiming a lien against the amount recovered from the city. The foreclosure decree ordered a sale of the mortgaged real estate and granted mortgagee a lien on the damage award to satisfy any deficiency that remained after the foreclosure sale. In affirming this decree, the appellate court stated, in part: "If, by condemnation proceedings, the city had appropriated any part of the mortgaged property, ... [a]s a mortgagee, [mortgagee] could have claimed so much of such damages as might be necessary to satisfy the indebtedness secured by the mortgage, if the part of the mortgaged property not taken or damaged by the city should prove insufficient for that purpose." Id. at 851. More recently, a California appellate court described the significance of *Bortenstein* as follows:

The case is illustrative of the fact that where the circumstances are such that the security has been or is immediately to be applied to satisfaction of the debt (e.g., foreclosure has occurred or is in progress) so that the security transaction is at an end and will not continue after distribution of the condemnation award, if the value of the security is equal to or in excess of the amount of the secured debt, its application to the debt will extinguish the debt, and nothing more is required to fully protect the lienholder. It also illustrates that where foreclosure proceedings are under way but it has not yet been ascertained whether the value of the security is sufficient to satisfy the debt, it is appropriate to protect the lienholder until that fact has been ascertained by imposing a lien or trust on the award for satisfaction of any deficiency between the value of the security and the unpaid amount of the debt.

People v. Redwood Baseline, Ltd., 149 Cal.Rptr. 11, 18 (Cal.Ct.App. 1978). While the foregoing cases are not definitive, they tend to support the two remedies this section confers on mortgagees in the condemnation-foreclosure context.

Where the mortgagee opts to foreclose and purchases at the sale for the full amount of the obligation, any further recovery from the condemnation award is barred by this section. While there is little case authority for this proposition in the condemnation context, this is, as noted earlier in this Reporters' Note, the overwhelming majority position with respect to insurance proceeds. See Reporters' Note to Comment *a*, supra. Moreover, the basic principle that a full credit bid bars further recourse by the mortgagee against either the mortgagor or what remains of the res is pervasively accepted. As one court has stated, in "California, when the lienholder forecloses and bids in the entire unpaid amount of the indebtedness the lien is extinguished and the lienholder is not entitled to any part of a fund of money resulting from injury to the property." People v. Redwood Baseline, Ltd., 149 Cal. Rptr. 11, 20 n.8 (Cal.Ct.App.1978). See Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975) (mortgagee action for waste barred "since she purchased the subject property at the trustee's sale by making a full credit bid"); Western Fed. Sav. & Loan Ass'n v. Sawyer, 13 Cal.Rptr.2d 639 (Cal.Ct.App.1992) (mortgagee's full credit bid at foreclosure sale conclusively established that its security for mortgage obligation was not impaired and, thus, mortgagee could not maintain an action for fraud against mortgagor); Duarte v. Lake Gregory Land and Water Co., 113 Cal.Rptr. 893 (Cal.Ct.App.1974) (full credit bid bars mortgagee recovery from tort damage award against third parties for injury to the real estate); Schumacher v. Gaines, 96 Cal.Rptr. 223 (Cal.Ct. App.1971) (where mortgagee purchases at foreclosure sale for full amount of obligation, mortgagee cannot recover damages for acts of impairment of security occurring prior to foreclosure).

§ 4.9 Acquisition of Foreclosure Title by the Holder of the Equity of Redemption or Other Junior Interests: Effect Upon Junior Interests

(a) A holder of the equity of the redemption who purchases real estate at a foreclosure sale of any lien on that real estate acquires title subject to any lien or other interest that was junior to the foreclosed lien.

(b) A holder of a junior interest who purchases real estate at the foreclosure sale of any senior lien on that real estate acquires title free and clear of the interest of the holder of the equity of redemption and of any interest that was junior to the foreclosed lien.

Cross-References:

Section 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability; § 7.1, Effect of Mortgage Priority on Foreclosure; § 7.5, Mortgaging After-Acquired Real Estate.

Comment:

a. Introductory note. It is a fundamental axiom of mortgage law that a valid foreclosure of a senior lien not only terminates the owner's equity of redemption, but also all junior interests who were made parties defendant. See § 7.1. Likewise, a power of sale (nonjudicial) foreclosure that complies with applicable statutory requirements accomplishes the same result. Id. Thus, a purchaser at a foreclosure sale not only acquires the prior owner's equity of redemption, but a title free and clear of all interests that were junior to the lien that was foreclosed. This section focuses on the rare instances where fairness and policy considerations dictate a departure from the foregoing principle.

b. Effect of foreclosure purchase by holder of equity of redemption on junior interests. Under Subsection (a), the holder of the equity of redemption, whether personally liable on a junior mortgage obligation or not, may not, by purchasing at the foreclosure of a senior lien, cut off that junior mortgage or other junior interests in the real estate. See Illustrations 1–3. The rule applies when any senior lien is foreclosed, including liens that arise from failure to pay real estate taxes. See Illustration 4. The rule not only burdens the original mortgagor, but also all of his or her transferees whether they assume liability on existing liens or not. See Illustrations 5–6. Moreover, the rule also generally applies where the prior holder of the equity of redemption reacquires title other than as the foreclosure sale purchaser. Thus, the principle clearly may not be evaded by collusive arrangements which call for a third party to purchase at the foreclosure sale and thereafter to transfer title to the prior holder of the equity of redemption. See Illustration 7. It is only where a bona fide purchaser acquires title at the foreclosure sale or thereafter and subsequently sells the real estate to the prior holder of the equity of redemption, that the latter will hold title free and clear of previously destroyed junior interests. See Illustration 8.

Strong fairness concerns support the foregoing approach. Where a mortgagor is personally obligated on a junior lien, or where the mortgage simply contains the usual warranties of title, it would be undesirable and inequitable to allow the mortgagor to profit by violating those obligations. Even where the mortgage obligation is completely "non-recourse," the mortgagor agrees to the satisfaction of that obligation out of the mortgaged real estate. Thus, actions by the mortgagor that undermine the ability of the mortgagee to realize on the benefits of that agreement should be discouraged. Strong policy considerations also compel the application of the same rule to transferees of the mortgagor who take subject to the mortgage, but who do not assume liability on existing liens. In this type of transaction, the purchase price paid by the transferee is almost always reduced by the value of any liens that the transferee agrees are to remain on the real estate. To permit the transferee under such circumstances to acquire title through a senior lien foreclosure and, in so doing, to destroy junior liens, would enable the transferee to acquire the real estate for less than originally contemplated. Such unjust enrichment of the transferee should be discouraged.

On the other hand, there are good reasons to allow the original holder of the equity of redemption to reacquire title from a bona fide purchaser free and clear of previously foreclosed interests. Under normal recording act principles, a bona fide purchaser of real estate that is subject to a prior unrecorded interest may transfer good title to a transferee even though that transferee has knowledge of that interest. This latter principle enhances the alienability of real estate and gives a bona fide purchaser the ability to transfer good title to a subsequent person who cannot qualify for bona fide purchaser status. Under this approach, the original holder of the equity of redemption, albeit tainted by unclean hands, becomes the beneficiary of a policy designed to protect bona fide purchasers and foster real estate marketability.

Illustrations:

1. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a Mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee-2 and gives Mortgagee-2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor later goes into default on the obligation secured by the mortgage to Mortgagee-1 and Mortgagee-1 validly accelerates that obligation and forecloses its mortgage. Mortgagor purchases Blackacre at the foreclosure sale. Mortgagee-2 still has a valid lien on Blackacre.

2. The facts are the same as Illustration 1, except that the note secured by Mortgagee-2's mortgage states: "No personal liability shall exist under this note, and foreclosure on the mortgage shall be mortgagee's sole remedy for default." Mortgagee-2 still has a valid lien on Blackacre.

3. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then delivers a deed to E granting E a roadway easement over Blackacre. The easement deed is immediately recorded. Mortgagor later goes into default on the obligation secured by the mortgage to Mortgagee-1 and Mortgagee-1 validly accelerates that obligation and forecloses its mortgage. Mortgagor purchases Blackacre at the foreclosure sale. E still has a valid easement on Blackacre.

4. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor fails to pay real property taxes on Blackacre, a tax lien therefore arises,

and the appropriate government agency forecloses on Blackacre. Mortgagor purchases at the tax lien foreclosure sale. Mortgagee-1 still has a valid lien on Blackacre.

5. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee-2 and gives Mortgagee-2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then sells and conveys Blackacre to Transferee, who assumes liability on both notes and mortgages. The obligation secured by the mortgage to Mortgagee-1 then goes into default, the obligation is validly accelerated, and Mortgagee-1 forecloses its mortgage on Blackacre. Transferee purchases Blackacre at the foreclosure sale. Mortgagee-2 still has a valid lien on Blackacre.

6. The facts are the same as Illustration 5, except that Transferee takes subject to, but does not assume liability on, the notes and mortgages. Mortgagee-2 still has a valid lien on Blackacre.

7. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee-2 and gives Mortgagee-2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Later Mortgagor defaults on the obligation to Mortgagee-1, that obligation is validly accelerated, and Mortgagee-1 forecloses. F, Mortgagor's friend, agrees that, if F is the successful foreclosure purchaser, F will thereafter convey Blackacre to Mortgagor. F then purchases Blackacre at the foreclosure sale and thereafter conveys Blackacre to Mortgagor. Mortgagee-2 still has a valid lien on Blackacre.

8. The facts are the same as Illustration 7, except that the purchaser at the foreclosure sale is P, who does not know Mortgagor, has no knowledge of Mortgagor's plan to terminate Mortgagee-2's mortgage, and qualifies as a bona fide purchaser. Thereafter P sells and conveys Blackacre to Mortgagor. Mortgagor owns Blackacre free and clear of any mortgage in favor of Mortgagee-2.

c. Effect of foreclosure purchase by junior interest on holder of the equity of redemption and other junior interests. Under Subsection (b) a purchase by a junior lienor or other junior interest at a validly conducted foreclosure of a senior lien cuts off the rights of both the holder of the equity of redemption and other junior interests as well. This is the case whether the senior foreclosure is of a mortgage, a lien for unpaid real estate taxes, or any other lien. See Illustrations 9–14.

This approach of Subsection (b) is equitable and consistent with sound policy. As against the mortgagor or other holder of the equity of redemption, a mortgagee has no duty to pay senior liens, including liens for unpaid real estate taxes. On the other hand, the holder of the equity of redemption does have an obligation to pay taxes and an obligation (often personal) to pay other liens on the real estate. Thus, the principle reflected in this subsection seeks te prevent the holder of the equity of redemption from taking advantage of the holder's own default. Moreover, it increases the incentive to the mortgagor to pay taxes promptly and to other lienors to bid at senior foreclosure sales.

The argument for permitting the junior lienor who purchases at a senior sale to take free of other junior interests is equally strong. It is sometimes asserted that junior interests should be treated in this context as joint tenants or tenants in common. The latter persons generally may not, by purchasing the property at a foreclosure sale, take free of the interests of fellow cotenants. This is because each such cotenant has a duty to pay taxes and therefore the principle is applicable that one should not profit by failing to satisfy that duty. On the other hand, as among junior lienors and other junior interests, there is neither a contractual duty nor a duty inherent in their relationship to pay taxes or other senior liens. If anything, the common derivation of their interests in the same land does not create a common interest, but numerous ones that are adverse. Thus, it is appropriate to conclude that, in bidding at a senior foreclosure sale, the holder of a junior interest is acting solely for its own benefit.

Illustrations:

9. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Mortgagor then borrows money from Mortgagee–3 and gives Mortgagee–3 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then defaults on the obligation to Mortgagee–1, the obligation is validly accelerated, and Mortgagee–1 forecloses its mortgage. Mortgagee–3 purchases at the foreclosure sale. Mortgagee–3 takes title to Blackacre free and clear of the interests of both Mortgagor and Mortgagee–2.

10. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Mortgagor then fails to pay real property taxes on Blackacre. A tax lien therefore arises and the appropriate government agency forecloses on Blackacre. Mortgagee–2 purchases at the tax lien foreclosure sale. Mortgagee–2 takes title to Blackacre free and clear of the interests of Mortgagor and Mortgagee–1.

11. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then sells and conveys Blackacre to Transferee, who assumes both notes and mortgages. Transferee then fails to pay real property taxes on Blackacre. A tax lien therefore arises, and the appropriate government agency forecloses on Blackacre. Mortgagee–2 purchases at the tax lien foreclosure sale. Mortgagee–2 takes title to Blackacre free and clear of the interests of Transferee and Mortgagee–1.

12. The facts are the same as Illustration 11, except that Transferee takes subject to, but does not assume, the notes and mortgages. Mortgagee–2 takes title to Blackacre free and clear of the interests of Transferee and Mortgagee–1.

13. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then delivers to E a deed granting E a roadway easement over Blackacre. The easement deed is immediately recorded. Mortgagor then defaults on the obligation to Mortgagee–1, the obligation is validly accelerated, and Mortgagee–1 forecloses. E purchases at the foreclosure sale. E takes title to Blackacre free and clear of the interests of Mortgagor and Mortgagee–2.

14. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then

delivers to E a deed granting to E a roadway easement over Blackacre. The easement deed is immediately recorded. Mortgagor then fails to pay real property taxes on Blackacre. A tax lien therefore arises and the appropriate government agency forecloses on Blackacre. E purchases at the tax lien foreclosure sale. E takes title to Blackacre free and clear of the interests of Mortgagor and Mortgagee–1.

REPORTERS' NOTE

Introductory note, Comment a. For further consideration of the basic rules of mortgage priorities, see 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 1.1, 7.12, 7.14, 7.19 (3d ed. 1993); I G. Glenn, Mortgages § 39.3 (1943).

Effect of foreclosure purchase by holder of equity of redemption on junior interests, Comment b. It is clear that the acquisition of title by a mortgagor at the foreclosure sale of a senior lien does not terminate junior liens. See Martin v. Raleigh State Bank, 111 So. 448 (Miss. 1927); Old Republic Insurance Co. v. Currie, 665 A.2d 1153 (N.J. Super. 1995); Salamanca Federal Savings & Loan Ass'n v. Darrow, 619 N.Y.S.2d 508 (N.Y. Misc. 1994) (relying on warranty provision in mortgage); Dixieland Realty Co. v. Wysor, 158 S.E.2d 7 (N.C. 1967); Merchants' National Bank of Fargo v. Miller, 229 N.W. 357 (N.D. 1930); Home Owners' Loan Corp. v. Guaranty Title Trust Co., 76 S.W.2d 109 (Tenn.1934); Third National Bank in Nashville v. McCord, 688 S.W.2d 446 (Tenn.Ct.App.1985); Federal Farm Mortgage Corp. v. Larson, 278 N.W. 421 (Wis.1938); I G. Glenn, Mortgages 257–58 (1943). The same rule applies when the mortgagor acquires title through collusion with another. See Barberi v. Rothchild, 61 P.2d 760 (Cal.1936); Old Republic Insurance Co. v. Currie, 665 A.2d 1153 (N.J. Super. 1995); Dorff v. Bornstein, 14 N.E.2d 51 (N.Y.1938); Wood & Oberreich, Revival of a Second or Subsequent Mortgage upon Reacquisition of Title by the Original Mortgagor after Foreclosure of a First Mortgage, 11 Ind. L.J. 429 (1936); White, Revival of Mortgages, 10 U. Cinn. L. Rev. 217 (1936).

The same rule applies to assuming transferees of the mortgagor. See Beitel v. Dobbin, 44 S.W. 299 (Tex. Ct. Civ. App. 1898). However, there is at least one case holding that the rule is inapplicable to one who took "subject-to" a senior lien, but did not assume it. See Searles v. Kelley, 88 Miss. 228, 40 So. 484 (1906). The latter approach emphasizes that there is no duty on a nonassuming transferee to pay off the mortgage. Subsection (a), however, takes the position that the rule applies to the latter transferee. To permit a nonassuming transferee to purchase at a senior lien foreclosure and, in so doing, to terminate junior liens unjustly enriches the transferee, who undoubtedly subtracted such liens from the purchase price upon his or her original acquisition of title. In any event, there is significant authority in the tax lien foreclosure context that the rule of this subsection is applicable to nonassuming transferees. See Tuft v. Federal Leasing, 657 P.2d 1300 (Utah

1982); 16 L.R.A.N.S., 121, 124 (1908); 1914, L.R.A. N.S., 877, 878 (1941).

Courts differ in their treatment of the holder of the equity of redemption who reacquires title from a bona fide purchaser. Some hold that the former still holds subject to the junior interest. See Transamerica Financial Services, Inc. v. Lafferty, 856 P.2d 1188 (Ariz.Ct.App.1993); Federal Land Bank of Columbia v. Bank of Lenox, 16 S.E.2d 9 (Ga.1941); Kerr v. Erickson, 24 S.W.2d 21 (Tex. Ct. App. 1930); Merchants' National Bank of Fargo v. Miller, 229 N.W. 357 (N.D. 1930); Wood & Oberreich, Revival of a Second or Subsequent Mortgage upon Reacquisition of Title by the Original Mortgagor after Foreclosure of a First Mortgage, 11 Ind. L.J. 429 (1936). Others follow the approach taken by Subsection (a) (see Comment *b* and Illustration 8) that allows a bona fide purchaser to pass good title to any subsequent grantee, including the mortgagor or other prior holder of the equity of redemption. See Zandri v. Tendler, 193 A. 598 (Conn.1937); Dorff v. Bornstein, 14 N.E.2d 51 (N.Y.1938); Schultz v. Cities Service Oil Co., 86 P.2d 533 (Kan. 1939); Note, 52 Harv. L. Rev. 1176 (1939). The latter approach is justified by policy rule that generally a "bona fide purchaser of property that is subject to a prior unrecorded interest may pass good title to a subsequent purchaser who does not qualify for BFP status." See Chergosky v. Crosstown Bell, Inc., 463 N.W.2d 522 (Minn.1990). This "filter" concept is designed to protect the alienability of real estate. See Hoggarth v. Somsen, 496 N.W.2d 35, 41 (N.D.1993).

The general rule of this section is further graphically illustrated in the property tax foreclosure context. Because the owner of the equity of redemption has, as against lienholders, the obligation to pay taxes, he or she may not default in that obligation and purchase at the tax lien foreclosure sale free and clear of junior interests. See Danforth v. Gautreau, 556 A.2d 217 (Me.1989); Dayton v. Rice, 47 Iowa 429 (1877); Waring v. National Savings & Trust Co., 114 A. 57 (Md. 1921); Allison v. Armstrong, 9 N.W. 806 (Minn.1881); Salamanca Federal Savings & Loan Ass'n v. Darrow, 619 N.Y.S.2d 508 (N.Y. Misc. 1994) (relying on warranty provision in mortgage and after-acquired property principles); Tuft v. Federal Leasing, 657 P.2d 1300 (Utah 1982). Contra, Melahn v. Hearn, 460 N.Y.S.2d 103 (N.Y.App.Div.1983), affirmed, 459 N.E.2d 156 (N.Y. 1983). The following commentary illustrates this principle:

> The mortgagor in possession, being bound to pay the taxes as between himself and the mortgagee cannot, therefore, default in that obligation, allow the property to be sold for taxes, which constitute a paramount lien, and then buy at the tax sale free and clear of the mortgage. He cannot base a title on the violation of his duty and his purchase, so far as the mortgagee is concerned, will be considered a payment of the taxes.... Further, the great weight of authority holds that a transferee of the mortgagor, whether he assumes the payment of the mortgage debt or merely takes subject to it cannot defeat the lien of the mortgagee any more than could the mortgagor.

1 G. Nelson & D. Whitman, Real Estate Finance Law 276 (3d ed. 1993).

The approach of Subsection (a) is generally consistent with the approach taken by those states that have enacted statutory redemption.

In about half the states, once there has been a valid foreclosure of the equity of redemption, a statutory right to redeem begins. Some states limit the right to the foreclosed holder of the equity of redemption, while others give such a right to junior lienholders. When a mortgagor redeems, a majority of courts, using a variety of rationales, hold that all liens existing prior to the foreclosure sale are revived. See, e.g., Farmers Production Credit Ass'n v. McFarland, 374 N.W.2d 654 (Iowa 1985); 1 G. Nelson and D. Whitman, Real Estate Finance Law § 8.6 (3d ed. 1993). A minority of jurisdictions reject lien revival in this context. See West's Ann. Cal. Code Civ. Pro. § 729.080 ("Liens extinguished by the sale ... do not reattach to the property after redemption and the property that was subject to the extinguished lien may not be applied to the satisfaction of the claim or judgment under which the lien was created.").

Effect of foreclosure purchase by junior interest on holder of the equity of redemption and other junior interests, Comment c. While it is axiomatic that a valid foreclosure of a senior lien destroys all junior interests in the foreclosed real estate, this is not the case, as the foregoing note indicates, where the foreclosure purchaser is the holder of the equity of redemption. Courts have also been reluctant to allow the normal foreclosure rule to operate where a mortgagee purchases at a real estate tax lien foreclosure and, in so doing, purports to take title free and clear of the interest of the holder of the equity of redemption and other lienholders.

In this connection, a majority of cases prohibit the mortgagee tax sale purchaser from taking free and clear of the interest of the mortgagor or other holder of the equity of redemption. See, e.g., Koch v. Kiron State Bank, 230 Iowa 206, 297 N.W. 450, 140 A.L.R. 273 (1941); Eblen v. Major's Adm'r, 147 Ky. 44, 143 S.W. 748 (1912); Crofts v. Johnson, 313 P.2d 808 (Utah 1957); Annot., 140 A.L.R. 294, 303–311 (1942). The rationale for this position is that

> the mortgagor and mortgagee have a unity of interest in the protection of their title and it is not equitable that either of them should act adversely to the other in the preservation of the title in the maintenance of which both are interested. It was primarily the duty of the mortgagor to pay the taxes, and when he failed to do so, and the property was sold for the taxes, the duty devolved upon the mortgagee to relieve the property from the burden.... And he cannot be permitted to put himself in a better position by failing to redeem and then buying in the property at the tax sale.

Eblen v. Major's Adm'r, 143 S.W. 748, 751 (Ky.1912).

On the other hand, a significant minority of decisions permit a mortgagee to purchase at the tax sale free of the interest of the mortgagor or holder of the equity of redemption. See McLaughlin v. Acom, 50 P. 441 (Kan.1897); Reimer v. Newell, 49 N.W. 865 (Minn. 1891); Baird v. Fischer, 220 N.W. 892 (N.D.1928); Williams v. Townsend, 31 N.Y. 411 (N.Y. 1865) ("[T]here is no such relation of trust or confidence between the maker and holder of a mortgage as prevents the latter from acquiring title to its subject matter, either under his own or any other valid lien."); Annot., 140 A.L.R. 294, 311–316 (1942).

The minority approach, which is incorporated in Subsection (b), seems more consistent with sound policy. To argue, as many of the majority decisions do, that mortgagor and mortgagee share a common interest and that they have a fiduciary obligation to each other seems substantively unsound. As one commentary stresses:

> Some [cases] let the mortgagee buy at the tax sale and cut off the rights of the mortgagor. They argue that the mortgagee had no duty to pay the taxes and stood in no fiduciary relation to the mortgagor. A denial of the privilege would let the mortgagor—who did have the duty to pay taxes—force the mortgagee still to hold only as a security claimant. This would allow the mortgagor to take advantage of her own default. Further, the rule does not operate harshly against the mortgagor since, under tax statutes, she can redeem from the tax sale. Moreover, the incentive to the mortgagor and other mortgagees to pay taxes promptly and to purchase at the tax sale would be increased.

1 G. Nelson & D. Whitman, Real Estate Finance Law 277 (3d ed. 1993).

Courts have been similarly split on the question of whether a purchase by a junior lienor at a tax lien foreclosure sale cuts off senior liens. A significant majority hold that a junior mortgagee cannot assert a tax title against a senior mortgage where both mortgages are outstanding. See Petition of Candlewick Lake Ass'n, 476 N.E.2d 800 (Ill. 1985); Miller v. First National Bank of Englewood, 435 P.2d 899 (Colo.1968); Koch v. Kiron State Bank of Kiron, 297 N.W. 450 (Iowa 1941); Buchanan v. Hansen, 820 P.2d 908 (Utah 1991); Annot., 140 A.L.R. 294, 319–329 (1942); Note, 90 U. Pa. L. Rev. 90, 96 (1941). The rationale for the latter approach has been articulated as follows:

> [E]quity regards the land as a common fund for the payment of all liens and mortgages and it would be inequitable and a fraud for one lienor to acquire title to the land by a tax sale and use it to destroy the claim of another lienor or mortgagee. The lienor is authorized to redeem from the tax sale and equity will not allow him to acquire the title for an inconsiderable sum when he was authorized to remove the trifling encumbrance by redemption. Equity will relieve against such oppression and teach the grasping creditor moderation in his demands, and that he cannot force others to build up his fortunes.

Petition of Candlewick Lake Ass'n, 476 N.E.2d 800, 802 (Ill. Ct. App. 1985).

A minority of cases permit a junior lienor to purchase at a tax sale free and clear of other liens. See Security Mortgage Co. v. Herron, 296 S.W. 363 (Ark.1927); Security Mortgage Co. v. Harrison, 3 S.W.2d 59 (Ark. 1928); Bank of University v. Athens Savings Bank, 33 S.E. 34 (Ga.1899); Annot., 140 A.L.R. 297, 329–331 (1942). The minority approach, incorporated in Subsection (b), seems preferable on balance from a policy perspective. According to one commentary,

> Occasionally it is said that the mortgagee is like a trustee and therefore is debarred from founding a title on the tax sale in opposition to the mortgagor or other mortgagees. But the mortgagee may buy at even his own foreclo-

sure sale and, consequently, even if it were true that he is a trustee, it is difficult to see why purchase at a tax sale would be a breach of any fiduciary obligation owed to the mortgagor or other mortgagees. Sometimes the analogy of joint tenants is invoked. But each joint tenant has a duty to pay taxes and therefore as to them the general principle applies that one cannot profit by failing to do his duty. There is no such duty on a mortgagee not in possession, in the absence of an express contractual obligation in favor of the mortgagor or another mortgagee, to pay the taxes. Still other courts stress the community of interest of the parties in preserving the estate by the payment of taxes and conclude that it would thus be inequitable conduct to acquire and assert a tax title against the others, ... Just why it is inequitable where there is neither a contractual duty or one arising out of their relationship to pay the taxes is not explained. Moreover, the common derivation of their interests in the land does not create a common interest but rather antagonistic interests, certainly as between the two mortgagees.

1 G. Nelson & D. Whitman, Real Estate Finance Law 278–279 (3d ed. 1993). At one time the majority rule may have been justifiable because most tax foreclosure statutes did not require that mortgagees be provided personal notice of a tax lien foreclosure sale. Consequently, it probably was unfair to permit the termination of a mortgagee's lien where the mortgagee may not have had adequate notice of the foreclosure sale and the opportunity to protect its interest by participating in it. However, in Mennonite Board of Missions v. Adams, 462 U.S. 791, 103 S.Ct. 2706, 77 L.Ed.2d 180 (1983), the United States Supreme Court held that notice by publication and posting to a mortgagee of real estate being sold for nonpayment of real estate taxes violated the notice requirements of the due process clause of the Fourteenth Amendment of the United States Constitution. The Court emphasized that "when the mortgagee is identified in a mortgage that is publicly recorded, constructive notice by publication must be supplemented by notice mailed to the mortgagee's last known available address, or by personal service. But unless the mortgagee is not reasonably identifiable, constructive notice alone does not satisfy the [constitutional] mandate.... " Id. at 798, 103 S.Ct. at 2711, 77 L.Ed.2d at 187. Since mortgagees now must generally be provided at least mailed notice of a tax lien foreclosure, they clearly have the opportunity to protect their interests by bidding at the sale.

As pointed out in the Reporters' Note to Comment *b*, supra, a significant number of states have statutory redemption schemes. As also mentioned earlier, some of these states confer statutory redemption rights on foreclosed junior lienholders as well as on the former holder of the equity of redemption. Where this is the case, redemption by junior lienors generally gives the latter the same title the foreclosure purchaser would have obtained had there been no redemption. As a result, unlike the case of redemption by the holder of the equity of redemption, there is no revival of junior liens. See generally 1 G. Nelson and D. Whitman, Real Estate

Finance Law § 8.7 (3d ed. 1993). Consequently, the approach of Subsection (b) is largely consistent with the position taken in the statutory redemption context.

CHAPTER 5

TRANSFERS OF MORTGAGED REAL ESTATE AND MORTGAGES

Introductory Note: This Chapter deals with transactions in which real estate encumbered by a mortgage is transferred. Such transfers may occur either with (§ 5.1) or without (§ 5.2) an assumption of personal liability by the transferee. The legal doctrines that govern the rights and liabilities of the parties in these transactions are generally well-settled and are not controversial. The transferor is regarded as a surety, with the transferee (or the real estate, in the case of a transfer without assumption of liability) becoming principally liable. The principles of suretyship law, drawn from Restatement Third, Suretyship and Guaranty, govern their relationship. The absence of a direct relationship between the transferee and the mortgagee is not a barrier to the application of suretyship principles; see Restatement Third, Suretyship and Guaranty § 1, Comment *n* and Illustrations 28–29.

Section 5.3 governs situations in which the transferor may be discharged from personal liability on the mortgage obligation because of a modification, extension, or release granted by the mortgagee after the transfer of the real estate. The courts have had great difficulty establishing the applicable legal rules in this area. Confusion has resulted both from the unsettled nature of suretyship law and from the courts' uncertainty as to how that body of law should apply in the context of transfers of mortgaged real estate.

Under § 5.3 the transferor is generally discharged only to the extent of the actual loss suffered as a consequence of a release, extension, or modification entered into by the mortgagee. This is a departure from most of the prior case law, which awarded the transferor a complete discharge even when the mortgagee's extension or modification was trivial or benign. In this respect § 5.3 adopts and follows Restatement Third, Suretyship and Guaranty §§ 37–49.

Section 5.4 adopts the widely held view that a transfer of a mortgage obligation acts as a transfer of the mortgage itself as well, unless the parties intend to separate the mortgage and the obligation—an intention that is rare indeed. It also adopts the rule, less widely held, that a transfer of the mortgage will also transfer the obligation. Both of these rules are desirable because they tend to keep the obligation and the mortgage in the same hands. This is significant because, as § 5.4(c) states, when the mortgage and the obligation are separated, the mortgage becomes unenforceable.

Section 5.5 negates the common holding that the performance of a mortgage obligation, rendered to the mortgagee after the obligation has been transferred, is a nullity and does not discharge the mortgage or the debt. Instead, under § 5.5 such a performance is effective, provided it is rendered at a time when the obligor has no notice of the transfer. Hence, the section gives mortgage assignees a strong incentive to inform mortgagors of the assignments they take. Since responsible mortgage assignees routinely give such notice in any event, the section will prevent injustice while imposing no significant new burdens. The view adopted in § 5.5 is applicable only when the Uniform Commercial Code does not require a contrary result.

§ 5.1 Transfers with Assumption of Liability

(a) "Assumption of liability" means a promise by the transferee of mortgaged real estate, whether made to the transferor or to the mortgagee, to perform the obligation secured by the mortgage.

(b) When mortgaged real estate is transferred with assumption of liability:

(1) the mortgage remains effective against the real estate in the hands of the transferee; and

(2) the transferor remains personally liable for the covenants in the mortgage and for the obligation secured by the mortgage, to the extent such liability existed prior to the transfer; and

(3) in the event of a default in the performance of the obligation secured by the mortgage, the mortgagee has the right (except as limited by the parties' agreement, by statute, and by §§ 5.3, 8.2, and 8.4):

(i) to proceed against the transferor personally to the extent of the transferor's liability, and

(ii) to proceed against the transferee personally, to the extent of the transferee's liability under the assumption agreement, and

(iii) to enforce the mortgage, and thereafter to proceed against the transferor or the transferee personally for any deficiency, to the extent of their respective liabilities.

(c) The mortgagee's rights against the transferee under Subsection (b)(3) exist:

(1) whether or not the transferor is personally liable on the obligation secured by the mortgage; and

(2) whether the transferee receives the transferor's entire interest in the real estate, some portion of it, or a mortgage on it; and

(3) whether or not consideration is given by the mortgagee for the transferee's assumption agreement; and

(4) whether or not the transferor has a defense to the obligation or the mortgage, if the transfer is a sale and amount of the mortgage obligation is credited against the price paid; and

(5) even though the transferor and transferee, subsequent to the transfer, mutually rescind or modify the assumption agreement, provided that the mortgagee, prior to receiving notification of the rescission or modification, materially changes position in justifiable reliance on the assumption agreement, brings suit on it, or manifests assent to it at the request of the transferor or transferee.

(d) When mortgaged real estate is transferred with assumption of liability, the transferor is regarded as a secondary obligor, and the transferee as a principal obligor, under the principles of Restatement Third, Suretyship and Guaranty. If the transferee defaults in performance of the obligation secured by the mortgage, creates an unreasonable risk of default, or otherwise engages in conduct that impairs the transferor's expectation that the transferee will perform the obligation, the transferor is entitled to relief against the transferee and the security of the mortgaged real estate by way of exoneration and quia timet (Restatement Third, Suretyship and Guaranty § 21),

reimbursement (§§ 22–25), restitution (§ 26), and subrogation (§§ 27–31).

Cross-References:

Section 5.2, Transfers Without Assumption of Liability; § 5.3, Discharge of Transferor from Personal Liability; § 7.6, Subrogation; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage; § 8.4, Foreclosure: Action for a Deficiency; § 8.5, The Merger Doctrine Inapplicable to Mortgages; Restatement, Second, Contracts §§ 311, 318(3); Restatement Third, Suretyship and Guaranty §§ 21–31; Restatement of Security §§ 103–111.

Comment:

a. Assumption of liability. The rights and duties of the parties following a transfer of mortgaged real estate depend on whether the transferee has assumed liability on the mortgage and the obligation it secures. The transferee's assumption of liability need not be in any particular form or follow any particular verbal pattern. Any words indicating the transferee's intent to undertake personal liability for the obligation will suffice. However, the words "subject to the mortgage" or the like do not effect an assumption of liability; see Illustration 1.

The language of assumption may be placed in a separate agreement (see Illustration 2) or in the deed itself (see Illustration 3). Acceptance of a deed containing such language ordinarily evidences the grantee's assumption of liability, although this evidence may be rebutted by a showing that the grantee was not aware of the language and did not intend an assumption; see Illustration 4. An oral assumption agreement is also enforceable, since the Statute of Frauds is usually held inapplicable to assumption agreements.

If the assumption language is placed in the contract of sale, but is not repeated in the deed, it is nonetheless binding on the transferee after delivery of the deed. The doctrine of merger by deed does not operate to render the contract language ineffective.

In a few jurisdictions courts have been willing to find or to presume an assumption of liability, or an implied obligation on the part of the transferee to indemnify the transferor, merely from the fact that the purchaser of mortgaged real estate paid a cash amount equal to the difference between the agreed selling price and the balance owing on the mortgage obligation. Under this Restatement, however, such facts alone do not give rise to an assumption of liability or a duty to indemnify.

Subtle variations may occur in the language of assumption; thus, the transferee may agree to "assume the mortgage"; to "assume the mortgage loan"; to "assume the mortgage note"; or to "assume the mortgage and note." Ordinarily no weight should be attached to these variations. Under any of these formulations the transferee will usually be held to have assumed all covenants and obligations in both the note and the mortgage. While it is possible in principle for the transferee to assume the obligation represented by the note but not the covenants in the mortgage, or vice versa, this intention is surely rare and should not be found absent very clear and explicit evidence. For example, an assumption of "the loan" would ordinarily be held to make the transferee personally liable both on the debt evidenced by the promissory note and on an attorneys' fee clause in the mortgage.

Illustrations:

1. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash. The contract of sale provides "C agrees to take the premises subject to the existing mortgage." This language does not constitute an assumption of liability by C.

2. The facts are the same as in Illustration 1, except that the contract of sale provides "C agrees to assume the existing mortgage on the premises." This language constitutes an assumption of liability by C.

3. The facts are the same as in Illustration 2, except that the quoted language is found in the deed from A to C, rather than in the contract of sale. If C accepts delivery of the deed as grantee and is aware at the time of acceptance of the language of assumption, this language constitutes an assumption of liability by C, notwithstanding that C does not sign the deed.

4. The facts are the same as in Illustration 1, except that A, who drafts the deed, inserts language in it stating "C agrees to assume the existing mortgage on the premises." C does not consent to this insertion, is unaware of it, and has no intention to assume the mortgage. Moreover, C does not see the deed until after it is recorded and C's payment for the house has been disbursed. The inserted language is ineffective as an assumption of liability by C.

b. Mortgage continues to encumber transferred real estate. The fact that mortgaged real estato is transferred does not release the real estate from the mortgage, unless the mortgage is unrecorded and the transferee qualifies to take free of it under the applicable recording act. A recorded mortgage encumbers the title no matter into whose hands the real estate is transferred. No unfairness results from this principle, since any prospective transferee can examine the public records and discover the mortgage's existence. This principle applies whether or not the transferee assumes liability for the mortgage obligation.

c. Transferor remains liable. In general the mortgagee may proceed personally against the transferor in either of two ways: by a direct action on the debt or other obligation, or by seeking a deficiency after foreclosing the mortgage. See § 8.2 concerning the order in which these remedies may be pursued and § 8.4 with respect to limitations on the amount that may be recovered in a deficiency action. The transfer of mortgaged real estate does not operate to relieve the transferor of whatever personal liability he or she previously had. See Illustration 5. However, the original mortgage documents may make the obligation partially or entirely "non-recourse," and hence may restrict or prohibit a personal recovery against the transferor; see § 1.1. In such a case the fact that the real estate is transferred does not vary the transferor's liability. See Illustration 6. The mortgagee's recovery against the transferor may also be limited or prohibited in some jurisdictions by a statutory "one-action" or antideficiency rule.

Even though the transferee is also liable to the mortgagee by virtue of the assumption agreement (see Comment *d*), the mortgagee need not first pursue the transferee, but may proceed immediately against the transferor. However, the mortgagee must foreclose the mortgage before taking collection action against the transferor if doing so would not materially prejudice or burden the mortgagee and failure to do so would impose unusual hardship on the transferor; see Restatement Third, Suretyship and Guaranty § 51(2)(b).

The transferor's personal liability may be discharged by an express release granted by the mortgagee. In addition, transactions between the mortgagee and the transferee which would give the transferee a defense to the obligation may also give the transferor a defense. See Restatement Third, Suretyship and Guaranty § 34. Finally, the transferor may be discharged from personal liability by virtue of the "suretyship defenses." With respect to these forms of discharge, see § 5.3; Restatement Third, Suretyship and Guaranty §§ 37–49.

Illustrations:

5. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. If a default occurs in payment on the note, B may either recover the balance owing on the note by means of a personal action against A, or foreclose the mortgage and recover

against A any resulting deficiency, subject to the principles of §§ 8.2 and 8.4. B may also have recourse against C, but the availability of that recourse does not preclude A's liability.

6. The facts are the same as in Illustration 5, except that the note states "B's remedy under this note is limited to foreclosure of the mortgage which secures it, and A shall have no personal liability hereon." This language is effective according to its terms, and B may not obtain a personal judgment against A, either in lieu of foreclosure or following foreclosure of the mortgage.

d. Transferee is personally liable for obligation secured by mortgage. The critical feature of an assumption agreement is that it renders the assuming transferee directly liable on the obligation secured by the mortgagee. Except to the extent constrained by "one-action" or antideficiency statutes and §§ 8.2 and 8.4, the mortgagee can recover a personal judgment against the assuming transferee either before foreclosure or for a deficiency after foreclosure. See Illustration 7.

The foregoing statements presuppose that the mortgagee is not a party to the assumption agreement, but that the agreement is simply made between the transferor and transferee. In some cases the mortgagee may also be a party to the agreement; this frequently occurs when the mortgagee, acting under the authority of a due-on-sale or similar clause, reviews the credit of the proposed transferee and insists upon an assumption agreement. However, the mortgagee's recovery against the transferee is not dependent upon the mortgagee's being a party to the agreement.

The mortgagee's right of direct action against the assuming transferee is commonly explained on the basis that the mortgagee is a third-party beneficiary of the assumption agreement. This is the most satisfactory rationale. An alternative explanation is sometimes offered, based on the notion that the transferor-mortgagor is a surety, with the transferee having primary liability on the debt. Under this view, as stated by the United States Supreme Court,

> if one person agrees with another to be primarily liable for a debt due from that other to a third person, so that, as between the parties to the agreement, the first [the transferee] is the principal, and the second [the transferor, is] the surety, the creditor of such surety is entitled, in equity, to be substituted in his place, for the purpose of compelling such principal to pay the debt.

Keller v. Ashford, 133 U.S. 610, 623, 10 S.Ct. 494, 497, 33 L.Ed. 667, 673 (1890). The difficulty with this statement is that it is circular; by its terms, it applies only if the transferee is liable directly to the mortgagee, which is the point in issue.

Whatever theoretical rationale is adopted, the principle is firmly established: The mortgagee can enforce the obligation directly against the assuming transferee.

Some cases relying on the subrogation theory hold that the mortgagee's recovery against the transferee must be in equity (since subrogation is an equitable concept). For example, since foreclosure is inherently equitable, the mortgagee might first foreclose the mortgage and thereafter seek a deficiency judgment against the transferee in the same proceeding. However, that restriction is not followed in this Restatement, which instead recognizes the right of the mortgagee to proceed in an action at law, except where the procedure is constrained by specific statutes.

While assumption agreements typically encompass the entire obligation which the mortgage secures, it is also possible for a transferee to assume only a portion of the obligation. In such a case the transferor may have greater liability than the transferee. See Illustration 8.

Illustrations:

7. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. If a default occurs in payment on the note, B may either recover the balance owing on the note by means of a personal action at law against C, or foreclose the mortgage and recover against C any resulting deficiency, subject to the principles of §§ 8.2 and 8.4.

8. The facts are the same as Illustration 7, except that C's assumption agreement states, "C's liability under this agreement shall in no event exceed $75,000." If a default occurs in payment on the note, B's recovery against C, whether in an action on the debt or for a deficiency after foreclosure, is limited to $75,000. After such recovery, B may recover from A the remaining amount due, subject to the principles of § 8.4.

e. Transferee is liable to mortgagee even if transferor had no liability. Where a transferee assumes liability on a mortgage obligation, the mortgagee's right to enforce that liability does not depend on a showing that the transferor was personally liable. However, as noted above, it must be shown that the transferee intended to undertake personal liability.

This issue can arise in at least three distinct contexts. First, the transferor's liability on the obligation may previously have been released voluntarily by the mortgagee, or may have been discharged in insolvency proceedings. See Illustration 9. Second, the obligation may originally have been non-recourse in nature. Here the assuming transferee's liability depends on the language negating recourse. See Illustrations 10 and 11. Third, the transferor may not be the original mortgagor, but may be a transferee in a previous transfer who did not assume liability. See Illustration 12.

Illustration 12 deals with the problem of a break in the chain of assumptions. Under § 5.1(c)(1) of this Restatement, a transferee who assumes the underlying obligation is liable even if his or her transferor is not. Hence, a break in the assumption chain does not immunize subsequent assuming parties from liability. This rule implements the parties' apparent intent and produces no unjust enrichment. If a transferee assumes liability, he or she ordinarily expects to be compelled to perform the obligation. The fact that the transferor had no liability, and hence no need to procure the assumption, is irrelevant. The assumption agreement evidences an intent to confer a benefit upon the mortgagee.

Illustrations:

9. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. After C assumes liability, A files a petition in bankruptcy and is completely discharged from personal liability on the mortgage and obligation. If C defaults in payment on the note, B may recover the balance owing on the note by means of a personal action against C, or foreclose the mortgage and recover against C any resulting deficiency, subject to the principles of §§ 8.2 and 8.4, notwithstanding A's discharge in bankruptcy.

10. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. The note states, "A shall have no personal liability to pay this note." Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. A court is warranted in finding, on the basis of the note's language, that A and C intended that C would have personal liability notwithstanding the absence of personal liability

on A's part. Upon such a finding, the remedies mentioned in Illustration 9 will be available to B.

11. The facts are the same as Illustration 7, except that the note states, "No personal liability shall exist under this note, and the foreclosure of the mortgage shall be B's sole remedy for default." A court is warranted in finding, on the basis of the note's language, that A and C did not intend that C would have personal liability on the obligation. Upon such a finding, the remedies mentioned in Illustration 9 will not be available to B.

12. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and takes title subject to the mortgage, but does not assume liability on the note or mortgage. Thereafter C sells the house to D for $150,000. D pays C $50,000 in cash and assumes liability on the note and mortgage. B may assert against D the remedies mentioned in Illustration 9.

f. Assuming junior mortgagee who takes a subordinate security interest is liable to senior mortgagee irrespective of consideration. Some case authority holds that when a junior mortgagee assumes liability on a senior mortgage obligation, the senior mortgagee may not recover on that assumption agreement unless consideration for it flowed from the senior to the junior mortgagee.

The typical modern context of this issue is the "wraparound" mortgage, in which a junior mortgagee promises (perhaps conditionally) to make payments on a senior mortgage debt as they fall due. The condition of the junior mortgagee's promise is usually that the mortgagor make timely payments on the debt due to the junior.

No reason is apparent why the senior mortgagee should not be permitted te enforce the junior's assumption agreement, provided that any conditions it contains have been satisfied. Whether the senior mortgagee gave any consideration for the junior's assumption should be entirely irrelevant. The contrary rule seems entirely out of consonance with the general body of law dealing with assumption agreements, and is not followed here.

Illustration:

13. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A borrows an additional $25,000 from C, giving C a second mortgage on the house. C promises A that C will make all payments due on the obligation owed to B, provided that A makes

specified payments to C. A makes these payments as agreed, but C fails to make the payments due to B. In addition to B's rights against A, B may either recover the sum owing on the note by means of a personal action at law against C, or foreclose the mortgage and recover against C any resulting deficiency, subject to the principles of §§ 8.2 and 8.4.

g. Transferee in a sale transaction may not assert transferor's defenses. When the transferee in a sale of real estate enters into an assumption agreement, the promise to discharge the mortgage obligation is part of the price the transferee is paying for the property. The transferee is not permitted to evade the agreement, even if the transferor might have raised defenses to the mortgage or the obligation. To permit the transferee to do so would result in the transferee's unjust enrichment. See Illustration 14.

This restriction on the raising of defenses does not apply to gift transfers (see Illustration 15), or to sales in which the transferee pays the full price in cash with the understanding that the transferor will discharge the mortgage obligation. In these circumstances there is no unjust enrichment in permitting the transferee to raise any available defenses. Similarly, if a junior mortgagee assumes and promises to pay a senior debt (so that the junior mortgage is a "wraparound" mortgage), the junior mortgagee may raise defenses against the senior mortgage and obligation; no unjust enrichment results. See Illustration 16.

If the mortgagee in fact recovers from the transferee notwithstanding the existence of defenses on the obligation or the mortgage, the mortgagee may thereby be unjustly enriched. Under these circumstances, principles of restitution may require the mortgagee to pay over all or some part of the recovery to the transferor.

Defenses that the transferee is not permitted to raise under the rule stated here include the statute of limitations, forgery, lack of capacity, failure of consideration, and other matters that would render the obligation or the mortgage invalid. A defense based on usury may also be barred, depending on the jurisdiction's usury statute and its construction.

Illustrations:

14. A gives B a promissory note for $100,000, secured by a mortgage on A's house, to evidence a loan B promises to make to A. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. C then discovers that B never advanced the $100,000 in

loan proceeds to A, a fact that constitutes failure of consideration and would be a complete defense to an action by B against A on the note. In an action by B against C, C is not permitted to raise this defense, but is obligated to pay the note according to its terms.

15. A gives B a promissory note for $100,000, secured by a mortgage on A's house, to evidence a loan B promises to make to A. Subsequently A makes a gift of the house, which has a value of $150,000, to A's daughter C, who pays no cash but who assumes liability on the promissory note and mortgage. C then discovers that B never advanced the $100,000 in loan proceeds to A, a fact that constitutes failure of consideration and would be a complete defense to an action by B against A on the note. In an action by B against C, C may raise this defense and avoid payment on the note and foreclosure of the mortgage.

16. A gives B a promissory note for $100,000, secured by a mortgage on A's house, to evidence a loan B promises to make to A. Subsequently A borrows an additional $25,000 from C, giving C a second mortgage on the house. C promises A that C will make all payments due on the obligation owed to B, provided that A makes specified payments to C. C then discovers that B never advanced the $100,000 in loan proceeds to A, a fact that constitutes failure of consideration and would be a complete defense to an action by B against A on the note. In an action by B against C, C may raise this defense and avoid payment on the first mortgage note and foreclosure of the mortgage.

h. Effect of modification or rescission of an assumption agreement. After a transfer in which the transferee enters into an assumption agreement, the transferor and transferee may later mutually modify or rescind it. Whether the modification or rescission is binding on the mortgagee depends on whether the mortgagee has made a change of position in justifiable reliance on the assumption agreement. Such a change of position might take many forms; perhaps the most obvious is a decision not to foreclose the mortgage because the assumption agreement entered into by the transferee appears to make the mortgagee's position less risky. See Illustration 17.

This Restatement follows Restatement, Second, Contracts § 311 in the view that the mortgagee's justifiable reliance can be established by a showing that the mortgagee has brought a suit on the assumption agreement, or that the mortgagee has manifested assent to it at the request of either of the parties to it. Such a manifestation of assent is very common in mortgage assumption transactions. See Illustration 18.

Illustrations:

17. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. B is informed of the sale and assumption. Because B considers that C is less likely to default on the note than A, B agrees to extend the due date of the note by one year. Thereafter A and C agree to rescind the assumption agreement. Because B has changed position in reasonable reliance on the assumption agreement, the rescission of the agreement by A and C is ineffective against B.

18. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A desires to sell the house to C for $125,000. C proposes to pay A $25,000 in cash and to assume liability on the promissory note and mortgage. Because the mortgage contains a due-on-sale clause, A seeks B's consent to the sale. B examines C's credit, finds it satisfactory, and consents to the sale and assumption. The sale and assumption transaction occurs. Thereafter A and C agree to rescind the assumption agreement. Because B has manifested assent to the assumption agreement at A's request, the rescission of the agreement by A and C is ineffective against B.

i. Transferor's recourse against transferee. A transferor of mortgaged real estate whose transferee enters into an assumption of liability is regarded as a surety, and is secondarily liable on the secured obligation. The transferee becomes principally liable. Four traditional forms of recourse are recognized in favor of persons who are secondarily liable against those with principally liability: exoneration and quia timet, reimbursement, restitution, and subrogation. These forms of recourse are governed by Restatement Third, Suretyship and Guaranty §§ 18–31. With respect to subrogation, see also § 7.6 of this Restatement.

Under the concept of subrogation, the transferor who discharges the secured obligation in full may foreclose the mortgage against the land in the transferee's hands, and may also bring a direct action on the obligation, either prior to foreclosure or for a deficiency after foreclosure, except as limited by statute and the principles of §§ 8.2

and 8.4. The mortgage and the obligation are regarded as assigned to the transferor by operation of law. Of course, a careful transferor who paid the obligation might well request a formal assignment of the mortgage and the obligation, and such would ordinarily be given. Indeed, if the mortgagee refuses to make such an assignment, equity will compel it at the request of the transferor. But whether a written assignment is given or not, an assignment is recognized in equity to have occurred.

It is often the practice of transferors and their counsel in this situation to ask that the assignment be made to a nominee of the transferor, in order to avoid the assertion that, when ownership of the mortgage is placed in the transferor-debtor's hands, a merger occurs that destroys the mortgage, thereby precluding foreclosure. The better view, even in jurisdictions that continue to recognize the merger doctrine, is that the transferor who takes an assignment of the mortgage ordinarily does not intend a merger to occur, and that absent such intent there is no merger. Under this Restatement, the doctrine of merger of mortgages is abolished; see § 8.5. Hence use of a nominee is unnecessary.

The transferor's subrogation right to foreclose the mortgage or sue on the obligation arises only after the transferor has discharged the underlying obligation in full. A partial payment will not suffice. Because subrogation is by nature derivative, under this theory the transferor may not assert greater rights than could have been claimed by the mortgagee; see § 7.6; Restatement Third, Suretyship and Guaranty § 28 and Comment *c*.

A second form of recourse by the transferor against the assuming transferee is the right to reimbursement for money expended by the transferor toward performance of the mortgage obligation. This recourse exists only if the transferor is personally liable on the obligation, but does not depend on the transferor's having completely discharged it. For example, the transferor may claim reimbursement for paying arrearages due in order to bring the obligation current. In several states there is a statutory right to pay such arrearages and thereby to reinstate the mortgage loan, notwithstanding the mortgagee's attempt to accelerate it. See § 8.1, Comment *e*. The transferor who makes such a payment can also recover reasonable incidental expenses, such as fees, penalties, interest, or attorneys' fees necessary te cure the default. See Restatement Third, Suretyship and Guaranty § 23. Under some limited circumstances, the transferor may be unable to claim reimbursement, but may still seek restitution from the transferee of the amount by which the transferee has been unjustly enriched by the transferor's performance; see Restatement Third, Suretyship and Guaranty § 26.

A further form of recourse available to the transferor is the right to compel the transferee to perform the obligation he or she assumed. This right exists because the transferor is entitled to freedom from the burden of discharging the mortgage obligation. Hence, it can be claimed only if the transferor is currently personally liable on that obligation. However, it is not dependent upon the transferor's having first discharged or made even partial payment on the obligation, nor on the mortgagee's having taken any action to enforce its rights. A default on the obligation by the transferee gives rise to a direct right of action by the transferor. The court's order in such an action will compel the transferee to perform so that the transferor will not have to do so.

The transferor's action may be viewed simply as a contract suit on the assumption agreement; alternatively, it may be regarded as an action for exoneration under the law of suretyship. See Restatement Third, Suretyship and Guaranty § 21. Such an action may result in an order compelling the transferee to discharge the obligation directly to the mortgagee, or it may result in a money judgment in favor of the transferor. If the transferor recovers funds from the transferee in an action based on exoneration, but has not previously paid an equivalent sum to the mortgagee, it would be unjust to permit the transferor to retain these funds; in fairness, they should be passed through to the mortgagee, reducing the balance on the obligation secured by the mortgage. Hence, a court may grant whatever equitable order appears necessary to ensure that the transferor's recovery is so applied. See Illustration 19.

Even actions by the transferee creating an unreasonable risk of default, as distinct from a default itself, may activate a claim by the transferor. This may occur, for example, if the transferee threatens or commits waste on the real estate, takes other actions that reduce its value as security, or engages in a fraudulent transfer. The transferor's right here is analogous to the right of a contract obligee to demand reasonable assurances that the obligor will perform, as recognized in Restatement, Second, Contracts § 251. The judicial remedy in such cases is sometimes referred to as quia timet relief. It is not limited to money damages, but might also include an injunction prohibiting behavior that threatens to harm the property's value, an order requiring the transferee to deposit funds into court, or a requirement that the transferee provide additional security. See Restatement Third, Suretyship and Guaranty § 21.

Illustration:

19. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house.

Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and assumes liability on the promissory note and mortgage. C then defaults on the payment due on the note, and A brings an action against C for the delinquent payment. A is entitled to a judgment for the sum due, but thc court may order A to pay the sum to B, and if necessary to ensure this result may order the judgment paid into court and distributed to B.

REPORTERS' NOTE

Assumption of liability, Comment a. On the distinction between mortgage assumptions and subject-to transfers, see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 5.1–5.8 (3d ed. 1993); Cunningham & Tischler, Transfer of the Real Estate Mortgagor's Interest, 27 Rutgers L. Rev. 24 (1973); Storke & Sears, Transfer of Mortgaged Property, 38 Corn. L. Q. 185 (1953).

Illustration 1 is supported by Brichetto v. Raney, 245 P. 235 (Cal.App. 1926); Klegman v. Moyer, 266 P. 1009 (Cal.Ct.App.1928); Sooner Fed. Sav. & Loan Ass'n v. Oklahoma Cent. Credit Union, 790 P.2d 526 (Okl.1989) (grantee who does not assume—in this case, a foreclosing junior mortgagee—has no personal liability on the mortgage debt); Manget Foundation, Inc. v. White, 113 S.E.2d 235 (Ga.Ct.App.1960); and Hancock v. Fleming, 3 N.E. 254 (Ind.1885).

Illustration 2 is based on United States v. McLain, 769 F.2d 500 (8th Cir.1985) (the terms "assume the loan" and "assume the mortgage" have the same effect), and Thomas v. Home Mut. Bldg. Loan Ass'n, 90 N.E. 1081 (Ill.1910) (the term "assumes" is equivalent to "assumes and agrees to pay"). See also Hyde Wholesale Dry Goods Co. v. Edwards, 500 S.W.2d 85 (Ark.1973) (statement by grantee that he hoped to be able to take care of the debt to the mortgage holders was not sufficiently definite to constitute an assumption of liability); Yager v. Rubymar Corp., 230 N.Y.S.2d 609 (N.Y.Sup.Ct.1962) (the term "assume" need not be used, and a covenant to pay the debt is equivalent to an assumption). Cf. Mutual Security Financing v. Unite, 847 P.2d 4 (Wash. Ct.App.1993) (mortgagee could not recover from assuming grantee, where mortgagee erroneously sued on the promissory note and not on the assumption agreement).

Cases that infer an assumption of liability from the fact that the transferor credited the amount of the mortgage debt against the purchase price include Daugharthy v. Monritt Assoc., 444 A.2d 1030 (Md.1982); Brice v. Griffin, 307 A.2d 660 (Md. 1973); Hollings v. Hollings, 78 A.2d 919 (N.J. Super. Ct. 1951); Lang v. North Jersey Agency, Inc., 44 A.2d 44 (N.J. 1945); Fidelity Union Trust Co. v. Prudent Inv. Corp., 19 A.2d 224 (N.J. 1941); Johnson v. Davis, 293 P. 197 (Okla.1930); Allgood v. Spearman, 118 S.E. 189 (S.C.1923); Sanderson v. Turner, 174 P. 763 (Okla.1918). The Pennsylvania courts do not find a full assumption on these facts, but do find an implied obligation on the part of the transferee to indemnify the transferor who pays the mortgage obligation. See Northern Trust Co. v. Philadelphia W. Drug Co., 5 A.2d 193

(Pa.1939); Orient Bldg. & Loan Ass'n v. Freud, 148 A. 841 (Pa.1930).

These cases represent a minority view and are not followed in this Restatement. For express rejections of the position of these cases, see Adams v. George, 812 P.2d 280 (Idaho 1991); McVeigh v. Mirabito, 556 So.2d 1226 (Fla.Dist.Ct.App.1990); Fluke Capital & Mgmt. Serv. Co. v. Richmond, 724 P.2d 356 (Wash.1986); G. Glenn, Mortgages § 256 (1943); Annot., 36 A.L.R. 4th 136. See also First Interstate Bank of Washington v. Nelco Enterprises, Inc., 822 P.2d 1260 (Wash.Ct.App.1992) (assumption agreement must be proved by clear and convincing evidence).

Occasionally cases are found in which the court scrutinizes the language of assumption and determines that it applies only to the note and not the mortgage, or *vice versa*. See, e.g., Wood v. LaFleur, 408 So.2d 37 (La.Ct.App.1981) (where grantee assumed the balance owed, he was bound by the terms of the note but not of the mortgage); Leisure Villa Investors v. Life & Casualty Ins. Co., 527 So.2d 520 (La.Ct.App.1988) (if grantor assumes only the mortgage, he is not bound by the terms of the note that are not contained in the mortgage unless the mortgage incorporates the note's obligations). Such decisions smack of hypertechnicality and are not followed in this Restatement. By way of comparison, see First Indiana Fed. Sav. Bank v. Hartle, 567 N.E.2d 834 (Ind.Ct.App.1991) (covenant to "assume and agree to pay" the mortgage constitutes assumption of note as well).

Assuming "the mortgage" obviously makes the transferee liable for covenants in the mortgage itself. See Rumpf v. Home Fed. Sav. & Loan Ass'n, 667 S.W.2d 479 (Tenn.Ct.App. 1983) (where grantee knowingly takes subject to an existing mortgage, grantee is subject to the attorneys' fee clause in the mortgage); Iowa Nat'l Mutual Ins. Co. v. Central Mortg. & Inv. Co., 708 P.2d 480 (Colo.Ct.App.1985) (where grantee assumes the mortgage, he is bound by a clause requiring assignment of fire insurance proceeds to the mortgagee).

Illustration 3 is based on Dail v. Campbell, 12 Cal.Rptr. 739 (Cal.Ct. App.1961); Morse v. City Fed. Sav. & Loan Ass'n, 567 F.Supp. 699 (S.D.Fla. 1983); Hafford v. Smith, 369 S.W.2d 290 (Mo.Ct.App.1963); Beaver v. Ledbetter, 152 S.E.2d 165 (N.C.1967); Langman v. Alumni Assoc. of the University of Virginia, 442 S.E.2d 669 (Va.1994) (grantee might have avoided liability on assumption agreement in deed by renouncing title to the land, but failed te do so); Beacon Fed. Sav. & Loan Ass'n v. Panoramic Enterprises, Inc., 99 N.W.2d 696 (Wis. 1959). The transferee's understanding as to whether he or she is made personally liable by the assumption language may be shown by parol evidence; see Nutz v. Shepherd, 490 S.W.2d 366 (Mo.Ct.App.1973). See also Heggen Constr. Co. v. Turalba, 565 P.2d 420 (Wash.1977) (evidence sustained finding that grantee took delivery of deed knowingly intending to assume the mortgage obligation described therein).

The great majority of jurisdictions do not regard an agreement to assume liability under a mortgage obligation as falling within the Statute of Frauds. However, a few states have specific statutes requiring a writing for an assumption agreement. See the Statutory Note and Case Note at the end of this section.

Illustration 4 is based on Beaver v. Ledbetter, 152 S.E.2d 165 (N.C.1967) and Elliott v. Sackett, 108 U.S. 132, 2 S.Ct. 375, 27 L.Ed. 678 (1883). Cf. Wolk v. Resolution Trust Corp., 608 So.2d 859 (Fla.Dist.Ct.App.1992) (transferees' assertion that they did not read deed containing assumption clause is an insufficient defense to an action on the debt).

The mortgage remains effective against the real estate despite the transfer of title; see, e.g., Tomkus v. Parker, 224 S.E.2d 353 (Ga.1976); Norwest Bank Marion v. L T Enterprises, Inc., 387 N.W.2d 359 (Iowa.Ct. App.1986); Mancine v. Concord-Liberty Sav. & Loan Assn., 445 A.2d 744 (Pa. Super. Ct. 1982). The existence of a recorded mortgage is constructive notice to a subsequent purchaser of the mortgaged real estate, even if the purchaser has no actual knowledge of the mortgage; Zaltman v. Melrose Sav. Bank, 389 N.E.2d 1039 (Mass.App.Ct.1979).

A distinction is made between assumption and subject-to transfers in cases in which only a part of the mortgaged land is transferred. If the transferee assumes the mortgage, principles of marshaling dictate that the mortgage be foreclosed first against the transferred parcel, since the transferee has become principally liable on the obligation. Epperson v. Cappellino, 298 P. 533 (Cal.Ct.App. 1931). The same result follows after a transfer subject to the mortgage, if it is shown that the purchaser received a credit against the agreed purchase price for the entire balance owing on the obligation. However, if this cannot be shown the portions transferred and retained secure the obligation on a pro rata basis, absent an agreement to the contrary; Meadowlands Nat'l Bank v. Court Devel., Inc., 471 A.2d 801 (N.J. Super. Ct. 1983); Sanders v. Lackey, 439 S.W.2d 610, 616 (Tenn. Ct.App.1968). See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 10.11 (3d ed. 1993).

Mortgage continues to encumber transferred real estate, Comment b. See, e.g., Esplendido Apartments v. Metropolitan Condominium Ass'n of Arizona II, 778 P.2d 1221 (Ariz.1989); Hancock v. Fleming, 3 N.E. 254 (Ind. 1885).

Transferor remains liable, Comment c. Davis v. National Homes Accept. Corp., 523 F.Supp. 477 (N.D.Ala.1981); In re Knevel, 100 B.R. 910 (Bankr.N.D.Ohio 1989) (Veterans Administration, as assignee of original mortgagee, had no obligation to release grantor from liability); Swanson v. Krenik, 868 P.2d 297 (Alaska 1994); Berg v. Liberty Fed. Sav. & Loan Ass'n, 428 A.2d 347 (Del. Super. Ct. 1981); Prudential Sav. & Loan Ass'n v. Nadler, 345 N.E.2d 782 (Ill. App. Ct. 1976); Bradstreet v. Gill, 160 P. 354 (N.M.1916). The continued liability of the transferor is an illustration of a fundamental concept of contract law, as stated in Restatement, Second, Contracts § 318(3):

> Unless the obligee agrees otherwise, neither delegation of performance nor a contract to assume the duty made with the obligor by the person delegated discharges any duty or liability of the delegating obligor.

With respect to situations in which the transferor may be discharged from liability, see § 5.3, Reporters' Note to Comments *a* and *b.*

Transferee is personally liable to mortgagee for obligation secured by mortgage, Comment d. Cases illustrating the transferee's personal liability include United States v.

Wright, 850 F.Supp. 965 (D.Utah 1993) (Utah law); Black v. Krauss, 85 N.E.2d 647 (Ind.Ct.App.1949); Leisure Villa Investors v. Life & Casualty Ins. Co., 527 So.2d 520 (La.Ct.App. 1988); Smith v. General Investments, Inc., 150 So.2d 862 (Miss.1963); First Interstate Bank v. Rebarchek, 511 N.W.2d 235 (N.D.1994); Allgood v. Spearman, 118 S.E. 189 (S.C.1923); Washington Homes Ass'n v. Wanecek, 32 N.W.2d 223 (Wis.1948). For a discussion and rejection of the largely obsolete notion that the mortgagee must bring an action in equity to recover against the transferee, see Bankers Mortg. Corp. v. Jacobs, 613 F.Supp. 1579 (E.D.Va.1985).

Transferee is liable to mortgagee even if transferor had no liability, Comment e. Illustration 11 is based on Schultz v. Weaver, 780 S.W.2d 323 (Tex. Ct. App. 1989) ("[mortgagee] agrees to look only to the property securing said note for satisfaction of default under the terms of the note.").

Illustration 12 is based on Somers v. Avant, 261 S.E.2d 334 (Ga.1979) and Carr v. Nodvin, 342 S.E.2d 698 (Ga.Ct.App.1986). See also Schneider v. Ferrigno, 147 A. 303 (Conn.1929); Tighe v. Walton, 103 So.2d 8 (Miss. 1958). The outcome of cases of this sort depends on the precise terms of the assumption agreement. Thus in Illustration 12, if D had merely assumed "C's duties under the note and mortgage" rather than assuming "liability under the note and mortgage," D would have no personal liability; see Chambers v. Thomas, 844 P.2d 698 (Idaho 1992).

But see Dail v. Campbell, 12 Cal. Rptr. 739 (Cal.Ct.App.1961) (assuming grantee, following break in chain of assumptions, has no personal liability to prior grantor); De Leon v. Rhines, 74 F.2d 477 (D.C.Cir.1934) (assuming grantee, following break in chain of assumptions, has no personal liability to mortgagee); Bonhoff v. Wiehorst, 108 N.Y.S. 437 (N.Y.Sup. Ct.1908) (where grantor was a party to the mortgage but not the bond, she had no personal liability, and an assumption agreement by her grantee did not impose such liability upon him). See generally G. Glenn, Mortgages § 271 (1943); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.15 (3d ed. 1993); Annot., 12 A.L.R. 1529 (1921).

Assuming junior mortgagee who takes a subordinate security interest is liable to senior mortgagee irrespective of consideration, Comment f. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.16 (3d ed. 1993). The following cases state the rule that the senior mortgagee may hold the assuming junior mortgagee liable only if consideration flowed from the senior: Downs v. Ziegler, 477 P.2d 261 (Ariz. Ct.App.1970); Savings Bank of Southern California v. Thornton, 44 P. 466 (Cal.1896); Garnsey v. Rogers, 47 N.Y. 233 (1872). For cases in which the court found the requisite consideration, see Kozan v. Levin, 374 N.Y.S.2d 829 (N.Y.App.Div.1975) (senior mortgagee gave forbearance agreement in return for junior mortgagee's assumption). The rule stated in this subsection is criticized in G. Osborne, Mortgage § 266 (1951).

In general, consideration is required for an assumption of mortgage liability by a transferee, as for any other contract; see Robertson v. Robertson, 61 So.2d 499 (Fla.1952). However, where the assumption is part of the same transaction in which the real property, or some interest in it, is transferred to the assuming party, consideration obviously exists. The point of this subsection is that the consideration need not flow from the mortgagee, although it may do so; see Federal Land Bank of Wichita v. Krug, 856 P.2d 111 (Kan.1993) (mortgagee's review and approval of transferee was sufficient consideration for transferee's assumption of mortgage).

Transferee in a sale transaction may not assert transferor's defenses, Comment g. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.17 (3d ed. 1993); Annot., 141 A.L.R. 1184 (1942). See Michigan Wineries, Inc. v. Johnson, 242 N.W.2d 568 (Mich.Ct.App.1976) (grantee not permitted to assert that the original mortgage transaction violated state alcoholic beverage control statute); Northeast Savings v. Sennett, 555 N.Y.S.2d 915 (N.Y.App.Div. 1990) (grantee of property assumed existing construction loan, was not permitted to assert that some of the construction funds had been diverted through the mortgagee's negligence); Barber v. Federal Land Bank of Houston, 204 S.W.2d 74 (Tex. Ct. Civ. App. 1947) (grantee may not raise defenses based on error in legal description in mortgage or incompetency of mortgagor).

Effect of modification or rescission of an assumption agreement, Comment h. See Restatement, Second, Contracts § 311, Comment *f* and Illustration 8; 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.18 (3d ed. 1993); Copeland v. Beard, 115 So. 389 (Ala.1928) (where assumption agreement is rescinded before mortgagee has knowledge of the agreement, mortgagee cannot enforce it); Gibson v. Hambleton, 72 N.W. 1033 (Neb. 1897) (where assumption agreement is made for the benefit of, and with the express knowledge and consent of the mortgagee, a subsequent rescission between grantor and grantee will not bind the mortgagee); Barber v. Federal Land Bank of Houston, 204 S.W.2d 74 (Tex. Ct. Civ. App. 1947) (rescission without consent of mortgagee not binding on mortgagee); Annot., 47 A.L.R. 339, 342–43 (1927); Annot., 21 A.L.R. 439, 462–69 (1922).

Transferor's recourse against transferee, Comment i. With respect to the transferor's rights of subrogation and reimbursement, see Kyner v. Clark, 29 F.2d 545 (8th Cir.1928); Clayton v. Ft. Worth State Bank, 4 F.2d 763 (5th Cir.1925); Swanson v. Krenik, 868 P.2d 297 (Alaska 1994) (in chain of assumptions, ultimate liability rests upon grantees in the inverse order of assumption); Jones v. Rhodes, 75 N.W.2d 616 (Neb.1956); Thompson v. Miller, 79 S.E.2d 643 (Va.1954); Annot., 2 A.L.R. 242 (1919). See also Restatement Third, Suretyship and Guaranty §§ 22–24, 27–31; Restatement of Security §§ 103–111.

With respect to the transferor's right to recover from the transferee without first paying the obligation, see generally G. Glenn, Mortgages § 260 (1943); Riedle v. Peterson, 560 N.E.2d 725 (Mass.App.Ct.1990); Williams v. Fowle, 132 Mass. 385 (1882); Finzer v. Peter, 232 N.W. 762 (Neb.1930); Ruzyc to use of Bumbaugh v. Brown, 181 A. 783 (Pa.1935); Jones v. Bates, 127 S.E.2d 618 (S.C. 1962); Linbrook Realty Corp. v. Rogers, 163 S.E. 346 (Va.1932); Marshall v. Davies, 78 N.Y. 414, 422 (1879). Contra, see Stalcup v. Easterly, 351 P.2d 735 (Okla.1960) (grantor's right to recover against assuming grantee does not arise until grantor pays the deficiency owing on the debt). On the duty of the transferor to hold and pay over to the mortgagee any recovery obtained by way of exoneration, see Gustafson v. Koehler, 224 N.W. 699 (Minn. 1929); Claise v. Bernardi, 413 N.E.2d 609 (Ind.Ct.App.1980).

Additional cases holding that the transferee is personally liable to the transferor, but not dealing with the question whether the transferor must first discharge the obligation, include Toler v. Baldwin County Sav. & Loan Ass'n, 239 So.2d 751 (Ala.1970); Penney v. Odom, 71 So.2d 881 (Ala.1954); Fishel v. McDonald, 60 A.2d 820 (Pa. Super. Ct. 1948); and Jones v. Bates, 127 S.E.2d 618 (S.C.1962).

STATUTORY NOTE ON MORTGAGE ASSUMPTION FORMALITIES

California: Writing required; Cal. Civ. Code § 1624. "The following contracts are invalid, unless, the same, or some note or memorandum thereof, is in writing ... (7) An agreement by a purchaser of real property to pay an indebtedness secured by a mortgage or deed of trust upon the property purchased, unless assumption of said indebtedness by the purchaser is specifically provided for in the conveyance of such property."

See Cornelison v. Kornbluth, 125 Cal.Rptr. 557 (Cal. 1975), applying this statute.

Delaware: 25 Del. Code § 2713. "No action shall be brought to charge ... any defendant, upon any special promise, to answer for the debt, default, or miscarriage of another person, ... unless ... such promise and assumption is proved by the oath or affirmation of one credible witness, or some memorandum, or note in writing is signed by the party to be charged therewith." (It is unclear whether this statute would be applied to an assumption of an obligation secured by a mortgage, in view of the statute's use of the word "assumption.")

Idaho: Writing not required; Idaho Code Ann. § 9-506. "A promise to answer for the obligation of another, in any of the following cases, is deemed an original obligation of the promisor, and need not be in writing; ... 3. Where the promise, being for an antecedent obligation of another, is made upon ... a consideration beneficial to the promisor, whether moving from either party to the antecedent obligation, or from another person."

Substantially identical language is found in the statutes of Montana, North Dakota, Oklahoma, and Utah. Mortgage assumption agreements appear to fall within these statutes, and therefore not to require a writing; the grantor's promise to pay the debt is obviously "made upon ... a consideration beneficial to the promisor," namely the conveyance of the real estate. See Treasure Valley Plumbing & Heating, Inc. v. Earth Resources Co., 766 P.2d 1254 (Idaho Ct.App. 1988) (where the party assuming the indebtedness obtains a new benefit, his promise is original and not required to be in writing); Strange v. Maloney, 61 P.2d 725 (Okla.1936) (under statute, parol mortgage assumption agreement is enforceable if "clear and convincing"); McCormick v. Johnson, 78 P. 500, 502 (Mont. 1904): under statute,

> When the original debt was antecedently contracted and subsists, the promise to pay it is original if founded upon a new consideration moving to the promisor, and beneficial to him, and such that the

promisor thereby comes under an independent duty of payment, irrespective of the liability of the principal debtor.

Minnesota: Writing required in some circumstances; Minn. Stat. § 47.20, Subd. 6a. "If the purpose of a conventional loan dwelling for the borrower's primary residence, the lender shall consent to the subsequent transfer of the real estate and shall release the existing borrower from all obligations under the loan instruments, if the transferee ... (2) executes an agreement in writing with the lender whereby the transferee assumes the obligations of the existing borrower under the loan instruments, and (3) executes an agreement in writing to pay interest on the remaining obligation at a new interest rate...." (Note that this statute is arguably preempted by § 341, Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3.)

Montana: Writing not required; Mont. Code Ann. § 28-11-105. (Identical to Idaho statute.)

New Jersey: Writing required; N.J. Stat. Ann. § 46:9-7.1. "Whenever real estate ... shall be sold and conveyed subject to an existing mortgage or is at the time of any such sale or conveyance subject to an existing mortgage, the purchaser shall not be deemed to have assumed the debt secured by such existing mortgage and the payment thereof by reason of the amount of any such mortgage being deducted from the purchase price or by being taken into consideration in adjusting the purchase price, nor for any other reason, unless the purchaser shall have assumed such mortgage debt and the payment thereof by an express agreement in writing signed by the purchaser or by the purchaser's acceptance of a deed containing a covenant to the effect that the grantee assumes such mortgage debt and the payment thereof."

See Dieckman v. Walser, 168 A. 582 (N.J. 1933), decided before the adoption of the above statute, and holding a parol assumption of a mortgage obligation enforceable if established by clear and convincing evidence.

New York: Writing required; McKinney's New York Gen. Oblig. Law § 5-705. "No grantee of real property shall be liable upon any indebtedness secured by a mortgage thereon executed ... unless such grantee shall simultaneously with the conveyance to him of such real property execute and acknowledge ... a statement in writing stating in substance that such grantee assumes and agrees to pay such mortgage debt and giving the specific amount of the debt assumed."

See Northeast Savings v. Sennett, 555 N.Y.S.2d 915 (N.Y.App.Div.1990) (where purchaser assumed a construction mortgage by complying with above statute, he was estopped to avoid full liability on the debt despite his claim that the original mortgagor had diverted some funds from the construction project); Northeast Savings v. Bailey, 532 N.Y.S.2d 591 (N.Y.App.Div.1988) (under above statute, if grantee does not sign deed containing assumption clause, the property remains principally liable to satisfy the mortgage debt); Yager v. Rubymar Corp., 230 N.Y.S.2d 609 (N.Y.Sup.Ct.1962), holding the predecessor of the above statute inapplicable to a mortgage on property located in New Jersey.

North Dakota: Writing not required; N.D. Cent. Code § 22-01-05. (Identical to Idaho statute.)

Oklahoma: Writing not required; 15 Okla. Stat. Ann. § 325. (Identical to Idaho statute.)

Utah: Utah Code Ann. § 57-15-8. "(1) In order to effect an assumption under this chapter the original borrower ... shall give to the lender a written notice and request for an assumption...." See also Utah Code Ann. § 25-5-6. (Identical to Idaho statute.)

CASE NOTE ON MORTGAGE ASSUMPTION FORMALITIES

Alaska: Chena Lumber & Light Co. v. Laymon, 4 Alaska 221 (1910) (assumption of mortgage is an original undertaking and not within statute of frauds).

Arizona: Clack v. Rico, 204 P. 137 (Ariz.1922) (assumption of debt in exchange for secured property not required to be in writing).

Arkansas: Curlee v. Morris, 120 S.W.2d 10 (Ark.1938) (promise by grantee of land to pay debt of grantor as consideration for purchase is not within statute of frauds).

California: Miller v. Roach, 59 P.2d 418 (Cal.Ct.App.1936) (mortgage assumption may be shown by parol evidence if "clear and convincing"). But see Cal. Civ. Code § 1624, quoted supra.

Colorado: Enos v. Anderson, 93 P. 475 (Colo.1907) (mortgage assumption agreement not required to be in writing).

Connecticut: Cassidy v. Bonitatibus, 497 A.2d 1018 (Conn. App. Ct. 1985) (assumption may be shown by parol evidence, if "clear and convincing"); Foster v. Atwater, 42 Conn. 244 (1875) (same).

Indiana: Gregory v. Arms, 96 N.E. 196 (Ind.Ct.App.1911) (assumption of mortgage debt is not promise to pay the debt of another, and is outside statute of frauds).

Iowa: Lamb v. Tucker, 42 Iowa 118 (1875) (purchaser who agrees to pay mortgage debt is bound despite absence of writing).

Kansas: McAndrew v. Sowell, 163 P. 653 (Kan.1917) (assumption by grantee of encumbrance is not within statute of frauds).

Maine: Flint v. Winter, 36 A. 634 (Me.1896) (assumption agreement is not within statute of frauds).

Maryland: Daugharthy v. Monritt Associates, 444 A.2d 1030 (Md.1982) (statute of frauds inapplicable to mortgage assumptions); Brice v. Griffin, 307 A.2d 660 (Md.1973) (parol evidence admissible to prove intent to assume liability); Rosenberg v. Rolling Inn, 129 A.2d 924 (Md.1957) (where promise of assumption is made to the original debtor and not to the creditor, it is not within the statute of frauds).

Massachusetts: Brockton Savings Bank v. Shapiro, 88 N.E.2d 344 (Mass.1949) (statute of frauds inapplicable to mortgage assumptions).

Michigan: Keeler v. Richards Storage Corp., 260 Mich. 23, 244 N.W. 215 (1932) (oral assumption agreement will support an action for a deficiency against the assuming grantee).

Mississippi: Lee v. Newman, 55 Miss. 365 (1877) (vendee's oral agreement to pay mortgage debt is binding).

Missouri: Stevenson v. Stevenson, 618 S.W.2d 715 (Mo.Ct.App.1981) (assumption may be shown by parol evidence if "clear and convincing"); Hafford v. Smith, 369 S.W.2d 290 (Mo.Ct. App.1963) (assumption agreement is not a "promise to answer for the debt of another" and is not within the corresponding section of the statute of frauds).

Nebraska: Clay v. Tyson, 26 N.W. 240 (Neb.1886) (oral assumption agreement is enforceable).

Nevada: Simpson v. Harris, 31 P. 1009 (Nev.1893) (oral promise to pay debt of another is not within statute of frauds if security for such debt is transferred in exchange).

North Carolina: Parlier v. Miller, 119 S.E. 898 (N.C.1923) (oral promise by grantee of land to assume mortgage on such land is not within statute of frauds).

Ohio: Society of Friends v. Haines, 25 N.E. 119 (Ohio 1890) (assumption of mortgage is not within statute of frauds).

Oregon: Stotts v. Johnson, 235 P.2d 560 (Or.1951) (statute of frauds inapplicable to mortgage assumptions).

Rhode Island: Urquhart v. Brayton 12 R.I. 169 (1878) (an implied assumption of mortgage does not fall within statute of frauds).

Tennessee: Ruohs v. Traders' Fire Ins. Co., 78 S.W. 85 (Tenn.1903) (grantee's assumption of mortgage is not within statute of frauds).

Washington: Federal National Mortgage Ass'n v. Carrington, 374 P.2d 153 (Wash.1962) (mortgage assumption is enforceable despite lack of a signed, written agreement by grantee).

Wisconsin: Morgan v. South Milwaukee Lake View Co., 72 N.W. 872 (Wis.1897) (where part of consideration for purchase of land was promised to pay mortgage, such agreement was not promise to pay debt of another).

Wyoming: Bolln v. La Prele Live Stock Co., 196 P. 748 (Wyo.1921) (agreement to assume mortgage in exchange for land may be oral).

§ 5.2 Transfers Without Assumption of Liability

When mortgaged real estate is transferred without assumption of liability:

(a) the mortgage remains effective against the real estate in the hands of the transferee; and

(b) the transferor remains personally liable for the covenants in the mortgage and for the obligation secured by the mortgage, to the extent such liability existed prior to the transfer; and

(c) in the event of a default in the performance of the obligation secured by the mortgage, the mortgagee has the right (except as limited by the parties' agreement, by statute, and by §§ 5.3, 8.2, and 8.4):

(1) to proceed against the transferor personally, to the extent of the transferor's liability, and

(2) to enforce the mortgage, and thereafter to proceed against the transferor personally, to the extent of the transferor's liahility, for any deficiency.

(d) The transferee does not become personally liable, by virtue of the transfer, for the obligation secured by the mortgage.

(e) If the transfer is a sale and the amount of the mortgage obligation is credited against the price paid, the transferor is regarded as a secondary obligor, and the mortgaged real estate as a principal obligor, under the principles of Restatement Third, Suretyship and Guaranty. If the transferee defaults in performance of the obligation secured by the mortgage, the transferor is entitled to relief against the security of the mortgaged real estate by way of subrogation (Restatement Third, Suretyship and Guaranty §§ 27–31).

Cross-References:

Section 5.1, Transfers with Assumption of Liability; § 5.3, Discharge of Transferor from Personal Liability; § 7.6, Subrogation; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage; § 8.4, Foreclosure: Action for a Deficiency; § 8.5, The Merger Doctrine Inapplicable to Mortgages; Restatement Third, Property (Servitudes) §§ 3.1, 3.2 (Tentative Draft No. 2, 1991).

Comment:

a. Transferor remains liable. The transfer of mortgaged real estate does not operate to relieve the transferor from whatever personal liability he or she previously held. This result is otherwise if the mortgagee expressly releases the transferor from liability. The transferor's liability may also be restricted or eliminated by a one-action or antideficiency statute.

In general the mortgagee may proceed personally against the transferor in either of two ways: by a direct action on the debt or other obligation, or by seeking a deficiency after foreclosing the mortgage. See Illustration 1. The election of remedies required by § 8.2 and the fair value principle of § 8.4 may operate to restrict the mortgagee's actions. The transferor's liability is not enlarged by the making of the transfer; hence, if the original debt was partially or entirely non-recourse, it remains such as against the transferor after the transfer. See § 1.1 and § 5.1, Illustration 6.

Illustration:

1. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and does not assume the mortgage. If a default occurs in payment on the note, B may either recover the balance owing on the note by means of a personal action against A, or foreclose the mortgage and seek a judgment against A for any resulting deficiency, subject to the principles of §§ 8.2 and 8.4.

b. Transferee does not become personally liable, absent assumption. A transferee does not, merely by acquiring mortgaged real estate, become personally liable on the obligation secured by the mortgage. Only an express assumption of liability will have that effect. This is true even though the balance owing on the mortgage obligation is credited against the purchase price, as is usually the case. A non-assuming transferee has the risk of loss of title to the real estate by foreclosure if the secured obligation is not performed, but is subject to no further liability.

The amount of the indebtedness to be paid from the proceeds of a foreclosure sale is not necessarily limited to the balance owing on the obligation evidenced by the promissory note or other debt instrument. It may also include amounts incurred under the terms of the mortgage itself. For example, if the mortgage contains an enforceable attorneys' fee clause, the amount of the attorneys' fees may be recovered by the mortgagee from the foreclosure proceeds. However, the transferee is not personally liable for such attorneys' fees.

Notwithstanding the general insulation of the non-assuming transferee from personal liability on the note and mortgage obligations, the transferee may nonetheless be held personally liable by the mortgagee for waste committed on the premises, at least to the extent that the transferee's acts would constitute waste irrespective of the covenants in the mortgage itself. However, the mortgagee has no duty to the transferor to pursue an action in waste.

In addition, the mortgage itself may contain covenants affecting the use, maintenance, or improvement of the real estate which might be regarded as "running with the land" so as to burden a grantee even in the absence of an assumption agreement. See § 4.6, Comment *j*, which observes that such covenants will run to bind the mortgagor's successors to the extent that their subject matter is within the scope of the law of waste, as delineated by § 4.6. This Restatement takes no position as to whether covenants outside the scope of the law of waste will become the personal obligations of nonassuming transferees.

Illustration:

2. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash, but does not enter into an assumption of liability. If a default occurs in payment on the note, C may not be held personally liable for the indebtedness, either by A or B.

c. Transferor who pays obligation in full may foreclose mortgage. In a transfer in which the transferee does not assume liability for the mortgage obligation, but the balance owing on the obligation is credited against the price paid by the transferee, it is ordinarily the intent of the transferor and transferee that the transferee will in fact pay the obligation. If the transferee fails to do so, the transferor may pay it voluntarily or (if he or she is personally liable on the obligation) may be compelled to do so by a personal judgment obtained by the mortgagee.

In such an instance, the transferor, by virtue of making that payment, acquires an equitable right to be regarded as the owner of the mortgage, and to enforce it against the real estate in the hands of the transferee. This right is usually described as being one of subrogation or as analogous to subrogation; see § 7.6. It is said that the land becomes principally liable for payment of the obligation, and the transferor occupies the position of a surety and becomes secondarily liable. The subrogation right is governed by Restatement Third, Suretyship and Guaranty §§ 27–31. Subrogation here differs from the subrogation right against an assuming transferee, discussed in § 5.1, in that it lies only against the land and not against the transferee personally. See also Restatement Third, Suretyship and Guaranty § 2(f) and Comment *f*.

The transferor's right to foreclose the mortgage upon payment of the debt arises only in cases where the original transfer was a sale; it is the fact that the balance owing on the mortgage obligation was credited against the price which gives rise to the inference that the transferee is expected to discharge the obligation. Whether a similar expectation can be found in a gift transaction depends on the parties' understanding and intent. If the transferor promises or intends to discharge the obligation in full in due time, thus ultimately conferring on the transferee an unencumbered title, then no right of subrogation exists. But if the gift is only of the transferor's equity of redemption, and the transferee is expected to discharge the obligation, then the transaction is not a "pure" gift, but rather a "bargain sale," and upon the transferee's default and the transferee's performance of the obligation, a right of subrogation as against the land arises in the transferor.

Some additional forms of "subject-to" transfer will not entitle the transferor to subrogation. For example, the transferee may make an initial cash payment that is less than the full agreed price, and may promise to pay the remainder of the price in installments (which may be secured by a second or "wraparound" mortgage.) See § 7.8. In this form of sale, the original mortgage remains on the real estate, and the parties expect that the transferor, not the transferee, will make the further payments on it as they fall due. If the transferor unjustifiably fails to do so, thus causing a default in the "underlying" mortgage obligation, he or she does not have the rights described in this subsection. Similarly, in rare cases the transferee may pay the full cash price for the real estate with the expectation or understanding that the transferor will discharge the mortgage in due time. Here again, the transferor who defaults in this duty has no right of subrogation against the land.

As discussed in § 5.1, Comment *i*, the transferor may enforce the mortgage only after fully discharging the secured obligation. It would be unsound to award the transferor this right after only a partial discharge, thus bifurcating the mortgage security. See § 7.6, Comment *a*; Restatement Third, Suretyship and Guaranty § 28.

A further question arises as to the transferor's right to foreclose the mortgage by way of subrogation if the transferor pays the mortgage obligation despite the absence of any personal obligation to do so. For example, the obligation may originally have been nonrecourse in nature, or the transferor may have been a subject-to transferee in a prior transaction, and thus have assumed no personal liability. In such a case it may not be obvious why the transferor would pay the mortgage, but plausible reasons may exist. For example, such a payment might serve to protect or enhance the transferor's business reputation by making the payment; or the transferee may be a close relative of the transferor, who may make the payment to avoid a foreclosure that would take the real estate out of the family.

Even when the transferor has no personal liability, this Restatement recognizes that the transferor may have a right of subrogation if the transferor performs to protect an interest. See § 7.6(b)(1) and Comment *b* thereunder. To this extent, it rejects the "volunteer rule," which has sometimes been employed to deny a right of subrogation to one who pays a mortgage debt with no personal liability and with no property interest to protect. That rule has been applied in an unpredictable and inconsistent manner. In a "subject-to" transfer, the transferor is obviously no stranger to the mortgage. Even in the absence of personal liability, such an individual may have a sufficient interest in performing the obligation. A transferor who does so should acquire the mortgagee's rights against the real estate.

Section 5.1(d) recognizes that in transfers with mortgage assumption, the transferor has not only subrogation rights, but also personal claims for reimbursement, restitution, and exoneration against the transferee. However, in the context of the present section, dealing with sales subject to a mortgage but without assumption, the rights of reimbursement, restitution, and exoneration, which are predicated on the transferee's personal liability, do not exist. Nonetheless a personal judgment in favor of the transferor enjoining or awarding damages for waste might be entered against the nonassuming transferee. Such a judgment might be similar in its effect to an action for exoneration. See Restatement Third, Suretyship and Guaranty § 21, Comment *j*.

Illustration:

3. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. The note provides that A will not be personally liable on the debt. Subsequently A sells the house to C, who is A's daughter, for $125,000. C pays A $25,000 in cash, and does not enter into an assumption of liability. Thereafter C defaults in payment on the note. In order to protect C from eviction as a result of B's foreclosure of the mortgage, A pays $100,000 to B, thereby fully discharging the debt. A is subrogated to B's rights in the mortgage, and is entitled to an assignment of the mortgage upon request. Whether or not A obtains a formal assignment, A is entitled to foreclose the mortgage against C.

d. Transferee in a sale transaction may not assert transferor's defenses. When the transferee in a sale of land takes subject to an existing mortgage, and the amount owing on the obligation secured by the mortgage is credited against the purchase price, it is implicit that the parties expect the transferee to discharge the mortgage obligation as part of the price. The transferee is not permitted to evade this expectation by raising defenses to enforcement of the mortgage, even if the transferor might have raised such defenses. To permit the transferee to do so would result in the transferee's unjust enrichment. See Illustration 4.

This restriction on the raising of defenses does not apply te gift transfers, or to sales in which the transferee pays the full price in cash with the understanding that the transferor will discharge the mortgage obligation. In these circumstances there is no unjust enrichment in permitting the transferee to raise any available defenses. Likewise, a junior mortgagee who takes subject to a senior mortgage is fully permitted to raise defenses against the senior mortgage and obligation. See § 5.1, Illustration 16.

Section 5.1, Comment *g*, contains further commentary which is applicable by analogy to the present topic.

Illustration:

4. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C for $125,000. C pays A $25,000 in cash and takes subject to the mortgage, but does not assume it. C then discovers that B never advanced the $100,000 in loan proceeds to A, a fact that constitutes failure of consideration, a complete defense on the note. In a proceeding by B to foreclose the mortgage, C is not permitted to raise this defense.

REPORTERS' NOTE

Transferor remains liable, Comment a. Illustration 1 is based on Hazifotis v. Citizens Fed. Sav. & Loan Ass'n, 505 N.E.2d 445 (Ind.Ct. App.1986) and Bradstreet v. Gill, 160 P. 354 (N.M.1916). The following cases employ the principles discussed in Illustration 1.

The original mortgagor or transferor continues to be liable in a direct action on the debt, notwithstanding the transfer of the mortgaged real estate: Blackmon v. Patel, 396 S.E.2d 128 (S.C.App.1990); United States v. Rivera, 671 F.Supp. 886 (D.P.R.1987); Berg v. Liberty Fed. Sav. & Loan Ass'n, 428 A.2d 347 (Del.1981).

The original mortgagor or transferor is liable for a deficiency judgment after foreclosure of the mortgage, notwithstanding the transfer of the mortgaged real estate: Hazifotis v. Citizens Fed. Sav. & Loan Ass'n, 505 N.E.2d 445 (Ind.Ct.App. 1986); Moore v. Lewis, 9 Ill.Dec. 337, 366 N.E.2d 594 (Ill. App. Ct. 1977).

The operative principle of this subsection serves to continue the liability, not only of the original mortgagor, but also of any assuming transferee who makes a further transfer; see Steinert v. Galasso, 63 A.2d 443 (Pa. Super. Ct. 1949), aff'd, 69 A.2d 841 (Pa.1949).

Transferee does not become personally liable, absent assumption, Comment b. Cases declaring the transferee free of personal liability include Cely v. DeConcini, McDonald, Brammer, Yetwin & Lacy, 803 P.2d 911 (Ariz.Ct.App.1990); Esplendido Apartments v. Metropolitan Condominium Ass'n of Arizona II, 778 P.2d 1221 (Ariz.1989); Northeast Savings v. Rodriguez, 553 N.Y.S.2d 490 (N.Y.App.Div.1990); Sooner Fed. Sav. & Loan Ass'n v. Oklahoma Central Credit Union, 790 P.2d 526 (Okla. 1989); Cassidy v. Bonitatibus, 497 A.2d 1018 (Conn. App. Ct. 1985); Life Sav. & Loan Ass'n v. Bryant, 467 N.E.2d 277 (Ill. App. Ct. 1984); Dorothy Edwards Realtors, Inc. v. Mc-

Adams, 525 N.E.2d 1248 (Ind.Ct.App. 1988); Trauner v. Lowrey, 369 So.2d 531 (Ala.1979); Fye v. Cox, 263 N.W.2d 725 (Iowa 1978); Tomkus v. Parker, 224 S.E.2d 353 (Ga.1976); and Zastrow v. Knight, 229 N.W. 925 (S.D. 1930). See also cases cited in Reporters' Note to Comment *a*; Annot., 94 A.L.R. 1329 (1935).

If a non-assuming transferee files a petition under Chapter 11 of the Bankruptcy Code, the mortgagee may be permitted to make a claim against the bankruptcy estate under § 1111(b) for the full amount of the debt, not limited by the value of the real estate. See In re 680 Fifth Avenue Assoc. v. Mutual Benefit Life Ins. Co., 29 F.3d 95 (2d Cir.1994).

The mortgagee's right to recover attorneys' fees, as provided for in a mortgage clause, in foreclosure against a non-assuming transferee, is recognized in Rumpf v. Home Fed. Sav. & Loan Ass'n, 667 S.W.2d 479 (Tenn.Ct.App.1983).

The mortgagee's right to hold the transferee personally liable for waste, despite the absence of an assumption agreement, is illustrated by Taylor v. Brennan, 621 S.W.2d 592 (Tex.1981) and Prudential Ins. Co. v. Spencer's Kenosha Bowl, Inc., 404 N.W.2d 109 (Wis.App. 1987). These holdings do not depend on the running of mortgage covenants with the real estate, for common-law waste is derived from tort, not contract, principles. Whether similar liability would extend to actions that would not be waste at common law, but are made waste because they violate covenants in the mortgage (see § 4.6(a)(4)), is uncertain; see the discussion of the running of mortgage covenants in the next few paragraphs. The mortgagee has no duty to the mortgagor to pursue an action in waste; see Damiano v. Bergen County Land Co., 180 A. 489 (N.J. 1935); G. Osborne, Mortgages § 135 (1951).

As just noted, a question exists as to whether a non-assuming grantee may be held personally liable for breach of covenants in the original mortgage that "touch and concern the land" or satisfy a modern equivalent of that principle. See Restatement Third, Property (Servitudes) §§ 3.1, 3.2 (Tentative Draft No. 2, 1991). It is settled that a covenant in the mortgage to perform the secured obligation does not touch and concern the land, and hence does not "run with the land" and burden non-assuming grantees. See, e.g., Schram v. Coyne, 127 F.2d 205 (6th Cir.1942); Seventeenth & Locust Streets Corp. v. Montcalm Corp., 54 F.2d 42 (3d Cir. 1931); Clement v. Willett, 117 N.W. 491 (Minn.1908).

However, other covenants sometimes found in mortgages might be regarded as having a closer connection to the real estate, and hence as burdening non-assuming grantees. A covenant requiring certain levels of maintenance or repair on the real estate, or conceivably one requiring the payment of taxes or insurance premiums, might be regarded as having this quality. However, case authority on the point is extremely meager, and all of the reported cases deal with covenants to pay ground rent or taxes, breaches of which might well be considered waste even if the covenant's burden did not run with the real estate. See Union Trust Co. v. Rosenburg, 189 A. 421 (Md.Ct.App. 1937) (covenant to pay taxes); Jones v. Burgess, 4 A.2d 473 (Md.Ct.App. 1939) (covenants to pay ground rent and taxes); McKinnon v. Bradley, 165 P.2d 286 (Or.1946) (covenant to pay taxes). By analogy, see Esplendido

Apartments v. Metropolitan Condominium Ass'n, 778 P.2d 1221 (Ariz. 1989), holding that a due-on-sale clause "ran with the land" and bound a non-assuming grantee; but the mortgagee's remedy in that situation was acceleration and foreclosure, not damages against the grantee. See generally Leipziger, The Mortgagee's Remedies for Waste, 64 Cal. L. Rev. 1087, 1133–35 (1976), suggesting that the absence of horizontal privity of estate between mortgagee and original mortgagor might be a barrier to the running of such covenants. However, under modern covenant concepts, privity might well be disregarded; see Restatement Third, Property (Servitudes) §§ 5.1–5.2 (Tentative Draft No. 5, 1995). Moreover, privity is not required when the plaintiff seeks an equitable remedy for breach of a covenant. As noted in Comment *b*, this Restatement takes no position on whether mortgage covenants may run with the real estate and bind subsequent nonassuming grantees.

Transferor who pays obligation in full may foreclose mortgage, Comment c. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.9 (3d ed. 1993); G. Glenn, Mortgages § 259 (1943).

Cases recognizing the transferor's right to foreclose the mortgage against the "subject-to" transferee are collected in Annot., 2 A.L.R. 242 (1919); see, e.g., Finance Co. of America v. Heller, 234 A.2d 611 (Md. 1967); Smith v. Mangels, 240 P.2d 168 (Ariz.1952); Vincent v. Garland, 58 P.2d 1320 (Cal.Ct.App.1936); Seward v. New York Life Ins. Co., 152 S.E. 346 (Va.1930); Zastrow v. Knight, 229 N.W. 925 (S.D.1930); University State Bank v. Steeves, 147 P. 645 (Wash. 1915); and Johnson v. Zink, 51 N.Y. 333 (1873).

The transferor's claim of subrogation was rejected in Best Fertilizers of Arizona, Inc. v. Burns, 570 P.2d 179 (Ariz.1977). The court reasoned that when the original mortgagor paid the debt, the liability of the mortgagor (and hence the mortgage itself) were canceled under the language of pre-1990 U.C.C. § 3–601(3), which provided:

> The liability of all parties is discharged when any party who has himself no right of action or recourse on the instrument ... acquires the instrument in his own right....

The defect in the court's reasoning arises because of its narrow reading of the phrase " ... who has himself no right of recourse on the instrument." While it is technically correct that the subject-to transferor's right of subrogation is not an action on the instrument, it is the practical equivalent of such an action, to the extent of the value of the real estate. The transferor and mortgagee obviously intend no discharge of the mortgage, and to find such a discharge confers unjust enrichment upon the transferee. Best Fertilizers of Arizona, Inc. v. Burns is not followed in this Restatement. Cases rejecting its underpinnings, and upholding the mortgagor's right of subrogation, include Beach v. Waite, 131 P. 880 (Cal.Ct.App.1913); Baker v. Northwestern Guaranty Loan Co., 30 N.W. 464 (Minn.1886). See Annot., 2 A.L.R. 242 (1919).

The transferor's right to an equitable decree compelling the mortgagee to make a written assignment of the mortgage to the transferor who pays the debt was recognized in Howard v. Robbins, 63 N.E. 530 (N.Y. 1902). See generally § 7.6, Comment *a*; Restatement Third, Suretyship and Guaranty § 28, Comment *h*; 1 G. Nelson & D. Whitman, Real Estate Finance Law § 10.8 (3d ed. 1993).

The original mortgagor or transferor is entitled to claim the subrogation right to foreclose the mortgage, even though he or she is not personally liable for it; see Ohmer v. Boyer, 7 So. 663 (Ala.1890); Manilla Anchor Brewing Co. v. Raw Silk Trading Co., 148 N.Y.S. 119 (N.Y.App.Div. 1914); Jones, Mortgages § 1120 (1928). These cases properly reject the "volunteer rule"; see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 10.4 (3d ed. 1993), suggesting that the volunteer rule should be discarded except when the payor clearly intended a gift. With respect to the characterization of the transfer as a gift as depending on the transferor's intent, see G. Osborne, Mortgages § 251 (1951).

Some sources loosely refer to the right of the transferor who discharges the obligation to foreclose the mortgage against the transferee as a right of "reimbursement" or "exoneration" against the land. See, e.g., G. Osborne, Mortgages § 252 n.53; § 286 n.31 (1951). However, such an action is technically based on subrogation; reimbursement and exoneration operate *in personam* and are unavailable where, as here, the transferee has no personal liability.

The requirement that the transferor in a subject-to sale pay the debt in full, as a precondition to asserting his or her subrogation right to foreclose the mortgage, was recognized in Steinert v. Galasso, 69 A.2d 841, 842 (Pa. 1949):

> It is settled that by taking "under and subject" without more, the grantee agrees to indemnify his grantor against loss and that a grantee who ... "shall, by an agreement in writing, have expressly assumed a personal liability" for the debt, thereby agrees to indemnify *not merely against loss but against liability.* ... In taking "under and subject," the grantee assumes an obligation enforceable when (but not before) the grantor sustains a loss, but in cases of agreement to pay the debt, the grantor's liability to his creditor may be enforced when the debt matures and remains unpaid, without waiting until the grantor has paid. (Italics added)

The quotation above must be read in light of the unusual Pennsylvania rule imposing a duty by the non-assuming grantee to indemnify the grantor after a transfer in which the balance on the mortgage debt is deducted from the cash price; see Reporters' Note to § 5.1, Comment *a*. Nevertheless, the court's distinction between recovery for actual loss (by way of subrogation) when the grantee does not assume and indemnity for liability (by way of reimbursement or exoneration) when the grantee expressly assumes is sound. To the same effect, see Linbrook Realty Corp. v. Rogers, 163 S.E. 346 (Va. 1932); Finzer v. Peter, 232 N.W. 762 (Neb.1930).

The right of the transferor to hold the non-assuming transferee liable personally for waste has been suggested by commentators, but no case has been found on the subject. See G. Osborne, Mortgages § 135 n.32 (1951); Note, 36 Colum. L. Rev. 329 (1936). Several cases recognize the right of the transferor to appointment of a receiver of the property in the hands of the non-assuming transferee, provided the jurisdiction's usual requirements for a receivership are met. See American Comm. & Sav. Bank v. McCammond, 238 N.W. 77, 78 A.L.R. 866 (Iowa 1931); Philadelphia Mortg. & Trust Co. v. Oyler, 85 N.W. 899 (Neb.1901); Annot., 78 A.L.R. 872 (1932).

Illustration 3 is based loosely on Springham v. Kordek, 462 A.2d 567 (Md.Ct.App.1983). In that case children paid their mother's mortgage debt after she was abandoned by the children's father, and the father subsequently acquired full title to the property as surviving tenant by the entirety upon the mother's death. The children were held entitled to subrogation against the father, notwithstanding their lack of legal obligation to make the payments. The court found that they were not mere volunteers since (1) they had an interest to protect, as potential heirs of the property; (2) they had a moral obligation to provide a home for their mother; and (3) they acted at their mother's request. The case does not involve a transfer of the mortgaged real estate from the children to their mother.

Cf. Blackford v. Dickey, 789 S.W.2d 445 (Ark.1990): Parents paid a mortgage debt on the house belonging to their daughter and son-in-law. The daughter and her husband subsequently divorced, and the parents claimed, by way of subrogation, ownership of the mortgage on the house with priority over certain judgment liens that had attached as a consequence of the husband's unpaid debts. The court refused to recognize the parents' subrogation claim, holding that they were volunteers.

In a transfer of the real estate financed by a "wraparound" mortgage, the transferor remains principally liable on the underlying mortgage and obligation; see Newsom v. Starkey, 541 S.W.2d 468 (Tex. Ct. Civ. App. 1976).

Transferee in a sale transaction may not assert transferor's defenses, Comment d. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.17 (3d ed. 1993); Warm, Some Aspects of the Rights and Liabilities of Mortgagor, Mortgagee, and Grantee, 10 Temp. L. Rev. 116, 143–44 (1935); Annot., 141 A.L.R. 1184 (1942). See Eurovest v. Segall, 528 So.2d 482 (Fla.Dist.Ct.App.1988); Ortega, Snead, Dixon & Hanna v. Gennitti, 597 P.2d 745 (N.M.1979); Pacific First Fed. Sav. and Loan Ass'n v. Lindberg, 667 P.2d 535 (Or. Ct.App.1983).

§ 5.3 Discharge of Transferor from Personal Liability

Notwithstanding the provisions of §§ 5.1 and 5.2, the transferor of mortgaged real estate may be discharged from personal liability by receiving from the mortgagee an express release from the obligation secured by the mortgage, or by virtue of suretyship defenses under the principles of Restatement Third, Suretyship and Guaranty §§ 37–49.

Cross-References:

Section 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability; Restatement Third, Suretyship and Guaranty §§ 37–49; Restatement, Second, Contracts §§ 280, 314; Restatement of Security §§ 108, 122, 128–130; U.C.C. §§ 3-606 (1987), 3-605 (1990).

Comment:

a. Release of transferor by mortgagee. As §§ 5.1 and 5.2 point out, the transferor of mortgaged real estate ordinarily remains liable on the mortgage obligation after the transfer is completed. This section deals with circumstances under which that liability may be discharged. The most obvious way is that the mortgagee may expressly release the transferor from liability. This may occur at the time of the transfer or thereafter; it often occurs when the transferee assumes personal liability, in effect substituting for the transferor. For example, where the mortgagee has a right to accelerate the indebtedness upon transfer (under a "due-on-sale" or similar clause), it is common for the mortgagee to release the transferor from liability if the transferee has satisfactory credit, the mortgagee is satisfied with the terms of the obligation, and the transferee assumes liability for the obligation. However, no principle of mortgage law compels the mortgagee to give such a release.

Illustration:

1. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. The mortgage contains a due-on-sale clause. Subsequently A proposes to sell the house to C for $125,000, with C to pay A $25,000 in cash and to assume liability on or take subject to the promissory note and mortgage. A describes the proposed transaction to B and requests B's approval. B approves the transaction and agrees to release A from personal liability upon consummation of the sale. A is discharged from liability by B's release.

b. Discharge of transferor by mortgagee's release of transferee. In addition to an express release granted by the mortgagee to the transferor, other circumstances may result in the discharge of the transferor. As noted in §§ 5.1 and 5.2, the relationship of the transferor to the transferee (in the case of a transfer with assumption) or of the transferor to the mortgaged real estate (in the case of a transfer without assumption) is that of surety and principal, with the transferor as surety being secondarily liable. In general, any action of the mortgagee that impairs the transferor's rights of recourse against the transferee or the real estate will discharge the transferor to the extent that the impairment would otherwise cause loss to the transferor; see Restatement Third, Suretyship and Guaranty § 44. It would be inequitable for the mortgagee to continue to hold the transferor fully liable after the mortgagee has undermined the transferor's ability to pass that liability back to the transferee and the real estate, where the primary responsibility for performance rests. Such actions by the mortgagee are said to give rise to "suretyship defenses" in favor of the transferor. They are governed by Restatement Third, Suretyship and Guaranty §§ 37–49.

The most obvious of these defenses arises when a mortgagee grants a full release of liability to a transferee who assumed liability in the purchase transaction. In the absence of specific evidence that the mortgagee intonds to continue to hold the transferor liable, the transferor is entitled to treat the release as benefiting him or her as well, with the result that the transferor is fully discharged; see Restatement Third, Suretyship and Guaranty § 39(b). Even if the language or circumstances of the release show an intent by the mortgagee to retain its claim against the transferor, the latter will still be discharged to the extent that the release of the transferee would otherwise cause the transferor a loss. Commonly that loss is equal to the total amount owing on the obligation, since the release is binding on the transferor as well as the mortgagee, thus making it impossible for the transferor to assert recourse against the transferee under theories of exoneration, reimbursement, restitution, or subrogation (unless the mortgagee expressly preserves the transferor's recourse under Restatement Third, Suretyship and Guaranty § 38; see Comment *h*). See Illustration 2; § 5.1, Comment *i*. The transferor is also discharged to the extent of the value of any consideration paid by the transferee for the release; such consideration is regarded as a payment on the obligation itself.

In some cases the discharge of the transferee may not cause a loss to the transferor, or may cause a loss that is less than the full value of the obligation, resulting in only a partial discharge of the transferor. For example, if the real estate was inadequate as security for the obligation, and if the transferee (in the case of a transfer with assumption) was insolvent or had insufficient assets to pay the obligation in full, the transferor's right of recourse will have had a value less than the full obligation, and the transferor's discharge will be limited to that amount. Moreover, if the transferor consented to the release of the transferee, or waived suretyship defenses generally, the transferor may claim no benefit at all from the release. See Comment *g*; Restatement Third, Suretyship and Guaranty § 48.

In all cases in which the obligation is nonmonetary in nature, the transferor's discharge is total, on the ground that the practical difficulties of proving the amount of the transferor's loss would be excessive. See Restatement Third, Suretyship and Guaranty § 39(c)(iii) and Comment *g*.

Illustration:

2. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's consent, B releases C from personal liability on the note. At the time of the release, C is solvent and the real estate adequately secures the outstanding debt. Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. A is fully discharged from personal liability on the note.

c. Discharge of transferor by mortgagee's release or impairment of collateral. The foregoing discussion concerning the release of the transferee obviously applies only when the real estate was transferred with assumption of liability; in the case of a nonassuming transferee there is literally no liability to release. However, an analogous result follows in the case of a nonassuming transferee if the mortgagee releases the real estate from the security of the mortgage. Since the real estate represents the transferor's only recourse in such cases, a release of the mortgage completely destroys that recourse. Hence, the transferor is discharged to the extent of the value of the real estate. The same principle governs transfers with an assumption of liability, followed by the mortgagee's release of the collateral; again, the transferor's discharge is measured by the value of the real estate. See Restatement Third, Suretyship and Guaranty § 42. It is true that in cases in which the transferee has assumed liability, the transferee may perform the obligation voluntarily, may be compelled to perform, or may reimburse the transferor, so that the transferor will suffer no actual loss because of the release of collateral. Nonetheless, the transferor will be discharged as discussed above; the transferor need not be put to the expense and uncertainty of establishing whether the transferee will perform.

Partial releases of the real estate security are treated in a similar manner. However, since the discharge is measured by the loss that would be suffered by the transferor if he or she were not discharged, it is not necessarily the full value of the released real estate. In cases in which the obligation was originally oversecured, the value of the remaining security may be sufficient to fully cover the debt, so that the release does not cause loss to the transferor. Alternatively the loss (that is, the shortfall between the amount of the obligation and the value of the remaining security) may be less than the value of the security released. In partial release cases, it is the loss and not the released real estate's value *per se* that determines the amount of the transferor's discharge. Again, the discharge does not depend on a showing of the transferee's insolvency or inability to perform. See Restatement Third, Suretyship and Guaranty § 42, Comment *g*.

The transferor's position may be harmed not only by a formal release of the real estate by the mortgagee (see Illustrations 3 and 4), but also by the mortgagee's failure to take the steps required by ordinary prudence to perfect and preserve the mortgage on the real estate (see Illustrations 5, 6, and 7), by the mortgagee's subordinating the mortgage to intervening liens, by the mortgagee's consent to the demolition of valuable improvements, or by other acts by the transferee that impair the security value of the real estate. (However, the mortgagee is not required to pursue an action on account of the transferee's unconsented waste, even if such an action would have merit.) In all of these cases, the transferor is discharged by the amount that the mortgagee's misconduct reduces the amount of the obligation that can be recovered from the real estate. In addition, if the mortgagee fails to follow legally required procedures in foreclosing the mortgage, the transferor is discharged to the extent that the resulting foreclosure sale proceeds are reduced by the impropriety of the process. See Restatement Third, Suretyship and Guaranty § 42(2)(d).

Illustration 4 below involves a release of a portion of the land from the mortgage. In such a case a further factor, beyond the release of the land itself, may cause a loss to the transferor. The partial release may have the effect of dividing the real estate in a manner that makes the part remaining subject to the mortgage less acceptable in the market. In this situation, the value of the portion released does not fully measure the transferor's loss.

Illustrations:

3. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's consent, B releases the real estate from the mortgage. Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. The value of the real estate is $75,000 at the time of B's claim. A is discharged to the extent of $75,000 and is liable to B for $25,000.

4. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's farm. Subsequently A sells the farm to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's consent, B releases a portion of the real estate from the mortgage. Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. The value of the portion of the farm that was released from the mortgage is $40,000 at the time of B's claim against A. In addition, because the portion of the farm still subject to the mortgage is so small that it is difficult to farm it efficiently, its value is further reduced by $5,000, to $55,000. A is discharged to the extent of $45,000 and is liable to B for $55,000.

5. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's consent, B authorizes C to demolish the house, thereby reducing the value of the real estate, notwithstanding that such demolition would otherwise be actionable waste. Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. The value of the real estate has been reduced from $150,000 to $40,000 as a result of the demolition of the house. A is discharged to the extent of $60,000 and is liable to B for $40,000.

6. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Due to carelessness, B fails to record the mortgage in the public records. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Payment on the note is defaulted upon, and C files a petition in bankruptcy. C's trustee in bankruptcy establishes that, as a consequence of B's failure to record the mortgage, it is not cognizable in bankruptcy. B makes a claim against A for the balance owing on the note, which is still $100,000. The value of the real estate is $75,000 at the time of B's claim. A is discharged to the extent of $75,000 and is liable to B for $25,000.

7. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Payment on the note is defaulted upon, and B forecloses the mortgage. However, B fails to comply substantially with the advertisement provisions of the applicable foreclosure statute. The balance on the loan at the time of the

foreclosure is still $100,000, and the fair market value of the real estate is $75,000. However, as a consequence of the ineffectiveness of the advertisement of the foreclosure sale, the sale price is only $60,000. B brings an action against A for the deficiency, which B claims is $40,000. A is discharged to the extent of $15,000 as a result of B's noncompliance with the foreclosure statute, and is liable to B for $25,000.

d. Discharge of transferor by mortgagee's modification of the obligation with transferee. If the mortgagee and the transferee modify the terms of the obligation, the transferor will be discharged from personal liability to the extent that damage to the transferor would otherwise result. Application of this rule requires proof of the extent of the loss. A contrary rule, discharging the transferor entirely rather than merely to the extent of the loss suffered, would have the advantage of greater simplicity of proof, but would often result in an unjust windfall to the transferor. While many cases give a total discharge, Restatement Third, Suretyship and Guaranty § 41, which is followed here, recognizes a discharge only to the extent of the transferor's actual damage. This approach follows by analogy U.C.C. § 3-605 (1990). The burden of persuasion with respect to the existence and amount of impairment of the transferor's recourse is governed by Restatement Third, Suretyship and Guaranty § 49.

Many kinds of modifications may be entered into between the mortgagee and the transferee. The nature of some modifications is such that they can only benefit the transferor: A decrease in the interest rate or the provision of additional security by the transferee, for example, can cause no loss. But other sorts of modifications, such as an increase in the interest rate or an increase in the amount of required periodic payments, can result in a heightened risk of loss. When these sorts of modifications occur without the transferor's consent, the transferor is discharged to the extent of the actual loss that would otherwise result. See Illustration 8.

Illustration:

8. A borrows $100,000 from B and gives B a promissory note for that amount, due in two years with interest at 10 percent per annum payable annually. The note is secured by a mortgage on A's house. At the end of Year 1 A sells the house to C, who assumes liability on the promissory note and mortgage. B and C immediately enter into an agreement, without A's consent, increasing the interest rate on the note to 11 percent per annum. At the end of Year 2 payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note. The

balance at the end of Year 2, including interest, would have been $110,000 at the original rate of interest, but because of the increased rate the balance at the end of Year 2 is $111,000. A is discharged from liability for the additional $1,000 of interest, but remains liable to B for $110,000.

When the mortgagee and transferee enter into a modification of the obligation, the transferor (to the extent not discharged) is entitled to the benefit of the change. For example, if the interest rate is reduced, the transferor is now liable only at the agreed lower rate. On the other hand, if the obligation is one to pay money, the transferor also has the right to perform under the obligation's original terms. Thus, if the modification now provides for annual payments on the debt instead of the monthly payments that were required under the original obligation, the transferor is entitled to continue to pay monthly. In effect, the transferor has the choice of performing a monetary obligation in either its original or modified form. See Restatement Third, Suretyship and Guaranty § 41, Comment *f*. However, if the obligation is nonmonetary in nature, the transferor has no such option, but must perform the obligation as modified; otherwise, the performance might be useless or wasteful from the mortgagee's viewpoint. Of course, the transferor will be discharged from liability, as explained above, to the extent that the modification would otherwise cause loss to the transferor.

Some modifications may be so extreme that they impose fundamentally different risks on the transferor than those created by the original obligation. For example, the obligation might be modified to require personal services, the construction of a building, or other in-kind services rather than the payment of money required under the obligation's original form. In such cases the transferor is entirely discharged. Restatement Third, Suretyship and Guaranty § 41(b)(i).

e. Discharge of transferor by mortgagee's extension of time for transferee to perform obligation. Whether an extension of time to the transferee causes loss to the transferor depends on the facts. Loss may occur on account of an extension of time for a variety of reasons. The value of the mortgaged real estate may decline during the period of the extension; the balance owing on the obligation may increase during that period, typically as a result of the accrual of interest, late fees, and the like; and the transferee's solvency or ability to pay may deteriorate. The transferor is discharged to the extent that actual loss results from the extension. In essence, the transferor's liability is limited to the same net liability that the transferor would have experienced (after recourse against the real estate and, in a transfer with assumption, the transferee) if the extension had not been granted. See Restatement Third, Suretyship and Guaranty 40(b); Illustrations 9 and 10.

Illustrations:

9. A borrows $100,000 from B and gives B a promissory note for that amount, due in one year with interest payable monthly. The note is secured by a mortgage on A's house. During Year 1 A sells the house to C, who takes subject to, but does not assume liability on, the promissory note and mortgage. Thereafter, at C's request and without A's consent, B grants C an additional year to pay the note. At the end of Year 2 C defaults in payment on the note. B makes a claim against A for the balance owing on the note. The balance owing on the mortgage debt at the end of Year 2 remains $100,000, but the value of the real estate has declined during Year 2 from $100,000 to $90,000. A is discharged from liability for $10,000, but remains liable to B for $90,000. Since C has no personal liability on the mortgage debt, any changes in C's financial condition during Year 2 are irrelevant.

10. A borrows $100,000 from B and gives B a promissory note for that amount, due in one year with interest payable monthly. The note is secured by a mortgage on A's house. During Year 1 A sells the house to C, who has sufficient assets to pay the principal of the note, and who assumes liability on the note and mortgage. Thereafter, at C's request and without A's consent, B grants C an additional year to pay the note. At the end of Year 2 C defaults in payment on the note and has become insolvent. B makes a claim against A for the balance owing on the note. The balance at the end of Year 2 is $100,000, but the value of the real estate has declined during Year 2 from $100,000 to $90,000. A is discharged from liability for $10,000, but remains liable to B for $90,000.

When the mortgagee and transferee enter into an extension the transferor (to the extent not discharged) is entitled to the benefit of the extension in responding to a claim from the mortgagee, who may not demand performance from the transferor until due under the extension agreement. However, the transferor also has the option to perform under the original schedule, and the mortgagee must accept such performance. In effect, the transferor has the choice of performing under either the original or modified schedule. See Restatement Third, Suretyship and Guaranty § 40(c). On the other hand, the transferor's recourse against the transferee *is* modified by the time extension, and the transferor, in asserting that recourse, must recognize the extension unless a "preservation of recourse" has been effected; see Comment *h*.

f. Failure of mortgagee to sue or foreclose after request. Only an enforceable extension of time will ordinarily operate to discharge the transferor. If the mortgagee does not take reasonably prompt action to sue on the debt or to foreclose the mortgage after default, the result of the delay may be a reduction in the value of the real estate or the ability of the transferee to pay, to the detriment of the transferor. Nevertheless, the transferor has no right to demand that the mortgagee immediately foreclose or bring an action on the debt. See Restatement Third, Suretyship and Guaranty § 50. The decision as to when to pursue these remedies rests with the mortgagee alone. A delay by the mortgagee is not a modification of the obligation or a time extension, and does not ordinarily give the transferor any defense or discharge. When such a delay occurs, the transferor can assert the means of recourse that provide adequate immediate protection—namely the relevant rights of exoneration, reimbursement, restitution, and subrogation as provided in § 5.1(d), § 5.2(e), and Restatement Third, Suretyship and Guaranty §§ 21–31.

However, if the mortgagee takes no action to foreclose the mortgage or to enforce the obligation against either the transferee or the transferor until the statute of limitations as to the transferee has run, the transferee may be discharged. See Restatement Third, Suretyship and Guaranty § 43. If the applicable statute bars only an action on the debt, and not foreclosure of the mortgage, the result of the running of the statute is as if the mortgagee had released the transferee from liability on the obligation as of the date the statute runs. See Comment *b*, supra. If the applicable statute bars foreclosure of the mortgage, the result is as if the mortgagee had released the real estate from the mortgage as of that date; see Comment *c*, supra.

Some limited case authority suggests that, if the transferor demands that the mortgagee foreclose or bring an action on the obligation, and the mortgagee refuses to do so, the transferor is discharged to the extent of any loss that results from the refusal or delay. That view, usually named for the old New York case of Pain v. Packard, 13 Johns 174 (N.Y.1816), is not followed by this Restatement, but it is in effect by statute in several states. Except as provided by statute or by agreement between the transferor and mortgagee, the transferor has no power to compel the mortgagee to foreclose promptly.

g. Waiver of suretyship defenses; consent of transferor. A release, extension, modification, or other impairment of recourse will not discharge a transferor who consents to it. See Restatement Third, Suretyship and Guaranty § 48. The consent may be given in the original mortgage or evidence of the obligation, in which case it is often termed a "survival" or "waiver of defenses" clause. See Illustration 11. Alternatively, the consent may be given later, either before, concurrently with, or after the transfer of the real estate and before, concurrently with, or after the release, extension, or modification. See Illustration 12. A clause or agreement giving consent may be worded narrowly and, if so, will be ineffective with respect to a release, extension, or modification outside its scope. See Illustration 13. No consideration need be shown to validate the consent. The Statute of Frauds is inapplicable, and the consent may be oral. If the transferor becomes a party to the document that accomplishes the release, extension, or modification, the transferor's consent may readily be inferred. See Illustration 14.

Illustrations:

11. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. The note contains a clause stating, "In the event of a release of security, extension of time, or modification of this note by any successor of the maker hereof, the payee's rights against the maker are reserved." Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's further consent, B releases the real estate from the mortgage. Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. Notwithstanding the release of the real estate as security, A is not discharged and is liable to B for $100,000.

12. A borrows $100,000 from B and gives B a promissory note for that amount, secured by a mortgage on A's house. Subsequently A sells the house to C, who assumes liability on the promissory note and mortgage. Thereafter, at C's request and without A's consent, B releases the real estate from the mortgage. Later B informs A of the release. A states, "I have no objection to your having released the real estate." Payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note, which is still $100,000. Notwithstanding the release of the real estate as security, A is not discharged and is liable to B for $100,000.

13. The facts are the same as Illustration 11, except that the clause in the note states, "In the event of an extension of time or modification of this note by any successor of the maker hereof, the

payee's rights against the maker are reserved." Because the clause does not mention release of security, A is discharged to the extent of the value of the real estate. See Illustration 3.

14. A borrows $100,000 from B and gives B a promissory note for that amount, due in two years with interest at 10 percent per annum payable annually. The note is secured by a mortgage on A's house. At the end of Year 1 A sells the house to C, who assumes liability on the promissory note and mortgage. A, B, and C immediately enter into an agreement increasing the interest rate on the note to 11 percent per annum. At the end of Year 2 payment on the note is defaulted upon, and B makes a claim against A for the balance owing on the note. Because A was a party to the modification agreement, A is not discharged to any extent, and is liable to B for the full balance owing on the note, including the accrued interest at 11 percent per annum.

h. Reservation of the mortgagee's rights without the transferor's consent. Under traditional suretyship law, there was an additional method by which a mortgagee who entered into a release, modification, or extension agreement with a transferee could avoid discharging the transferor. The mortgagee could insert a so-called "reservation of rights" clause in the release, modification, or extension agreement itself. Such a clause would have the two-fold effect of preventing the discharge of the transferor, and at the same time allowing the transferor to assert the usual forms of recourse (exoneration, reimbursement, restitution, and subrogation) against the transferee on the obligation's original terms. The usual explanation was that the clause's purpose was to warn the transferee that the transferor was not bound by the release, modification, or extension agreement, and hence might seek recourse against the transferee as if the change in terms had not occurred. As explained in Restatement of Security § 122, Comment *d*,

> The creditor, by a release with reservation of rights against the surety, was in effect notifying the principal that, in spite of the release, the surety might pay as a result of compulsion or voluntarily and that the principal would then be liable to reimburse the surety.

Unfortunately, this form of "warning" was so obscure that it is doubtful that many transferees understood it as such. Moreover, the applicable legal doctrine did not require any notice to the transferor that the underlying obligation or security had been modified. In the case of a time extension, for example, the transferor might well assume that the transferee had paid the debt as originally scheduled, and might therefore fail to take loss prevention measures, with the result that the transferor's liability might ultimately be far larger than if the modification had not occurred.

Restatement Third, Suretyship and Guaranty § 38 rejects the reservation of rights doctrine, as does this Restatement. A mortgagee who impairs the transferor's rights of recourse cannot prevent a discharge of the transferor by inserting a reservation of rights clause in a document of release, extension, or modification.

However, there is a mechanism available to the mortgagee to minimize the risk of discharging the transferor. The mortgagee who releases the transferee from liability or who extends the time for performance may effect a "preservation" of the transferor's recourse. See Restatement Third, Suretyship and Guaranty § 38. Such a preservation is accomplished by providing in express terms, in the release or extension, that the mortgagee retains the right to seek performance of the obligation from the transferor, and that the transferor retains the corresponding rights of recourse against the transferee as though the modification or extension had not occurred.

The mortgagee's ability to preserve recourse in this fashion is available only when the obligation is a money debt. Whether a provision preserving recourse will be acceptable to the transferee may vary. It makes the release or extension less attractive to the transferee, since the risk remains that the transferor will assert recourse against the transferee on the obligation's original terms. In many contexts, however, the transferee may strongly desire the extension or release and may well be willing to accept that risk.

Use of a preservation of recourse does *not* necessarily prevent the transferor's discharge under the suretyship defenses discussed above. It does, however, have the potential to reduce the extent of the transferor's discharge. The reason is that, as discussed above, a discharge under the suretyship defenses is ordinarily measured by the loss the transferor would otherwise suffer from the release or extension. When a preservation of recourse is employed, both the transferor's duties (to the mortgagee) and rights of recourse (against the transferee) are unchanged by the release or extension. Hence, it is less probable that any loss will result to the transferor.

Nonetheless, a loss and a corresponding discharge are entirely possible even when a preservation of recourse clause is used. For example, an extension of time to pay the obligation may result in a further deterioration of the transferee's financial position, with the result that transferee is less able to respond to the transferor's demand for recourse. If this occurs, the transferor will be discharged to the extent of the resulting loss. See Restatement Third, Suretyship and Guaranty § 38, Comment *b*.

i. Assertion of transferee's defenses by transferor. Except when a preservation of recourse is employed as discussed in Comment *g* above, any modification of the obligation or extension of the time for performance benefits the transferor as well as the transferee. Thus, as noted in Comments *d* and *e* above, if the mortgagee and transferee agree to lower the interest rate, the transferor is thereafter liable only at the lower rate. If the mortgagee grants the transferee an extension of time to pay, the transferor is entitled to the same extension. Each of these examples is applicable both to assuming and non-assuming transferees. On the other hand, defenses that are personal to the transferee, such as lack of capacity or discharge in insolvency, do not grow out of transactions between the mortgagee and the transferee and cannot be raised by the transferor; Restatement Third, Suretyship and Guaranty § 34(1).

REPORTERS' NOTE

See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 5.18–5.20 (3d ed. 1993); G. Osborne, Mortgages §§ 269–71 (1951); G. Glenn, Mortgages §§ 272–79 (1943); Annots., 41 A.L.R. 277 (1926); 72 A.L.R. 389 (1931); 81 A.L.R. 1016 (1932); 112 A.L.R. 1324 (1938).

Release of transferor by mortgagee, Comment a. In some limited circumstances, mortgagees may have a legal duty to release transferors from liability. For example, under § 132 of the Housing and Urban Development Reform Act of 1989, Pub. L. No. 101–235, 103 Stat. 1987, codified at 12 U.S.C. § 1739 (1989), the Secretary of HUD must adopt procedures:

> [I]n any case where personal liability under a mortgage is assumed, requiring that the original mortgagor be advised of the procedures by which he or she may be released from liability. In any case where the homeowner does not request a release from liability, the purchaser and the homeowner shall have joint and several liability for any default for a period of 5 years following the date of the assumption. After the close of such 5-year period, only the purchaser shall be liable for any default on the mortgage unless the mortgage is in default at the time of the expiration of the 5-year period.

Somewhat analogous provisions are found in the regulations issued by the Office of Thrift Supervision under the authority of § 341 of the Garn–St. Germain Depository Institutions Act of 1982, which preempts state law restricting the enforcement of due-on-sale clauses. See 12 C.F.R. § 591.5(b)(4):

> A lender waives its option to exercise a due-on-sale clause as to a specific transfer if, before the transfer, the lender and the existing borrower's prospective successor in interest agree in writing that the successor in interest will be obligated under the terms of the loan and the interest on sums secured by the lender's security interest will be payable at a rate the lender shall request. Upon such agreement and resultant waiver, a

lender shall release the existing borrower from all obligations under the loan instruments, and the lender is deemed to have made a new loan to the existing borrower's successor in interest.

See Bank USA v. Sill, 582 N.E.2d 310 (Ill. App. Ct. 1991), in which the court refused to find a release under the foregoing language, despite the transferor's argument that, by virtue of the mortgagee's approval of the transferee under the authority of the due-on-sale clause, a release was mandatory.

The release may be from all liability on the mortgage as well as the obligation it secures, or it may be a more limited release. In Bruno v. First Fed. Sav. & Loan Ass'n, 772 P.2d 1198, 1205 (Idaho 1989), the assumption agreement recited:

> ... Borrower and the Purchaser have requested the association to approve the sale and to substitute the Purchaser for the Borrower as obligor on the note secured thereby, and to release the Borrower from further liability thereon, which the Association has agreed to do on the following terms and conditions.

The court held that the transferor was released from liability on the note, but was still liable on the warranty of title contained in the mortgage.

A release of the transferor's liability may be inferred from the circumstances of the transfer and the mortgagee's subsequent dealings with the transferee, even if no express release is given. See FDIC v. Prann, 694 F.Supp. 1027 (D.P.R.1988). The parties may also agree to a novation, which is in essence a discharge of the transferor's original obligation and the creation of a new obligation between the mortgagee and the transferee. See Restatement, Second, Contracts § 280. However, the courts will not find a novation in the absence of clear evidence that the mortgagee intended to release the transferor.

b. Discharge of transferor by mortgagee's release of transferee, Comment b. American courts have historically viewed the role of the transferor as that of a surety, with the transferee (in an assumption transfer) or the land (in a subject-to transfer without assumption) being principally liable. When a mortgagee enters into a release, modification, or extension of time with the transferee, the courts have usually applied suretyship principles (with varying degrees of rigor) to determine whether the transferor should be discharged from liability. Because American law has traditionally viewed sureties with great solicitude, the result has frequently been a holding that the transferor who does not consent to the modification or extension is entirely discharged.

The discharge of the transferor has generally been justified on two closely related grounds: The first is that a modification or extension may increase the risk that the transferee will default, that the real estate will prove inadequate security, and that the transferor will have to pay. The second ground is that the transferor's rights of recourse against the transferee will have been impaired by the release, modification, or extension. See Brockton Sav. Bank v. Shapiro, 88 N.E.2d 344 (Mass.1949); Restatement of Security § 129; A. Stearns, Suretyship § 6.16 (5th ed. 1951). Concern for the transferor is surely legitimate. Nevertheless, the cases have often protected the transferor extravagantly, granting a full discharge when only a lesser benefit or none at all would be warranted.

There has been increasing recognition for many years that traditional American law was over-solicitous of the surety's position when the principal and the creditor entered into a release, modification, or extension. In 1941 the Restatement of Security § 128 took the position that a modification should discharge a compensated surety only if it materially increased the surety's risk, and that absent an increase in risk, a discharge should occur only to the extent of the loss suffered from the modification. See, e.g., Anstalt v. F.I.A. Ins. Co., 749 F.2d 175 (3d Cir. 1984). Similarly, in § 129 it asserted that an extension of time should discharge a compensated surety only to the extent it was harmed by the extension. See, e.g., Gebrueder Heidemann, K.G. v. A.M.R. Corp., 746 P.2d 579, rev. denied, 750 P.2d 378 (Idaho 1988); Bayer & Mingolla Constr. Co. v. Deschenes, 205 N.E.2d 208 (Mass. 1965). Professor Durfee was perhaps the most vigorous proponent of extending the "actual loss" approach to all sureties, not merely those who were compensated; see Durfee, Book Review, 17 Corn. L. Rev. 707, 709–712 (1932).

The Restatement of Security also moved toward a more moderate position with respect to release of the principal or of property held as collateral. Section 132 took the view that where the creditor released, harmed, or failed to preserve such collateral, the surety's obligation should be reduced pro tante, and not necessarily totally discharged. See Puyallup Valley Bank v. Mosby, 44 Wash. App. 285, 723 P.2d 2 (1986) (failure of creditor to record mortgage on real estate did not discharge guarantors, where the mortgage would have been worthless in any event).

Perhaps surprisingly, courts deciding cases involving transfers of mortgaged property paid scant attention to this trend toward liberalization of the creditor's rights against the surety. Instead, for the most part they continued to engage in a rather mechanistic discharge of the transferor, whether the mortgagee's actions actually resulted in loss or harm to the transferor or not. That approach was also embodied in pre–1990 U.C.C. § 3–606, which provided for a complete discharge to any party to an instrument if the creditor impaired the collateral or gave a release to a person against whom the party seeking the discharge had a right of recourse.

The Restatement Third, Suretyship and Guaranty, which is followed here, rejects this rigid approach, and instead calls for an evaluation of the extent of the actual loss that would be suffered by the surety (here, the transferor) as a result of the obligee's (here, the mortgagee's) granting a modification, extension, or release of collateral or of the person principally liable (here, the assuming transferee or, in a subject-to transfer, the real estate). It takes this approach whether or not the surety is compensated. In doing so, it follows the concepts embodied in U.C.C. § 3–605 (1990), which has replaced pre–1990 U.C.C. § 3–606. The new § 3–605 deals with creditors' rights against indorsers and accommodation parties of negotiable paper, and hence does not literally apply to transfers of mortgaged real estate. (But see Hughes v. Tyler, 485 So.2d 1026 (Miss.1986), holding pre–1990 U.C.C. § 3–606 directly applicable to the assumption of a mortgage loan.) However, the problems are closely analogous. The operative language of § 3–605(d) is as follows.

> If a [creditor] agrees, with or without consideration, to a material modification of the obligation of a party ... the modification discharges the obligation of [a surety] having a right of recourse against the person whose obligation is modified *to the extent the modification causes loss to the [surety] with respect to the right of recourse.* (emphasis added)

The following material illustrates the manner in which judicial decisions have dealt with these issues. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.19 (3d ed. 1993).

The release by the mortgagee of an assuming transferee is widely held to operate as a complete release of the transferor as well. See In re Roth, 272 F. 516 (N.D.Ohio 1920); Prigal v. Kearn, 557 So.2d 647 (Fla.Dist.Ct. App.1990); Gilliam v. McLemore, 106 So. 99, 43 A.L.R. 79 (Miss. 1925); Insley v. Webb, 209 P. 1093, 41 A.L.R. 274 (Wash. 1922). See also Cook v. American States Ins. Co., 275 N.E.2d 832 (Ind.Ct.App.1971) (mortgagee's acceptance of deed in lieu of foreclosure and release of grantee acts as full payment of debt and discharges original mortgagor); Landmark KCI Bank v. Marshall, 786 S.W.2d 132 (Mo. Ct. App. 1989) (release by creditor of a co-maker of the note without the consent of an accommodation maker discharged the accommodation maker). See generally G. Osborne, Mortgages § 270 (1951) at 754–55; G. Glenn, Mortgages § 280 (1943). Cf. First Interstate Bank v. Rebarchek, 511 N.W.2d 235 (N.D. 1994) (release of transferor and guarantors does not release assuming grantee, who is primarily liable for debt).

The position taken in Restatement Third, Suretyship and Guaranty § 40, and in this Restatement, with respect to the release of the transferee is contrary to that of U.C.C. § 3–605 (1990), which deals with the different but analogous issue of discharge of indorsers and accommodation parties to instruments; these parties, like the transferor of mortgaged real estate, assume the role of surety. Section 3–605(b) provides that a release of the principal obligee on an instrument does not discharge indorsers and accommodation parties. See Restatement Third, Suretyship and Guaranty § 40, Reporter's Note to Comment *f.*

Discharge of transferor by mortgagee's release or impairment of collateral, Comment c. Where the mortgagee releases the real estate from the mortgage, the case law is divided. One view holds that the transferor is completely released; see, e.g., Haberl v. Bigelow, 855 P.2d 1368 (Colo.1993) (subordination of mortgage; based on pre-1990 U.C.C. § 3–606); Chrysler First Business Credit Corp. v. Kawa, 914 P.2d 540 (Colo.Ct.App.1996) (release of mortgage); Hughes v. Tyler, 485 So.2d 1026 (Miss.1986) (based on interpretation of U.C.C. § 3–606); Lundquist v. Nelson, 395 N.Y.S.2d 568 (N.Y.App.Div.1977); Black Bull Enterprises, Inc. v. Hall, 813 P.2d 571 (Or.Ct.App.1991) (guarantor completely discharged by release of collateral posted by other guarantors). Under the other view, the transferor is discharged only to the extent of the property's value; see In re Roth, 272 F. 516 (N.D.Ohio 1920); Mann v. Bugbee, 167 A. 202 (N.J. 1933). This approach is codified in N.C. Gen. Stat. § 45–45.1(4). In effect the former view presumes that the property was worth at least as much as the debt, a result which seems illogical and unjustified. See generally G. Glenn, Mortgages § 281 (1943). This Restatement follows the latter view in the case of complete release of the real estate.

Illustration 4 is based on Restatement, Second, Contracts § 314 and its Illustration, which adopts the suretyship defenses in principle but stops short of applying them to the broad range of facts represented in this section.

Similar concepts apply where the mortgagee has improperly authorized waste or damage to the real estate, or has failed to take ordinary precautions to preserve the lien of the mortgage. See Lundquist v. Nelson, 395 N.Y.S.2d 568 (N.Y.App.Div.1977) (where mortgagee consented to demolition by assuming grantee of building on mortgaged real estate without grantor's consent, grantor's liability was discharged); Lynn Five Cents Bank v. Portnoy, 28 N.E.2d 418 (Mass.1940) (same); Peacock v. Farmers and Merchants Bank, 454 So.2d 730 (Fla.Dist.Ct.App.1984) (mortgaged property was sold free of the mortgage lien by order of the bankruptcy court, but mortgagee opposed the sale; held: mortgagee was not negligent and not at fault in loss of collateral, and did not discharge the liability of guarantors under pre-1990 U.C.C. § 3-606).

In Poynot v. J & T Devel., Inc., 355 So.2d 1052 (La.Ct.App.1978), the mortgagee voluntarily subordinated the mortgage to an intervening lien. The court recognized that this action might prejudice the position of indorsers on the note secured by the mortgage, giving them a partial or total discharge. On the facts, however, the court found that the indorsers had shown no prejudice from the subordination.

However, the mortgagee need not act affirmatively to preserve the physical quality of the real estate, where the mortgagee is not in possession. See West Point Corp. v. New North Mississippi Fed. Sav. & Loan Ass'n, 506 So.2d 241 (Miss.1986) (mortgagee which was not in possession did not unjustifiably impair the collateral under pre-1990 U.C.C. § 3-606, although it permitted the property to suffer severe waste and deterioration while taking no action against the grantee; the grantor's liability was thus not discharged); Commerce Union Bank v. May, 503 S.W.2d 112 (Tenn.1973) (mortgagee which was not in possession did not unjustifiably impair the collateral under pre-1990 U.C.C. § 3-606 or analogous common-law principles, where grantee permitted fire insurance policy to lapse; both grantor and mortgagee had equal opportunity to reinstate insurance); Damiano v. Bergen County Land Co., 180 A. 489 (N.J. 1935) (mortgagee has no duty to mortgagor to pursue waste action against transferee); G. Osborne, Mortgages § 135 (1951).

Discharge of transferor by mortgagee's modification of the obligation with transferee, Comment d. The typical case involves an increase in the interest rate on the debt secured by the mortgage. The courts usually apply traditional suretyship principles and conclude that any variation in the terms of the obligation acts to fully discharge the transferor; as above, if the transfer was without assumption, the value of the real estate acts as a ceiling on the discharge. See Oellerich v. First Fed. Sav. & Loan Ass'n, 552 F.2d 1109 (5th Cir.1977); First Fed. Sav. & Loan Ass'n v. Arena, 406

N.E.2d 1279 (Ind.Ct.App.1980); L. Simpson, Suretyship § 72 (1950). Compare Bank USA v. Sill, 582 N.E.2d 310 (Ill. App. Ct. 1991), holding that an agreement between the mortgagee and the transferees reducing the interest rate and the monthly payment, without any extension of maturity, actually benefited the transferors and did not discharge them.

A modification may be so extensive that it amounts to a novation, creating such a different set of duties that it would be inequitable to continue to hold the transferor liable. See, e.g., Vivion v. Grelling, 837 S.W.2d 255 (Tex. Ct. App. 1992) (changes made in principal amount, interest rate, monthly payment amount, and number of monthly payments; transferor held discharged).

Discharge of transferor by mortgagee's extension of time for transferee to perform obligation, Comment e. Where the mortgagee grants an extension of time to an assuming transferee to perform the mortgage obligation, the prevailing view has been that the transferor who does not consent to the extension is completely discharged, whether or not any actual loss to the transferor can be shown. See, e.g., Miller v. Roach, 59 P.2d 418 (Cal.Ct.App.1936); Moss v. McDonald, 772 P.2d 626 (Colo.Ct.App.1988); Pearson v. Smith, 273 N.E.2d 179 (Ill. App. Ct. 1971); Mutual Life Ins. Co. v. J.H.C. Corp., 64 N.Y.S.2d 256 (N.Y.Sup.Ct.1946) (mortgagor discharged unless extension agreement contains an express reservation of rights clause); Calvo v. Davies, 73 N.Y. 211 (1878); State v. Pitts, 173 P.2d 923 (Okla.1946) (dictum); Annot., 112 A.L.R. 1324 (1938); L. Simpson, Suretyship § 73 (1950), at 362; S. Williston, Contracts § 1225 (3d ed. 1967). Cf. First Nat'l Bank of Anthony v. Dunning, 855 P.2d 493 (Kan.Ct. App.1993) (no discharge where the time extension did not cause actual harm to surety); Ascension Sav. & Loan Ass'n v. Martinez, 308 So.2d 357 (La.Ct.App.1975) (where there is no formal extension, but a mere forbearance to sue or foreclose, the grantor is not discharged).

Where the transfer is merely subject to the mortgage, with no assumption, the courts have usually reached the same result, except that the discharge is limited to the value of the real estate, since in the absence of an assumption by the grantee the real estate represents the only recourse available to the transferor. See, e.g., Shine Laundry, Inc. v. Washington Loan & Banking Co., 146 S.E.2d 371 (Ga.Ct.App.1965); Commercial Cas. Ins. Co. v. Roman, 199 N.E. 658 (N.Y.1936), noted 22 Va. L. Rev. 964 (1936); Branch Banking & Trust Co. v. Kenyon Inv. Corp., 332 S.E.2d 186, 192–93 (N.C.Ct.App.1985); Singer–Fleischaker Royalty Co. v. Whisenhunt, 402 P.2d 886 (Okla.1964); Simms v. Wolverton, 375 P.2d 87 (Or. 1962); Zastrow v. Knight, 229 N.W. 925 (S.D.1930), noted 72 A.L.R. 379.

Cf. Braun v. Crew, 192 P. 531 (Cal. 1920) (time extension acts as complete discharge of subject-to grantor, not limited to value of the real estate); Occidental Life Ins. Co. v. McCracken, 65 P.2d 130 (Cal.Ct.App. 1937) (same); and at the other extreme, Yasuna v. Miller, 399 A.2d 68 (D.C.App.1979) (absent a specific three-party agreement designating the grantor as a surety, a time extension does not discharge the grantor to any extent); Peter v. Finzer, 217 N.W. 612 (Neb.1928), noted 65 A.L.R. 1419 (absent statutory directive, an extension of time given to grantee does not discharge grantor). The notion that the discharge can exceed the actual loss to the transferor is sharply criticized in Stevens, Extension Agreements in the "Subject-To" Mortgage Situation, 15 U. Cin. L. Rev. 58, 82–84 (1941).

Failure of mortgagee to sue or foreclose after request, Comment f. The view that the transferor is discharged to the extent of loss resulting from the delay if the mortgagee fails to sue or foreclose after a demand from the transferor is a derivation of the doctrine of Pain v. Packard, 13 Johns. 174 (N.Y.1816). That case involved conventional suretyship, and it is unclear that it would have been applied in a case of transfer of mortgaged real estate, even in New York; see King County Trust Co. v. Derx, 261 N.Y.S. 909 (N.Y.App.Div.1933); Marshall v. Davies, 78 N.Y. 414 (1879). Compare Lichtstern v. Forehand, 194 N.W. 421 (Wis.1923), refusing to apply the doctrine of *Pain v. Packard.* The doctrine was rejected by Restatement of Security § 130 (1941), and has a very limited following. It has subsequently been repealed legislatively in New York; see N.Y. Gen. Obl. L. § 15–701. It is not recognized by this Restatement, although it is in effect by statute in several states. See G. Glenn, Mortgages § 282.1 (1943); Friedman, Discharge of Personal Liability on Mortgage Debts in New York, 52 Yale L.J. 771, 795–796 (1943).

Waiver of suretyship defenses; consent of transferor, Comment g. If a mortgagor is willing to agree at the outset that, if a subsequent transfer of the property occurs, the mortgagee may thereafter engage in behavior that increases the mortgagor's risk, such an agreement is generally honored, although the courts construe it strictly. See Phillips v. Plymale, 381 S.E.2d 580 (Ga.Ct.App.1989) (transferor consented in sale contract to subordination of existing mortgage being assumed); Kent v. Rhomberg, 6 N.E.2d 271 (Ill. App. Ct. 1937); Mutual Life Ins. Co. v. Rothschild, 123 N.E. 880 (N.Y. 1918); Federal Land Bank of Louisville v. Taggart, 31 Ohio St.3d 8, 508 N.E.2d 152 (1987) (reservation of rights in the original note held effective to preserve the mortgagee's claim against an accommodation maker after an extension of time); Friedman, Discharge of Personal Liability on Mortgage Debts in New York, 52 Yale L.J. 771, 788 (1943); G. Glenn, Mortgages § 276 (1943). See also Agribank, FCB v. Whitlock, 621 N.E.2d 967 (Ill. App. Ct. 1993) (consent clause in mortgage by accommodation parties prevented their discharge when primary mortgagors were released by mortgagee).

A good example is First Fed. Sav. & Loan Ass'n v. Arena, 406 N.E.2d 1279 (Ind.Ct.App.1980). In that case the mortgagors signed an agreement at the time they obtained the loan that provided:

> That in the event the ownership of said property ... becomes vested in a person other than the Mortgagor, the Mortgagee may, without notice to the Mortgagor, deal with such successor ... in interest ... in the same manner as with the Mortgagor, and may forbear to sue or may extend time for payment of the debt, secured hereby, without discharging or in any way affecting the liability of the Mortgagor hereunder.

Id. at 1283. Thereafter the mortgagors sold the property subject to the mortgage, and the grantee subsequently entered into an agreement with the mortgagee to extend the time for payment of the debt and to increase the interest rate. The court held that the time extension was within the scope of the reservation clause quoted above, and hence would not, by itself, discharge the mortgagors' liability. The increase in interest rate, however, was found to be outside the scope of the clause, and thus to result in a discharge of the mortgagors to the extent of the land's full value. Note that under this Restatement the discharge would not be absolute but *pro tanto*, to the extent that the higher rate resulted in a higher balance owing on the mortgage loan or otherwise caused loss to the mortgagors, with the land's value acting as a ceiling on the discharge. See also Moss v. McDonald, 772 P.2d 626 (Colo.Ct.App.1988) (where original note language consented to extensions after maturity, it did not serve as a consent to an extension granted prior to maturity).

In Indianapolis Morris Plan Corp. v. Karlen, 319 N.Y.S.2d 831 (N.Y. 1971), the holder of a note brought an action against guarantors who claimed a discharge because the creditor had approved a substitution of the original collateral. The promissory note stated that a release of security would not release the liability of the guarantors, and the court found that this language served as an effective consent of the guarantors, denying them a discharge. See also Tolzman v. Gwynn, 324 A.2d 179 (Md.Ct. App.1974), reaching the same result where the language of consent was found in the guaranty agreement.

An effective consent may also be given by the transferor after the inception of the mortgage. See, e.g., Zellner v. Hall, 80 S.E.2d 787 (Ga. 1954) (mortgagor consented to increase in interest rate and change in monthly payments; hence was not discharged). Cf. Haberl v. Bigelow, 855 P.2d 1368 (Colo.1993) (no consent implied from transferor's silence). See also Restatement of Security § 128, Illustrations 1 and 2. Where the transferor's consent is given after the release, modification, or extension has been entered into, the consent may be thought of as a ratification, or as a waiver by the transferor of the right to be discharged; id.

Reservation of the mortgagee's rights without the transferor's consent, Comment h. It was traditionally held that, where the mortgagee and the transferee entered into an agreement extending the time for performance of the mortgage obligation, the transferor's liability on the obligation could be fully preserved if a clause reserving the mortgagee's rights was included in the extension agreement. See United States v. Hays, 877 F.2d 843, 845 n. 6 (10th Cir.1989); National Park Bank v. Koehler, 97 N.E. 468, 471 (N.Y.1912); Mutual Life Ins. Co. v. J.H.C. Corp., 64 N.Y.S.2d 256 (N.Y.Sup.Ct.1946); L. Simpson, Suretyship § 73 at 351, 362 (1950).

The effectiveness of a reservation of rights in the extension or modification agreement is not recognized under Restatement Third, Suretyship and Guaranty, and hence not under this Restatement. Instead, it follows the pattern established for indorsers and accommodation parties of negotiable paper by Uniform Commercial Code § 3–605 (1995), which abolishes the reservation of rights doctrine for such parties. As noted above, that section of the U.C.C. does not directly apply here, since a transferor is not technically an indorser or accommodation party, but its concepts are closely analogous. An extension or modification agreement will result in discharge of the transferor to the extent it causes the transferor actual loss, unless the original mortgage documents reserve the mortgagee's right to extend or modify the obligation or the transferor joins in the modification agreement or otherwise consents to or ratifies it.

§ 5.4 Transfer of Mortgages and Obligations Secured by Mortgages

(a) A transfer of an obligation secured by a mortgage also transfers the mortgage unless the parties to the transfer agree otherwise.

(b) Except as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise.

(c) A mortgage may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the mortgage secures.

Cross-References:

Section 5.5, Effect of Performance to the Transferor After Transfer of an Obligation Secured by a Mortgage.

Comment:

a. Introduction. This section deals with transfers of mortgages and their associated obligations by an original mortgagee to a successor, or from one successor to another. Such transfers occur in what is commonly termed the secondary mortgage market, as distinct from the primary mortgage market in which mortgage loans are originated by lenders to borrowers.

The essential premise of this section is that it is nearly always sensible to keep the mortgage and the right of enforcement of the obligation it secures in the hands of the same person. This is so because separating the obligation from the mortgage results in a practical loss of efficacy of the mortgage; see Subsection (c) of this section. When the right of enforcement of the note and the mortgage are split, the note becomes, as a practical matter, unsecured. This result is economically wasteful and confers an unwarranted windfall on the mortgagor.

It is conceivable that on rare occasions a mortgagee will wish to disassociate the obligation and the mortgage, but that result should follow only upon evidence that the parties to the transfer so agreed. The far more common intent is to keep the two rights combined. Ideally a transferring mortgagee will make that intent plain by executing to the transferee both an assignment of the mortgage and an assignment, indorsement, or other appropriate transfer of the obligation. But experience suggests that, with fair frequency, mortgagees fail to document their transfers so carefully. This section's purpose is generally to achieve the same result even if one of the two aspects of the transfer is omitted.

This section applies whether the transfer is outright or is given as collateral or security for some other obligation. When an obligation secured by a mortgage is transferred as collateral for another debt, the person receiving the security interest will generally wish to perfect that interest under U.C.C. Article 9. However, the principles of this section will operate to keep the obligation and the mortgage united whether or not perfection is achieved. Perfection as to the obligation will also constitute perfection as to the mortgage.

b. Transfer of the obligation also transfers the mortgage. A transfer in full of the obligation automatically transfers the mortgage as well unless the parties agree that the transferor is to retain the mortgage. The objective of this rule, as noted above, is to keep the obligation and the mortgage in the same hands unless the parties wish to separate them. This result is sometimes justified on the ground that "[a]ll the authorities agree that the debt is the principal thing and the mortgage an accessory," as the United States Supreme Court put it in 1872 in Carpenter v. Longan, 83 U.S. (16 Wall.) 271, 21 L.Ed. 313 (1872).

Ownership of a contractual obligation can generally be transferred by a document of assignment; see Restatement, Second, Contracts § 316. However, if the obligation is embodied in a negotiable instrument, a transfer of the right to enforce must be made by delivery of the instrument; see U.C.C. § 3-203 (1995). The principle of this subsection, that the mortgage follows the note, applies to either form of transfer of the note. Moreover, it applies even if the transferee does not know that the obligation is secured by a mortgage. See Illustrations 1-3.

Recordation of a mortgage assignment is not necessary to the effective transfer of the obligation or the mortgage securing it. However, assignees are well advised to record. One reason is that, if the assignment is not recorded, the original mortgagee appears in the public records to continue to hold the mortgage. If the mortgagee and mortgagor subsequently enter into and record a purported discharge or modification of the mortgage without the assignee's knowledge or involvement, and the real estate is then transferred to a good faith purchaser for value, the latter is entitled te rely on the record. The result is to prevent the assignee from enforcing the mortgage, in its original form, against the purchaser.

Illustrations:

1. Mortgagor borrows money from Mortgagee and gives Mortgagee a nonnegotiable promissory note for the amount borrowed and, to secure payment of the note, a mortgage on Blackacre. Mortgagee subsequently executes a separate "Assignment of Promissory Note" transferring ownership of the note to Assignee, but makes no mention and no express assignment of the mortgage. By this transfer Assignee becomes the owner of both the note and the mortgage.

2. The facts are the same as Illustration 1, except that the note is negotiable, and that rather than executing an assignment of the note to Assignee, Mortgagee delivers the note to Assignee for the purpose of giving Assignee the right to enforce the note. By this transfer Assignee becomes the owner of both the note and the mortgage.

3. The facts are the same as Illustration 1 or Illustration 2, except that Assignee has no knowledge that the note is secured by a mortgage. The result is the same as in Illustrations 1 and 2.

A transfer of the obligation with a retention of the mortgage is possible, but only if the transferor and transferee so agree. See Illustration 4. If the full obligation is transferred without the mortgage, the effect of such a transfer under Subsection (c) of this section is to make it impossible to foreclose the mortgage, and hence to make it practically a nullity, unless the transferor is also made the transferee's agent or trustee with authority to foreclose in the transferee's behalf. See Comment *e*.

Illustration:

4. Mortgagor borrows money from Mortgagee and gives Mortgagee a nonnegotiable promissory note for the amount borrowed and, to secure payment of the note, a mortgage on Blackacre. Mortgagee subsequently executes an "Assignment of Promissory Note" transferring ownership of the note to Assignee, which expressly provides that "the mortgage securing this note is not assigned to Assignee, but is retained as Mortgagee's property." By this transfer Assignee becomes the owner of the note, but not of the mortgage.

There is one situation in which a retention of the mortgage by the transferor of the obligation may be sensible and desirable. That is where the obligation is bifurcated. This may occur, for example, because the original mortgagee transfers only a partial interest in the secured obligation while retaining the residue, or because the obligation is represented by two notes and the original mortgagee transfers one of them while retaining the other. The obligation or the mortgage may, of course, contain terms either authorizing or prohibiting such transfers, and stating how the real estate mortgage is to be dealt with in the event of such a partial transfer of the obligation.

If these documents do not deal with the matter, the parties to the transaction, if well advised, will expressly agree as to the disposition of the security, and thus may express the intent mentioned in § 5.4(a). They may agree either that the mortgage is to pass to the transferee, or that it is to be retained by the transferor. Conceivably, they may agree that it is to be divided between the parties on some basis. If no specific intent is expressed by the parties, either in the original documents or at the time of the transfer, the effect of a partial transfer of the obligation, under § 5.4(a), will be to bifurcate the mortgage as well, and to transfer a proportionate interest in it to the partial transferee of the obligation, leaving the remainder in the transferor's hands. This result is cumbersome, but there is no fair and feasible alternative if the parties fail to agree on the disposition of the mortgage.

c. Transfer of the mortgage also transfers the obligation. When ownership of a mortgage is assigned to another, Subsection (b) of this section provides that the obligation secured by the mortgage is likewise transferred unless the parties agree that the obligation be retained by the transferor. In effect, the obligation will "follow" the mortgage even if not expressly mentioned in any document of transfer. The reason, as noted above, is that this is ordinarily what the parties desire and expect when a mortgage is assigned. Thus this section is designed to carry out the parties' intention even though they, through ignorance or inadvertence, have not fully documented it. See Illustrations 5 and 6. If the obligation is only partially owned by the transferor, or if the obligation is subject to prior liens or security interests, only the interest of the transferor in the obligation passes to the transferee.

Illustrations:

5. Mortgagor borrows money from Mortgagee and gives Mortgagee a nonnegotiable promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. Mortgagee negotiates a sale of the loan to Assignee. Mortgagee executes an assignment of the mortgage to Assignee, but the assignment makes no express mention of the note. Owner-

ship of the note passes to Assignee with the mortgage despite the absence of any express transfer of the note.

6. The facts are the same as Illustration 5, except that instead of executing an assignment of the mortgage, Mortgagee executes and delivers a deed of Blackacre to Assignee. The result is the same as in Illustration 5.

It is possible for a mortgagee to assign the mortgage while retaining full ownership of the obligation, but only if the parties so agree. See Illustration 7. The practical effect of such a transaction is to make it impossible to foreclose the mortgage, unless the transferee is also made an agent or trustee of the transferor or otherwise has authority to foreclose in the transferor's behalf. See Comment *e*.

Illustration:

7. Mortgagor borrows money from Mortgagee and gives Mortgagee a nonnegotiable promissory note for the amount borrowed and, to secure payment of the note, a mortgage on Blackacre. Mortgagee subsequently executes an assignment of the mortgage to Assignee, but the assignment expressly provides that "ownership of the promissory note secured by this mortgage is retained by Mortgagee, and Assignee acquires no interest in it." Assignee becomes the owner of the mortgage but not owner of the promissory note. Unless Assignee is authorized by Mortgagee to do so on Mortgagee's behalf, Assignee may not foreclose the mortgage.

If the mortgage obligation is a negotiable note, Uniform Commercial Code § 3–203 (1995) is generally understood to make the right of enforcement of the note transferrable only by delivery of the instrument itself to the transferee. Hence, when a mortgage is assigned but the negotiable note it secures is not delivered, the courts may find it necessary to disregard the rule of Subsection (b) in order to effectuate the Code.

Institutional purchasers of loans in the secondary mortgage market often designate a third party, not the originating mortgagee, to collect payments on and otherwise "service" the loan for the investor. In such cases the promissory note is typically transferred to the purchaser, but an assignment of the mortgage from the originating mortgagee to the servicer may be executed and recorded. This assignment is convenient because it facilitates actions that the servicer might take, such as releasing the mortgage, at the instruction of the purchaser. The servicer may or may not execute a further unrecorded assignment of the mortgage to the purchaser. It is clear in this situation that the owner of both the note and mortgage is the investor and not the servicer. This follows from the express agreement to this effect that exists among the parties involved. The same result would be reached if the note and mortgage were originally transferred to the institutional purchaser, who thereafter designated another party as servicer and executed and recorded a mortgage assignment to that party for convenience while retaining the promissory note. Again, the parties' agreement that ownership of the note should remain in the purchaser would be enforced.

Occasionally a mortgagee may wish to assign the mortgage in full, but to retain a partial interest in the obligation. For example, if the mortgage secures two notes, the mortgagee might transfer one note (along with the mortgage) and retain the other. There is no objection to such a transaction if the parties so agree. The portion of the obligation remaining in the mortgagee's hands will be unsecured, while the portion acquired by the transferee will be secured by the entire mortgage.

d. Competing transfers of obligations and mortgages. This section's focus is on the relationship between the transferor and transferee of obligations and mortgages that secure them. It does not purport to resolve conflicts resulting from multiple purported transfers by a transferor to competing transferees. That subject is complex and is governed by other bodies of law, including the recording acts and the Uniform Commercial Code, that are beyond the scope of this Restatement.

e. Mortgage may not be enforced except by a person having the right to enforce the obligation or one acting on behalf of such a person. As mentioned, in general a mortgage is unenforceable if it is held by one who has no right to enforce the secured obligation. For example, assume that the original mortgagee transfers the mortgage alone to A and the promissory note that it secures to B. Since the obligation is not enforceable by A, A can never suffer a default and hence cannot foreclose the mortgage. B, as holder of the note, can suffer a default. However, in the absence of some additional facts creating authority in A to enforce the mortgage for B, B cannot cause the mortgage to be foreclosed since B does not own the mortgage. See Illustration 8.

This result is changed if A has authority from B to enforce the mortgage on B's behalf. For example, A may be a trustee or agent of B with responsibility to enforce the mortgage at B's direction. A's enforcement of the mortgage in these circumstances is proper. See Illustration 9. The trust or agency relationship may arise from the terms of the assignment, from a separate agreement, or from other circumstances. Courts should be vigorous in seeking to find such a relationship, since the result is otherwise likely to be a windfall for the mortgagor and the frustration of B's expectation of security. See Illustration 10.

Illustrations:

8. The facts are the same as Illustration 4. If Mortgagor defaults in payment of the promissory note, Assignee may sue on the note, but neither Mortgagee nor Assignee may enforce the mortgage.

9. The facts are the same as Illustration 4, except that the assignment of the note further states, "Mortgagee is hereby designated agent of Assignee with a duty to foreclose the mortgage upon Assignee's request." If Mortgagor defaults in payment of the promissory note, Assignee may sue on the note, and Mortgagee must foreclose the mortgage if directed by Assignee to do so, subject to the provisions of § 8.2.

10. The facts are the same as Illustration 4, except that Mortgagee has often served as Assignee's agent in the past with authority to foreclose mortgages held by Assignee. A court is warranted in finding on the basis of this pattern of prior conduct that Mortgagee is Assignee's agent for purposes of foreclosing the instant mortgage. Upon such a finding, Mortgagee must foreclose the mortgage if directed by Assignee to do so, subject to the provisions of § 8.2.

REPORTERS' NOTE

Introduction, Comment a. General commentaries on the transfer of mortgages and their associated obligations include 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 5.27–5.35 (3d ed. 1993); G. Glenn, Mortgages § 314 (1943); Ellis & Lowry, A Comprehensive Note Purchase Guide (with Forms), Part I, Prac. Real Estate Lawyer 45 (July 1987); Part II, Prac. Real Estate Lawyer 49 (Sept.1987); Bautista & Kennedy, The Imputed Negotiability of Security Interests Under the Code, 38 Ind. L.J. 574 (1963); Note, Transfer of the Mortgagee's Interest in Florida, 14 U. Fla. L. Rev. 98 (1961); Britton, Assignment of Mortgages Securing Negotiable Notes, 10 Ill. L. Rev. 337 (1915).

The mortgage becomes useless in the hands of one who does not also hold the obligation because only the holder of the obligation can foreclose; see In re Atlantic Mortg. Corp., 69 B.R. 321 (Bankr.E.D.Mich.1987); Swinton v. Cuffman, 213 S.W. 409 (Ark.1919); Stribling v. Splint Coal Co., 5 S.E. 321 (W.Va.1888). When a separation of the two has occurred, some courts have imposed a constructive trust on the mortgage in favor of the holder of the obligation in order to make it available for foreclosure; see Lawrence v. Knap, 1 Root (Conn.) 248, 1 Am.Dec. 42 (1791); Pettus v. Gault, 71 A. 509 (Conn.1908); Kinna v. Smith, 3 N.J.Eq. 14 (1834); Rembert v. Ellis, 17 S.E.2d 165 (Ga.1941), noted 137 A.L.R. 479. The essential desirability of avoiding a separation of the obligation and the mortgage has been explained thus:

> Among the "gems" and "free offerings" of the late Professor Chester Smith of the University of Arizona College of Law was the following analogy. The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow.

Best Fertilizers of Arizona, Inc. v. Burns, 571 P.2d 675, 676 (Ariz.Ct. App.1977), reversed on other grounds, 570 P.2d 179 (Ariz.1977). See also Carpenter v. Longan, 83 U.S. (16 Wall.) 271, 21 L.Ed. 313 (1872).

Transfer of the obligation also transfers the mortgage, Comment b. Illustrations 1 and 2 are supported by In re Ivy Properties, Inc., 109 B.R. 10 (Bankr.D.Mass.1989); In re Union Packing Co., 62 B.R. 96 (Bankr. D.Neb.1986); First National Bank v. Larson, 17 B.R. 957, 965 (Bankr. D.N.J.1982); Rodney v. Arizona Bank, 836 P.2d 434 (Ariz.Ct.App.1992); Campbell v. Warren, 726 P.2d 623 (Ariz.Ct.App.1986) (an assignment of a portion of the payments from a promissory note automatically transfers a *pro tanto* interest in the mortgage that secures the note); Domarad v. Fisher & Burke, Inc., 76 Cal.Rptr. 529 (Cal.Ct.App.1969); Margiewicz v. Terco Properties, 441 So.2d 1124 (Fla.Dist.Ct.App.1983); Moore v. Lewis, 366 N.E.2d 594 (Ill. App. Ct. 1977); Jones v. Titus, 175 N.W. 257 (Mich. 1919); Goetz v. Selsor, 628 S.W.2d 404 (Mo.Ct.App.1982); Kernohan v. Manss, 41 N.E. 258 (Ohio 1895); Bartlett Estate Co. v. Fairhaven Land Co., 49 Wash. 58, 94 P. 900 (1908). See generally G. Glenn, Mortgages § 314 (1943).

See also Ala. Code § 8-5-24: "The transfer of a ... note given for the purchase of lands ... passes to the transferee the lien of the vendor of the lands"; Ariz. Rev. Stat. § 33-817: "The transfer of any contract or contracts secured by a trust deed shall operate as a transfer of the security for such contract or contracts"; West's Ann. Cal. Civil Code § 2936: "The assignment of a debt secured by a mortgage carries with it the security."

Some cases reach the same result as this subsection by finding that the transferor of the note is a constructive trustee of the mortgage for the benefit of the transferee. See, e.g., Pettus v. Gault, 71 A. 509 (Conn. 1908); Rembert v. Ellis, 17 S.E.2d 165, 137 A.L.R. 479 (Ga. 1941); Kinna v. Smith, 3 N.J.Eq. 14 (1834).

Illustration 3 is based on Mankato First National Bank v. Pope, 89 N.W. 318 (Minn.1902). See also Edwards v. Bay State Gas Co., 184 Fed. 979 (C.C. Del. 1911); Holland Banking v. See, 130 S.W. 354 (Mo.Ct.App.1910); Betz v. Heebner, 1 Pen. & W. 280 (Pa. 1830).

With respect to Illustration 4, there is substantial authority that the note and the mortgage are "inseparable." Several of the cases cited above in connection with Illustrations 1 and 2 so state; see Hill v. Favour, 84 P.2d 575 (Ariz.1938). However, under this Restatement a separation of the two rights is permissible if the parties so intend, although under Subsection (c) of this section the person who then owns the mortgage is generally unable to enforce it.

A partial transfer of the obligation effects a partial or pro tanto transfer of the mortgage as well, in the absence of contrary intent. See Allen v. Hamman Lumber Co., 34 P.2d 397 (Ariz.1934); Anderson Banking Co. v. Gustin, 146 N.E. 331 (Ind.Ct.App. 1925); New England Loan & Trust Co. v. Robinson, 76 N.W. 415 (Neb. 1898); Hyman v. Sun Ins. Co., 175 A.2d 247 (N.J. Super. Ct. 1961). However, the case law offers little guidance as to the practical management of such a bifurcated mortgage. Who has the power to make decisions regarding foreclosure, forbearance, and the like? Presumably the courts will permit those holding a majority interest in the obligation and mortgage to decide these questions, but the matter is unclear. See Perkins v. Chad Devel. Corp., 157 Cal.Rptr. 201 (Cal. Ct.App.1979), holding that where the mortgage is held by two co-owners, either of them has the power to foreclose without the consent of the other.

Questions may also arise concerning the relative priority of the parties in the proceeds of mortgage foreclosure. Modern case law generally treats them as pro-rata participants if there is no contrary agreement. See Perkins v. Chad Devel. Corp., 157 Cal.Rptr. 201 (Cal.Ct.App.1979); Domeyer v. O'Connell, 4 N.E.2d 830 (Ill. 1936); Farr v. Hartley, 81 P.2d 640 (Ut.1938); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.35 (3d ed. 1993); G. Glenn, Mortgages § 318 (1943). Well-advised parties will, of course, enter into a "participation agreement" dealing with all of these issues.

Transfer of the mortgage also transfers the obligation, Comment c. Illustration 5 is based on Gregg v. Williamson, 98 S.E.2d 481 (N.C.1957) (statement in margin of public records assigning a mortgage had the effect of transferring the note as well). See United States v. Freidus, 769 F.Supp. 1266 (S.D.N.Y.1991); Seabury v. Hemley, 56 So. 530 (Ala. 1911); Andrews v. Townshend, 1 N.Y.S. 421 (N.Y. Super. Ct. 1888); Loveridge v. Shurtz, 70 N.W. 132 (Mich.1897); Foster v. Trowbridge, 40 N.W. 255 (Minn.1888). See also Lawson v. Estate of Slaybaugh, 619 S.W.2d 910 (Mo.Ct.App.1981) (while an assignment of the mortgage without the note is ordinarily a nullity, it might be held to transfer the note if that was the intention of the assignor); In re United Home Loans, Inc., 71 B.R. 885 (W.D.Wash.1987) (where mortgage is assigned by document which states that the debt is also being transferred, ownership of the note passes to the assignee even though the note is not indorsed or delivered). See Kan. Stat. Ann. § 58–2323: "The assignment of any mortgage as herein provided shall carry with it the debt thereby secured."

There is also substantial contrary authority, holding that an assignment of the mortgage without the obligation is a nullity. That authority is not followed by this Restatement. See In re Hurricane Resort Co., 30 B.R. 258 (Bankr.Fla.1983); Hill v. Favour, 84 P.2d 575 (Ariz.1938); Domarad v. Fisher & Burke, Inc., 76 Cal.Rptr. 529 (Cal.Ct.App.1969) (dictum); Hamilton v. Browning, 94 Ind. 242 (1883); Pope & Slocum v. Jacobus, 10 Iowa 262 (1859); Van Diest Supply Co. v. Adrian State Bank, 305 N.W.2d 342 (Minn.1981); Kluge v. Fugazy, 536 N.Y.S.2d 92 (N.Y.App.Div.1988); Miller v. Berry, 104 N.W. 311 (S.D.1905). See Note, Transfer of the Mortgagee's Interest in Florida, 14 U. Fla. L. Rev. 98 (1961).

Illustration 6 is based on Carr v. Dorenkamper, 556 N.E.2d 1333 (Ind. Ct.App.1990) (quitclaim deed, effective as an "equitable assignment"). See also Welsh v. Phillips, 54 Ala. 309, 25 Am.Rep. 679 (1875) (warranty deed); Ruggles v. Barton, 79 Mass. (13 Gray) 506 (1859); Hinds v. Ballou, 44 N.H. 619 (1863) (quitclaim deed); Welch v. Priest, 90 Mass. (8 Allen) 165 (1864) (release effective to transfer mortgage and obligation). See generally Rollison, Priorities in the Law of Mortgages, 9 Notre Dame Law. 50 (1933).

There is substantial older authority that a conveyance of the land by the mortgagee is a nullity rather than a transfer of both the mortgage and the obligation. See Peters v. Jamestown Bridge Co., 5 Cal. 334, 63 Am.Dec. 134 (1855); Carter v. Bennett, 4 Fla. 283, 347 (1852); Delano v. Bennett, 90 Ill. 533 (1878); Johnson v. Cornett, 29 Ind. 59 (1867); Swan v. Yaple, 35 Iowa 248 (1872); Farnsworth v. Kimball, 91 A. 954, 956 (Me.1914); Smith v. Smith, 15 N.H. 55, 65 (1844); Devlin v. Collier, 22 A. 201 (N.J. 1891); Merritt v. Bartholick, 36 N.Y. 44 (1867). This Restatement does not follow that authority; since the mortgage is plainly an interest in real estate, it is difficult to see why a deed of the land should not be construed as assigning it.

Competing transfers of obligations and mortgages, Comment d. The principle permitting a subsequent good faith purchaser of a note to prevail over a prior assignee of the mortgage who did not obtain the note is supported by In re Vermont Fiberglass, Inc., 44 B.R. 505 (Bankr.D.Vt. 1984); Nazar v. Southern, 32 B.R. 761 (Bankr.Kan.1983); Second Nat. Bank v. Dyer, 184 A. 386 (Conn.1936); and Price v. Northern Bond & Mortg. Co., 297 P. 786 (Wash. 1931). The conclusion favoring the second taker is more probable when the note is negotiable; see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.34 (3d ed. 1993); G. Glenn, Mortgages § 315.2 (1943).

Mortgage may not be enforced except by the owner of the obligation or one acting on behalf of the owner, Comment d. Illustration 8 is explained as follows in In re Belize Airways Limited, 7 B.R. 604, 606 (Bankr.S.D.Fla.1980):

> To allow the assignee of a security interest [who did not also acquire the note] to enforce the security agreement would expose the obligor to a double liability, since a holder in due course of the promissory note clearly is entitled to recover from the obligor. Section 3-305, Uniform Commercial Code.

See also G. Glenn, Mortgages § 314 (1943):

> To transfer the mortgage and keep the debt would be futile at best.... [T]he transfer would be ineffectual, because the mortgagee's real interest in the property is a security interest. A mortgagee who parts with this security to a stranger, loses its benefit, nor can the stranger profit, unless he was a *bona fide* purchaser, a case that can happen if the mortgage has taken the form of an absolute deed.

By analogy, U.C.C. § 1-201(37) (1995) defines a security interest as "an interest in personal property ... which secures payment or performance of an obligation." Case law construing the Code holds that a security interest is unenforceable in the absence of its underlying obligation. See Bank of Lexington v. Jack Adams Aircraft Sales, 570 F.2d 1220 (5th Cir.1978). Hence, "in order for a creditor to have lien rights in the property of a debtor, the creditor must hold an enforceable obligation against the debtor"; In re G.O. Harris Financial Corp., 51 B.R. 100 (Bankr. S.D.Fla.1985). See Sobel v. Mutual Development Inc., 313 So.2d 77 (Fla. Dist.Ct.App.1975).

Because a transfer of the mortgage without the obligation is essentially futile, a court may strain to find that the holder of the mortgage holds it in trust for the benefit of the owner of the obligation. See Boruchoff v. Ayvasian, 79 N.E.2d 892 (Mass. 1948).

§ 5.5 Effect of Performance to the Transferor After Transfer of an Obligation Secured by a Mortgage

Except as otherwise provided by the Uniform Commercial Code, after transfer of an obligation secured by a mortgage, performance of the obligation to the transferor is effective against the transferee if rendered before the obligor receives notice of the transfer.

Cross-References:

Section 5.4, Transfer of Mortgages and Obligations Secured by Mortgages; § 6.4, Redemption from Mortgage by Performance or Tender; Uniform Commercial Code §§ 3-203, 3-301, & 9-318 (1995); Uniform Land Security Interest Act § 206; Uniform Land Transactions Act § 3-206; Uniform Consumer Credit Code § 3-204 (1974 version).

Comment:

a. Introduction. When a mortgage obligation is transferred by the original mortgagee to another investor, the mortgagor may or may not be informed of the transfer. In many cases, failure to advise the mortgagor is innocuous, since the investor-transferee often designates the original mortgagee as its servicing agent for purposes of collecting the obligation. Hence, the mortgagor may simply continue to perform the obligation to the mortgagee as in the past; the transferee, by virtue of the agency relationship, will be bound to give credit for performance made to its agent.

However, in some cases the mortgagee is not made the transferee's agent. Nonetheless, if the mortgagor is not informed of the transfer, the mortgagor may continue to perform to the original mortgagee. In theory the mortgagor might discover the transfer by demanding that the mortgagee exhibit the evidence of the obligation (typically a promissory note) before making each payment, but such a demand would be extremely cumbersome for both mortgagor and mortgagee, and is an entirely unrealistic expectation.

This section protects the innocent mortgagor who continues to make such payments. It provides that payments are effective against the transferee until the mortgagor receives notice of the transfer. See Illustration 1. The contrary rule, giving the mortgagor no credit for payments innocently made to the mortgagee after the transfer, is usually (although not exclusively) followed in the reported decisions. These cases generally take the position that a promissory note is a "symbolic writing" that embodies the obligation. Hence, the payor may demand to see the note before each payment, and a payor who fails to do so pays negligently and deserves no protection for having paid the wrong party. As noted above, that view is completely impractical and has the potential for great injustice to mortgagors. Except as noted below with respect to negotiable instruments, it has been abandoned by all modern model acts that deal with the issue, including the Uniform Commercial Code (with respect to obligations secured by accounts, chattel paper, or general intangibles), the Uniform Land Security Interest Act, the Uniform Land Transactions Act, and the Uniform Consumer Credit Code.

Illustration:

1. Mortgagor borrows money from Mortgagee and gives Mortgagee a nonnegotiable promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. The note requires Mortgagor to make monthly payments of principal and interest. Mortgagee subsequently indorses the promissory note to Assignee and executes an assignment of the mortgage to Assignee. Mortgagor has no notice of this transfer, and continues to make monthly payments to Mortgagee. These payments are effective against Assignee.

While Illustration 1 involves the making of regular monthly payments on the mortgage debt, the principle of this section is not so limited; it applies as well to acceptance by the mortgage transferor of final payments, balloon payments, and prepayments.

The practical effect of the rule of this section is to give investors who purchase mortgages on the secondary market, but who do not enter into servicing agreements with their transferors, a strong motivation to notify the mortgagors whose mortgages they have purchased. This burden is reasonable, for secondary market investors have in all events an obvious economic interest in knowing the names and current addresses of mortgagors, and often contact them to obtain estoppel statements prior to purchasing their mortgages.

One who has made an assignment, and who subsequently accepts payment or performance from the obligor and refuses to surrender it to the assignee, is obviously acting wrongfully with respect to the assignee. While this section bars an action by the assignee against the obligor for any payments made without notice of the transfer, the assignee will have an action against the assignor to recover the payment in order to avoid unjust enrichment.

The term "obligor" is used in a broad sense in this section, and comprehends all persons who may have an economic incentive to perform the secured obligation, provided the transferee of the mortgage is aware of their identities. It includes the original mortgagor, whether personally liable on the mortgage debt or not. It also includes any sureties, guarantors, indorsers, or accommodation parties, and any grantees of interests in the real estate, whether they assumed the obligation or merely took subject to it, if the transferee of the obligation has actual knowledge of them. Donees and transferees by will or intestacy are similarly also protected. Moreover, even if one of these parties is given notice of the transfer, performance to the transferor of the obligation by a different obligor who lacks notice is effective.

b. This section inapplicable to negotiable instruments. The principle of this section, protecting the mortgagor for payments innocently made to the mortgagee after a transfer of the obligation, is incompatible with the treatment of negotiable instruments under Uniform Commercial Code Article 3 (1995). Under U.C.C. § 3–602 (1995), an instrument is paid, and the payor is discharged, " . . . to the extent payment is made . . . to a person entitled to enforce the instrument." Under U.C.C. § 3–301 (1995), the phrase "person entitled to enforce" includes a holder to whom the instrument has been negotiated. It also includes any person to whom the instrument is delivered for the purpose of giving the right of enforcement, even if that person is not a holder; see U.C.C. § 3–203(a), (b) (1995). (For example, a transfer by delivery of the instrument without an indorsement will not constitute the transferee a holder, but the transferee is still entitled to enforce the instrument.) As is explained in U.C.C. § 3–203, Comment 1 (1995):

> [A negotiable] instrument is a reified right to payment. The right is represented by the instrument itself. The right to payment is transferred by delivery of possession of the instrument "by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."

These principles are widely understood to vest the power to discharge the obligation *exclusively* in the person "entitled to enforce" the instrument, although the Code does not expressly so state. Hence, if the original payee has delivered possession of the instrument to another for the purpose of transferring the right of enforcement, payment to the original payee is not recognized as discharging the obligation. This is true whether or not the new possessor of the instrument is a holder or is "in due course."

This result has been criticized on the grounds discussed in Comment *a* in the context of notes secured by mortgages, but it remains a part of U.C.C. Article 3 (1995). Despite the inequities it sometimes engenders, it is statutory in nature and cannot be varied by this Restatement.

However, the U.C.C.'s requirement that payment be made to the person in possession of the instrument is only rarely a problem for payors who pay the original mortgagee. One reason is that many notes secured by real estate mortgages are not negotiable in form because their promise to pay is conditional, because they are not payable to "bearer" or "order," or because they contain additional undertakings beyond the payment of money. See U.C.C. § 3–104 (1995). The U.C.C. does not govern discharge of nonnegotiable obligations.

Another reason is that very frequently when a mortgage loan is sold on the secondary mortgage market, the original mortgagee is formally designated as "servicer" of the mortgage loan by the holder, with full authority to receive payments on behalf of the holder. Hence such payments count as if they had been made to the holder directly. Moreover, if the servicing duties are later shifted to a different entity, federal law requires that notification of the change be given to the mortgagor if the mortgage is "federally related"; see 12 U.S.C.A. § 2605. Some state statutes impose similar duties.

Even when there is no specific grant of collection authority to the original mortgagee by the holder, courts often find implied authority from the prior course of dealing between the holder and the mortgagee; see Illustrations 2 and 3. If there is no such course of dealing, the holder's conduct may estop it from denying the mortgagee's authority; see Illustration 4. Finally, the holder's conduct after the mortgagee has received payment may constitute a ratification of that payment, thus compelling the holder to give credit for it. See Illustration 5.

Illustrations:

2. Mortgagor borrows money from Mortgagee and gives Mortgagee a negotiable promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. The note requires Mortgagor to make monthly payments of principal and interest. Mortgagee subsequently indorses the promissory note and delivers it to Assignee. Mortgagor has no

notice of this transfer, and continues to make monthly payments to Mortgagee. In the recent past Mortgagee has sold numerous other notes and mortgages to Assignee, and in each case has continued, after the transfer, to collect payments on those notes and to remit them to Assignee. Assignee has not previously objected to this practice. A court is warranted in finding from this course of dealing that Mortgagee is the agent of Assignee for purposes of collecting payments on the present note. These payments are effective against Assignee.

3. The facts are the same as Illustration 2 except that mortgagee has not previously sold notes and mortgages to Assignee. However, as Mortgagor continues to make payments to Mortgagee, Mortgagee consistently remits them to Assignee, who makes no objection to this practice. Thereafter Mortgagor pays the full remaining balance of the obligation to Mortgagee, who absconds with the funds. A court is warranted in finding from the course of dealing that Mortgagee is the agent of Assignee for purposes of collecting payments on the note, including the final payment. This payment is effective against Assignee.

4. Mortgagor borrows money from Mortgagee and gives Mortgagee a negotiable promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. The note requires Mortgagor to make monthly payments of principal and interest. Mortgagee subsequently indorses and delivers the promissory note to AA Investment Co. Mortgagor has no notice of this transfer, and continues to make monthly payments to Mortgagee. A sign displayed prominently on Mortgagee's business premises reads "Agent for AA Investment Co." Both Mortgagor and AA Investment Co. are aware of the existence of the sign prior to the time Mortgagee transfers the note and mortgage, and AA Investment Co. has made no objection to it. A court is warranted in finding that AA Investment Co. is estopped to deny Mortgagee's authority to collect payments on the note. These payments are effective against AA Investment Co.

5. Mortgagor borrows money from Mortgagee and gives Mortgagee a negotiable promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. The note requires Mortgagor to make monthly payments of principal and interest. Mortgagee subsequently indorses and delivers the promissory note to Assignee. Mortgagor has no notice of this transfer, and continues to make monthly payments to Mortgagee. After several additional payments have been made, Assignee tells Mortgagor, "I have purchased your note, but I see that you are still making payments to Mortgagee. I have no

problem with that." A court is warranted in finding that Assignee has ratified the payments already made to Mortgagee, and is also estopped to deny Mortgagee's authority to collect further payments on the note. All of these payments are effective against Assignee.

c. What constitutes notice. The most obvious and common form of notice under this section is written notification mailed or otherwise delivered by the mortgage assignee. See the discussion of means of delivering notice in § 4.2, Comment *f.* Alternatively, the obligor may be informed of the transfer by the assignor or some other person.

The mere recordation of the mortgage assignment in the public records does not constitute notice to the mortgagor, since to so hold would in effect impose on mortgagors a duty to examine the record title to their land before making each payment—plainly an unreasonable burden. See Illustration 6. However, when the mortgaged real estate is sold after an assignment of the mortgage has been recorded, the recordation takes on a different aspect. The reason is that the grantee who buys the land already has a strong incentive to examine the title, and is put to no additional effort to check for mortgage assignments. Hence, recordation imparts notice to such grantees. See Illustration 7.

Illustrations:

6. Mortgagor borrows money from Mortgagee and gives Mortgagee a promissory note for the amount borrowed and, as security for payment of the note, a mortgage on Blackacre. The note requires Mortgagor to make monthly payments of principal and interest. Mortgagee subsequently indorses the promissory note to Assignee and executes an assignment of the mortgage to Assignee, which Assignee records in the public records. Mortgagor is not held to have notice of this transfer from the recordation of the assignment, and Mortgagor's continued monthly payments to Mortgagee are effective against Assignee.

7. The facts are the same as Illustration 5, except that after recordation of the assignment, Mortgagor sells Blackacre to Grantee, who commences making monthly payments to Mortgagee. Grantee is held to have notice of the assignment from its recordation, and Grantee's payments are not effective against Assignee.

An obligor who receives notice that the obligation has been transferred is entitled to demand reasonable evidence that the purported transfer is authentic, and to continue paying the transferor until that evidence is provided. If notice is given by the transferee, a confirmation of the transfer by the transferor will ordinarily settle all doubt. However, if the transferee and transferor provide conflicting information to the obligor, it may be necessary for the obligor to file an action in the nature of interpleader to determine to whom payment should be made.

REPORTERS' NOTE

Introduction, Comment a. On the problem of payment to the transferor after assignment of the mortgage, see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 5.33 (3d ed. 1993).

This section's rule is unnecessary in cases in which the transferee of the obligation has appointed the transferor as agent or "servicer" with authority to collect the obligation, since in that context a payment to the servicer will obviously bind the transferee. See, e.g., Skott v. Bank of America Illinois, 468 S.E.2d 359 (Ga.1996) (express agency); Rockford Life Ins. Co. v. Rios, 261 N.E.2d 530 (Ill. App. Ct. 1970) (express agency); Caballero v. Wilkinson, 367 So.2d 349 (La.1979); Tedesco v. Bekker, 741 S.W.2d 896 (Mo.Ct.App.1987) (express agency); Holsclaw v. Catalina Sav. & Loan Ass'n, 476 P.2d 883 (Ariz.Ct.App. 1970) (agency implied from long course of dealing). Cf. Hagen v. Silva, 293 P.2d 143 (Cal.Ct.App.1956) (servicing agent had authority to collect interest but not principal).

A few cases support the rule of this section, upholding the efficacy of payments made to the transferor after the mortgage has been transferred but before notice to the payor. See First National Bank v. Larson, 17 B.R. 957 (Bankr.D.N.J.1982) (dictum); Felin Associates, Inc. v. Rogers, 326 N.Y.S.2d 413 (N.Y.App.Div. 1971) (dictum). The only direct holdings supporting the payor's position appear to be in Pennsylvania; see O'Maley v. Pugliese, 116 A. 308 (Pa. 1922), noted 42 Harv. L. Rev. 1082 (1929); Foster v. Carson, 28 A. 356 (Pa.1894). See also Md. Code, Real Property, § 7-103(b), adopting the rule of this section; Kan. Stat. Ann. §§ 58-2321 to 58-2322 and N.M. Stat. Ann. §§ 48-7-2 and 48-7-3, adopting the rule of this section if the mortgage assignment is unrecorded.

This section's approach is supported by numerous model acts. See Uniform Commercial Code § 9-318(3) (1995) with respect to obligations secured by accounts, chattel paper, or general intangibles, applied in Commercial Sav. Bank v. G & J Wood Products Co., 207 N.W.2d 401 (Mich.Ct.App.1973); Uniform Land Security Interest Act § 206(c); Uniform Land Transactions Act § 3-206(c); Uniform Consumer Credit Code § 2-412 (1968) and § 3-204 (1974). See Young v. Hawks, 624 P.2d 235 (Wyo.1981), applying the Uniform Consumer Credit Code.

This section is consistent with general contract law. Restatement, Second, of Contracts § 338, at 75-76, provides:

(1) Except as stated in this Section, notwithstanding an assignment, the assignor retains his power to discharge or modify the duty

of the obligor to the extent that the obligor performs or otherwise gives value until but not after the obligor receives notification that the right has been assigned and that performance is to be rendered to the assignee.

See Taylor v. Roeder, 360 S.E.2d 191, 193 (Va.1987).

Cases holding that the payments made after the obligor has notice of the mortgage assignment are ineffective against the transferee include Stegeman v. First Missouri Bank, 722 S.W.2d 349 (Mo.Ct.App.1987); Wood v. Gulf States Capital Corp., 217 So.2d 257, 269 (Miss.1968); Kaufman v. Bernstein, 100 So.2d 801 (Fla. 1958).

Numerous cases take a view contrary to this section, holding payments made to the transferor after assignment of the mortgage are ineffective even if the payor has no actual notice of the assignment. The most important case, widely cited, is Assets Realization Co. v. Clark, 98 N.E. 457 (N.Y.1912), affirming 123 N.Y.S. 1105 (N.Y.App.Div.1909). See also National Credit Union Admin. v. Metzler, 625 F.Supp. 1551 (E.D.Mo.1986); In re Columbia Pacific Mortgage, Inc., 22 B.R. 753 (Bankr.W.D.Wash.1982); Garrett v. Fernauld, 57 So. 671 (Fla. 1912); Silver Spring Title Co. v. Chadwick, 131 A.2d 489 (Md.1957); Culbertson State Bank v. Dahl, 617 P.2d 1295 (Mont.1980); Baxter v. Redevco, Inc., 566 P.2d 501 (Or.1977); Tilton v. Boland, 31 P.2d 657 (Or. 1934); Smith v. Jarman, 211 P. 962 (Ut.1922); Lambert v. Barker, 348 S.E.2d 214 (Va.1986). See Annots., 89 A.L.R. 171 (1934); 104 A.L.R. 1301 (1936).

The "symbolic writing" concept that is usually used to justify these decisions is discussed in E. Farnsworth, Contracts § 11.7 at 777 (1982); Restatement, Second, Contracts § 338, Comment *h*; Whitehead v. American Security & Trust Co., 285 F.2d 282, 285 (D.C.Cir.1960); In re Columbia Pacific Mortgage, Inc., 22 B.R. 753 (Bankr.W.D.Wash.1982); Baxter v. Redevco, Inc., 566 P.2d 501 (Or.1977); Rodgers v. Seattle–First National Bank, 697 P.2d 1009 (Wash. Ct.App.1985).

This section not applicable to negotiable instruments, Comment b. Some of the cases holding payment to the original payee ineffective when made after a negotiation of the note appear to treat it as required by the assignee's holder-in-due-course status under U.C.C. Article 3. See, e.g., Groover v. Petors, 202 S.E.2d 413 (Ga. 1973); Felin Associates, Inc. v. Rogers, 326 N.Y.S.2d 413 (N.Y.App.Div. 1971); Tilton v. Boland, 31 P.2d 657 (Or.1934); Carter v. South Texas Lumber Co., 422 S.W.2d 951 (Tex. Ct. Civ. App. 1967); American Security & Trust Co. v. John J. Juliano, Inc., 127 S.E.2d 348 (Va.1962). Other cases reach the same result from the fact that the transferee is a holder, whether in due course or not; see Lambert v. Barker, 348 S.E.2d 214 (Va.1986). However, as Comment *b* suggests, the critical issue is the negotiable nature of the instrument, not the holder or holder-in-due-course status of the transferee.

For the strongly stated view that it violates norms of "good sense and fairness" not to protect a mortgagor who innocently makes payments to the mortgagee after the transfer of a negotiable note, see Equity Bank v. Gonsalves, 691 A.2d 1143 (Conn.Super.1996).

Illustration 2 is based on Holsclaw v. Catalina Sav. & Loan Ass'n, 476 P.2d 883 (Ariz.Ct.App.1970). See also Rodgers v. Seattle-First Nat'l Bank, 697 P.2d 1009 (Wash.Ct.App.1985); United Missouri Bank v. Beard, 877 S.W.2d 237 (Mo.Ct.App.1994) (express authority of agent to collect monthly payments constitutes implied authority to receive lump sum prepayment as well). Illustration 3 is based on Northside Bldg. & Inv. Co. v. Finance Co. of America, 166 S.E.2d 608 (Ga.Ct.App.1969). Contra, see Steadman v. Foster, 92 A. 353 (N.J. 1914). Illustration 4 is based on Department of Banking & Finance v. Davis, 416 N.W.2d 566 (Neb.1987). Illustration 5 is based on Browne v. Nowlin, 570 P.2d 1246 (Ariz.1977).

The federal requirement that mortgagors be notified of transfers of servicing is found in 12 U.S.C.A. § 2605, part of the Real Estate Settlement Procedures Act (RESPA). Both the transferring and transferee servicers are required to send notices, and both are liable for damages resulting from failure to do so; 12 U.S.C.A. § 2605(f).

What constitutes notice, Comment c. Illustration 6 is based on Foster v. Carson, 159 Pa. 477, 28 A. 356 (1894):

> [I]t would be an intolerable hardship if, every time he may wish to make a payment and obtain a credit on his debt, he should be compelled to visit the recorder's office to ascertain whether or not his mortgage had been assigned.

See also Giorgi v. Pioneer Title Insurance Co., 454 P.2d 104 (Nev.1969); Uniform Land Security Interest Act § 206, comment 3.

A number of jurisdictions provide by statute that recordation of a mortgage assignment gives no constructive notice to the mortgagor. See, e.g., Md. Code, Real Property, § 7-103(b); McKinney's N.Y. Real Prop. Law § 32. See Kirby v. Palos Verdes Escrow Co., 227 Cal.Rptr. 785 (Cal. Ct.App.1986); Blumenthal v. Jassoy, 12 N.W. 517 (Minn.1882); Ward & Stewart, Mortgage Assignment and Payment Statutes, 8 J. Bar. Assn. Kan. 488, 495 (1940); Annot., 89 A.L.R. 171, 197 (1934). On the other hand, a few jurisdictions have construed their recording acts to impart constructive notice of recorded mortgage assignments to mortgagors, typically on the basis of the overgeneralization that recording is "notice to all the world." See Walmer v. Redinger, 227 P. 329 (Kan.1924); Dotto v. Ciamboli, 148 A. 197 (N.J. 1929), affirmed, 154 A. 631 (N.J. 1931); Bale v. Wright, 252 P. 56 (Okla.1926); Ross v. Johnson, 19 P.2d 101 (Wash.1933). See generally Annot., 89 A.L.R. 171, 196 (1934). This Restatement rejects that view.

Illustration 7 is based on Gilcrist v. Wright, 94 N.W.2d 476 (Neb.1959). See also First National Bank v. Larson, 17 B.R. 957, 965 n.5 (Bankr. D.N.J.1982) (dictum); Rucker v. State Exchange Bank, 355 So.2d 171 (Fla. Dist.Ct.App.1978); Connecticut Mutual Life Insurance Co. v. Talbot, 14 N.E. 586 (Ind.1887); Cornish v. Woolverton, 81 P. 4 (Mont.1905); Robbins v. Larson, 72 N.W. 456 (Minn.1897); Assets Realization Co. v. Clark, 98 N.E. 457 (N.Y.1912).

The definition provided by Uniform Land Security Interest Act (U.L.S.I.A.) § 112 is helpful in understanding "notice":

> (a) A person has "notice" of a fact if:
>
> (1) the person has actual knowledge of it;

(2) the person has received a notice or notification of it; or

(3) from all the facts and circumstances known to the person at the time in question the person has reason to know it exists.

* * *

(d) A person "receives" a notice or notification at the time it:

(1) comes to the person's attention; or

(2) is delivered at the place of business through which the person conducted the transaction with respect to which the notice or notification is given or at any other place held out by the person as the place for receipt of the communication.

The right of the obligor to evidence that the assignment has been made, and to continue payment to the assignor until such evidence is provided, is supported by U.L.S.I.A. § 206(c):

> If requested by the obligor, the assignee within ten days after the request is received shall furnish reasonable proof that an assignment has been made. The obligor need not perform to the assignee until requested proof is furnished. The obligor need not perform to the assignor until the time for furnishing proof of the assignment has expired.

The obligor's rights in this respect are further supported by U.C.C. § 9–318(3) (1995):

> If requested by the account debtor, the assignee must seasonably furnish reasonable proof that the assignment has been made and unless he does so the account debtor may pay the assignor.

See generally Annot., Construction and Operation of U.C.C. § 9–318(3) Providing that Account Debtor is Authorized to Pay Assignor Until He Receives Notification to Pay Assignee, 100 A.L.R.3d 1218 (1980).

With respect to the content of the notice, see South Floridabanc Sav. Assn. v. Prof. Inv. of America, 602 N.E.2d 677, 682 (Ohio.Ct.App.1991), dismissed, 588 N.E.2d 863 (Ohio 1992):

> The Ohio Supreme Court requires the notification to set forth three things. The first is an indication that the account has been assigned. Secondly, the notification must contain a specific direction that payment is to be made to the assignee, rather than the assignor. Thirdly, the notification must contain a reasonable identification of the rights assigned.

CHAPTER 6

PAYMENT AND DISCHARGE

Introductory Note: Section 6.1 adopts the view that the mortgagor has a free right of prepayment in the absence of an agreement barring prepayment or imposing a fee or charge. In so doing, it departs from the traditional common-law rule that a borrower has no right to prepay a mortgage obligation if the documents are silent on the point.

Section 6.2 generally approves enforcement of agreements among the parties to a mortgage that prohibit prepayment, or that impose a fee or charge for prepayment of a mortgage loan. However, it also gives the mortgagor the right to provide a substitute form of collateral to the mortgagee, and thus to obtain a release of the real estate from the mortgage, provided that the substitute is substantially the equivalent of cash.

Section 6.3 identifies certain situations in which a prepayment fee may not be charged. These are cases in which the lender has accelerated the debt as a result of a casualty loss or taking in eminent domain, despite the fact that there is no need to accelerate in order to protect the lender against an impairment of security. In such cases, the mortgagee's decision to demand payment does not justify the imposition of a fee.

Section 6.4 states the basic rules that govern the full performance or payment of mortgage obligations, whether occurring before or after maturity. It provides that such performance, if made by a person who is primarily responsible for the debt, automatically extinguishes the mortgage and stops the accrual of interest. Moreover, the payor is entitled to a recordable document showing that the mortgage is extinguished, and is entitled to judicial relief if the mortgagee fails to provide it. Even if the mortgagee refuses to accept the payment or performance, the act of tendering it has the same effect as actual payment.

A somewhat different set of results follow under § 6.4 if a mortgage obligation is fully paid or performed by one who is not primarily responsible for it. Rather than extinguishing the mortgage, such a performance assigns the mortgage to the payor by operation of law under the principle of subrogation, a principle more broadly outlined in § 7.6. Subrogation gives the payor the benefit of the mortgage to assist in collecting the payor's claim of reimbursement from those who are primarily responsible for the debt. The payor is entitled to a document evidencing the assignment and may have judicial relief if the mortgagee fails to give it. Here again, a tender of payment has the same effect as actual payment, even if the mortgagee refuses to accept the tender.

§ 6.1 Right of Mortgagor to Prepay in the Absence of Agreement Prohibiting Prepayment

In the absence of an agreement restricting or prohibiting payment of the mortgage obligation prior to maturity, the mortgagor has a right to make such payment in whole or in part.

Cross-References:

Section 6.2, Enforceability of Prohibitions and Restrictions on Prepayment.

Comment:

This section deals with the right of the mortgagor to prepay the debt when the mortgage documents are silent on the point. It recognizes an unrestricted right of prepayment unless the mortgage or some other enforceable agreement between the parties restricts or eliminates that right. Traditional common-law principles denied that such a right existed. Instead, under the "perfect tender in time" rule, it was held that the mortgagee had no obligation to accept any prepayment unless the mortgage documents expressly authorized it. Several recent cases and statutes have rejected the common-law rule in favor of the position adopted in this section.

The common-law rule is inconsistent with the usual expectations of parties who are not law-trained, and it often contradicts the principle that the documents should be construed against the drafter—usually the mortgagee in a mortgage transaction. The great majority of mortgages, and virtually all of those given to institutional or commercial lenders, deal expressly with the prepayment issue. Hence the issue addressed in this section arises most commonly when the mortgagee and mortgagor are both inexperienced nonprofessionals.

When courts adopt the rule of this section in jurisdictions that have previously followed the "perfect tender in time" rule or have not previously taken a position on the matter, they should be sensitive to the potential unfairness and adverse economic impact that might occur if a lender who had made a loan in reliance on prior law was compelled to accept prepayment.

This section deals only with prepayment of obligations secured exclusively by mortgages on real estate. It takes no position with respect to unsecured debts, or debts secured by personal property or mixed collateral.

REPORTERS' NOTE

Cases following the traditional "perfect tender in time" rule, which prohibits prepayment unless the documents permit it or the mortgagee consents, include Brannon v. McGowan, 683 So.2d 999 (Ala.Civ.App. 1996); Dugan v. Grzybowski, 332 A.2d 97 (Conn.1973); MacIntyre v. Hark, 528 So.2d 1276 (Fla.Dist.Ct.App.1988) (under common-law rule, prepayment must be accepted only if the borrower pays all principal and interest which would accrue during full loan term); Promenade Towers Mut. Housing Corp. v. Metropolitan Life Ins. Co., 597 A.2d 1377 (Md.1991); Poommipanit v. Sloan, 510 N.W.2d 542 (Neb. Ct.App.1993) (real estate installment contract); Patterson v. Tirollo, 581 A.2d 74 (N.H.1990); Peter Fuller Enter. v. Manchester Sav. Bank, 152 A.2d 179 (N.H.1959); Arthur v. Burkich, 520 N.Y.S.2d 638 (N.Y.App.Div. 1987); Beth-June, Inc. v. Wil-Avon Merchandise Mart, Inc., 233 A.2d 620 (Pa. Super. Ct. 1967); Young v. Sodaro, 456 S.E.2d 31 (W.Va.1995). See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 6.1 n.2 (3d ed. 1993); Alexander, Mortgage Prepayment: The Trial of Common Sense, 72 Cornell L. Rev. 288, 309 nn.113–14 (1987).

Even states following the traditional rule may strain to find contract terms permitting prepayment. For example, if the documents provide that payment is to be made "on or before" a specified date, courts usually allow free prepayment at any time. See Acord v. Jones, 440 S.E.2d 679, 680 (Ga.Ct.App.1994); Latimer v. Grundy Cy. Nat'l Bank, 607 N.E.2d 294, 295–96 (Ill. App. Ct. 1993); Coco v. Soniat, 144 So.2d 432 (La.Ct.App. 1962); Hatcher v. Rose, 407 S.E.2d 172 (N.C.1991); Edlund v. Bounds, 842 S.W.2d 719, 726 (Tex. Ct. App. 1992); Pedersen v. Fisher, 245 P. 30 (Wash.1926). Cf. Bayside Gardens Apartment Ventures v. Security Pacific Bank, 1996 WL 442689 (Wash. Ct. App. 1996) ("on or before" language did not override a specific clause requiring a prepayment fee); Cimarron West Properties, Inc. v. Lincoln Loan Co., 860 P.2d 871 (Or. Ct.App.1993) (no prepayment allowed, even though contract stated payment was to be made "on or before" a particular date). Compare Latimer v. Grundy County Nat'l Bank, 607 N.E.2d 294 (Ill. App. Ct. 1993) (prepayment allowed, where contract stated "if not sooner paid") with Kruse v. Planer, 288 N.W.2d 12

(Minn.1979) (no prepayment allowed, based on identical clause).

Recent cases rejecting the "perfect tender in time" rule and permitting prepayment if the documents are silent on the matter include Spillman v. Spillman, 509 So.2d 442 (La.Ct.App. 1987); Hatcher v. Rose, 407 S.E.2d 172 (N.C.1991); and Mahoney v. Furches, 468 A.2d 458 (Pa.1983). Florida and North Carolina have adopted this position by statute. See Fla. Stat. Ann. § 697.06 (West 1988) ("Any note which is silent as to the right of the obligor to prepay the note in advance of the stated maturity date may be prepaid in full by the obligor or his successor in interest without penalty."); MacIntyre v. Hark, 528 So.2d 1276 (Fla.Dist.Ct. App.1988); N.C. Gen. Stat. § 24–2.4 ("A borrower may prepay a loan in whole or in part without penalty where the loan instrument does not explicitly state the borrower's rights with respect to prepayment or where the provisions for prepayment are not in accordance with law.").

The Alabama Supreme Court declined to overturn the "perfect tender in time" rule out of concern that the lender in the case before it had relied on that rule to protect her against prepayments; see Brannon v. McGowan, 683 So.2d 999 (Ala.Civ. App.1996). However, a court might instead deal with this problem by a prospective adoption of this section.

§ 6.2 Enforceability of Probitions and Restrictions on Prepayment

(a) Subject to the general requirement of good faith and fair dealing (Restatement, Second, Contracts § 205), the power of courts to refuse enforcement of unconscionable contract terms (Restatement, Second, Contracts § 208), and other applicable law,

(i) an agreement that prohibits payment of the mortgage obligation prior to maturity is enforceable; and

(ii) except as provided in § 6.3, an agreement requiring the mortgagor to pay a fee or charge as a condition of such payment is enforceable.

(b) Notwithstanding an agreement of the type described in (a), the mortgagor has a right to the release of the mortgage on the real estate, provided that the mortgagor gives substitute security, equal in value to the mortgage obligation and any associated fees, that is substantially the equivalent of cash. The mortgagor must pay all costs associated with the substitution. The parties may agree that security other than the substantial equivalent of cash may be substituted, but may not agree to deny to the mortgagor the right of substitution.

Cross-References:

Section 6.3, Limitation on Enforcement of Prepayment Fees in Connection with Casualty Insurance or Taking in Eminent Domain; Restatement, Second, Contracts §§ 205, 208.

Comment:

a. Introduction. Mortgagees frequently insert provisions in their mortgage documents prohibiting payment of the obligation prior to maturity, or prohibiting payment for some fixed period of time after the inception of the mortgage transaction. Alternatively, the documents may permit payment prior to maturity, but only with the payment of an additional fee. The principal purpose of the first type of clause is to "lock in" the financial yield for which the mortgagee bargained at the inception of the transaction. The second type of clause seeks to compensate the mortgagee for the losses that may inhere in a payment prior to maturity.

The primary purpose of these clauses is to protect the mortgagee against the loss of a favorable interest yield. Such a loss will eventuate only if the obligation is prepaid at a time when new investment opportunities are available to the mortgagee only at lower yields than the original mortgage. Since it is impossible to know, when a mortgage loan is made, whether future rates will be higher or lower, this risk of prepayment with a loss of yield is present in every mortgage loan. Prepayment may also result in further losses, such as the administrative and legal costs of making a new loan (to the extent these costs are not paid by the new borrower), and in some cases additional tax liability. Moreover, the mortgagee may be forced to place the prepaid funds temporarily in a relatively low-yielding short-term investment while awaiting another suitable mortgage-lending opportunity.

b. Prohibition on prepayment. An absolute prohibition on prepayment or a prohibition for a specific time period is generally enforceable, except as provided in § 6.2(b). See Illustration 1. The mortgagee who has imposed such a prohibition is free to reject any tendered prepayment, or to bargain with the mortgagor as to the conditions under which a prepayment will be accepted. In this way the mortgagee is able to preserve in full the benefits of its original bargain, as mentioned above.

Prepayments are often accepted by mortgagees despite the fact that they are prohibited by the terms of the mortgage. If the mortgagor has an opportunity to refinance the indebtedness at a sufficiently attractive interest rate, the mortgagor will find it advantageous to prepay the existing mortgage debt even if the mortgagee demands payment of an additional fee sufficient to fully pay the damages that result to the mortgagee from prepayment. The parties may then negotiate over how much of the value of the additional advantage available to the mortgagor from refinancing will be paid to the mortgagee. In many cases an arrangement will be reached under which prepayment will be accepted and the mortgagor and mortgagee will share the benefit of the attractive rate available to the mortgagor. See Illustration 2.

Illustrations:

1. Mortgagor borrows $1 million from Mortgagee and gives Mortgagee a mortgage on Blackacre to secure repayment of the debt. The mortgage states, "No payment prior to maturity may be made without written consent of Mortgagee." Subsequently, when the balance on the mortgage debt has been reduced to $900,000, Mortgagor tenders repayment of that amount. Mortgagee is entitled to reject the tender and insist on payment when due.

2. The facts are the same as Illustration 1. Market interest rates have fallen since the mortgage loan was made, so that Mortgagor would experience a benefit with a present value of $50,000 by refinancing at current market rates, while the Mortgagee would experience a loss with a present value of $50,000 if a prepayment of the full balance were made. However, Mortgagor has access to new financing at a below-market interest rate, so that Mortgagor would experience a benefit having a present value of $75,000 if Mortgagor refinances. Mortgagor offers to prepay the entire debt and to give Mortgagee an additional fee of $60,000. Mortgagee may (but is not required to) accept this offer.

In Illustration 2 both parties are better off if the mortgagee accepts the mortgagor's offer of prepayment. Below-market financing might be available to the mortgagor through a tax-exempt bond issue, a corporate stock or bond issue, or other source. If the mortgagee is willing to accept prepayment, both parties will share the benefits of the below-market financing.

c. Prepayment fees. When a mortgage permits prepayment only with the payment of an additional fee, the clause providing for the fee accomplishes a shift from the mortgagor to the mortgagee of the risk of loss associated with prepayment. In substance, the clause compels the mortgagee to bear that loss, however great it may be, in return for receipt of the fee stated in the clause. The operation of the clause is analogous to the purchase of insurance by the mortgagor from the mortgagee; the mortgagee absorbs the risk of prepayment in return for receipt of the "insurance premium" represented by the fee. Since the amount of the loss depends largely on the movement of interest rates and cannot be predicted in advance of the actual prepayment, the amount of the fee may, as with other forms of insurance, be greater or smaller than the actual loss. The fee clause may also be viewed as analogous to a liquidation of damages.

Clauses prohibiting prepayment or providing for prepayment fees are widely sustained by the courts. An exception may be made if clause is unconscionable or is enforced in contravention of the duty of good faith and fair dealing. See Restatement, Second, Contracts §§ 205, 208. However, if the borrower fully understood and had the opportunity to bargain over the clause, either with the assistance of counsel or by virtue of the borrower's own experience and expertise, the clause will ordinarily be enforced. Since prepayment prohibitions and prepayment fee clauses occur much more commonly in mortgages on commercial and income-producing property than on owner-occupied homes, it is likely that in the great majority of transactions the clause does not violate these contract-law principles.

It might be argued that clauses providing for very large fees should be rejected by the courts as unconscionable *per se*. Such an argument is illogical. If the fee exceeds the present value of the savings to the mortgagor resulting from the prepayment, its exact amount is irrelevant. An extremely large fee may be thought of as the practical equivalent of a "lock-in" clause that prohibits prepayment entirely; as noted above, "lock-in" clauses are routinely enforced. However, as Illustration 2 shows, the presence of such a clause by no means establishes that prepayment will not occur. Rather, it means that the mortgagor must negotiate with the mortgagee and may be forced to give up some of the benefits the mortgagor expects to realize from prepayment. The same result follows if the mortgage provides for a very large prepayment fee. Hence, prepayment fee clauses should ordinarily be enforced irrespective of the size of the fee. In some cases the mortgagor will be able to avoid entirely the impact of the fee by using the right to substitute collateral for the real estate under § 6.2(b).

Illustration:

3. Mortgagor borrows $1 million from Mortgagee and gives Mortgagee a mortgage on Blackacre to secure repayment of the debt. The mortgage states "Payment prior to maturity may be made only upon the payment of an additional fee of five percent of the amount being prepaid." Subsequently, when the balance on the mortgage debt has been reduced to $900,000, Mortgagor tenders repayment of that amount but without the additional fee. Mortgagee is entitled to reject the tender.

Controversy has sometimes arisen concerning the collectability of a prepayment fee when the prepayment results from the mortgagee's acceleration of the secured debt on account of the mortgagor's default. Such prepayments have occasionally been described as "involuntary." In the first instance, the question is simply whether the relevant clause in the mortgage or the debt instrument purports to cover this sort of prepayment. If it clearly does so, there is no general reason courts should refuse to enforce it. The payment may be "involuntary" in the sense that the mortgagor would prefer that the debt not be accelerated, but it is still the mortgagor's action in defaulting that triggers the acceleration. The mortgagee obviously has no duty to refrain from accelerating a defaulted loan, and the acceleration gives rise to a payment that may impose costs and risks on the mortgagee identical to those flowing from a voluntary prepayment. Indeed, the mortgagee can fairly assert that the risk of a prepayment resulting from default and acceleration is well within the range of risks which the mortgagee has agreed to absorb in return for the fee. Of course, in a particular instance a court might find a demand for a prepayment fee on an accelerated debt to be unconscionable or to violate the duty of good faith and fair dealing.

d. Prepayment by bankrupt mortgagor. When a mortgagor who is in bankruptcy (or a trustee in bankruptcy of the mortgagor's estate) attempts to prepay a mortgage loan, and the mortgage requires a fee for prepayment, a question often arises as to whether the mortgagee may collect the fee as a secured claim in bankruptcy. The issue is significant because if the fee is not treated as a secured claim, it will often be wholly or partially uncollectible.

The issue is governed by § 506(b) of the Bankruptcy Code, which recognizes, as secured, claims for "reasonable fees, costs, or charges" provided for in the agreement. Hence the bankruptcy courts have generally applied a test of reasonableness in determining whether prepayment fees should be regarded as secured claims.

The bankruptcy issue just described is beyond the scope of this Restatement, but is mentioned by way of contrast with the principles of this section. In the context of bankruptcy, refusal to enforce excessive prepayment fees is sensible, for bankruptcy involves unique policy considerations; an improvident or excessive prepayment fee, if treated as a secured claim in the context of bankruptcy, may act to deprive undersecured or unsecured creditors of assets needed to pay their claims. Under the general principles of law stated here and applicable outside bankruptcy, no test of reasonableness of amount is necessary or applicable.

c. Substitution of collateral. It is sometimes desirable from a mortgagor's viewpoint to free the real estate from the lien of the mortgage without prepaying the indebtedness. Prepayment may be disadvantageous because the interest rate on the existing debt is favorable to the mortgagor, or it may be impossible because of a prohibition on prepayment or a very burdensome prepayment fee. At the same time, freeing the real estate from the mortgage may be beneficial because, for example, the mortgagor wishes to subdivide the property and purchasers would not be willing to take title to individual lots subject to a blanket mortgage.

Under § 6.2(b), the mortgagor has the right to demand that the mortgage be discharged as to the real estate if the mortgagor tenders a substituted form of collateral, equal in value to the secured debt, that is the substantial equivalent of cash. When this occurs, the mortgagee has no legitimate basis for complaint; the financial terms of the debt are not altered, the risk of loss is not increased, and the mortgagee has no occasion to be concerned about the burden of reinvestment. The law's long-standing policy in favor of free alienability of land is served by this rule; even though the continued presence of the mortgage would not in most cases literally restrain alienation, it is nonetheless true that alienability is to some degree enhanced by the mortgagor's ability to make a transfer free of the mortgage.

The substituted collateral's value must be sufficient to cover the secured debt, including any additional fees or costs (such as prepayment fees) that would later arise if the debt were paid. If the mortgage documents provide for future advances, the collateral must cover their amount as well.

The mortgagee's duty to accept a substitution of collateral arises only if the proposed substitution is the substantial equivalent of cash. See Illustration 4. This rule of equivalency is satisfied only by assets that are readily marketable, have a readily ascertainable value, and are not subject to any significant risk of loss of value. Examples include short-term debt obligations of the United States government or its agencies; short-term debt instruments issued by other parties but fully guaranteed by the full faith and credit of the United States; short-term certificates of deposit issued by financial institutions and fully covered by federal deposit insurance; and short-term commercial paper issued by large firms and highly rated by national rating agencies. Only short-term instruments may be considered cash equivalents, because they are not subject to significant fluctuation in capital value as a result of market changes in interest rates. If the term of the instruments used as collateral is shorter than the remaining life of the mortgage debt, provision must be made for reinvestment of the collateral in equivalent new instruments as the original instruments mature.

The parties may agree, in the mortgage or otherwise, for the substitution of collateral that is not the substantial equivalent of cash. But in the absence of such an agreement, the mortgagee has no obligation to accept non-cash-equivalent assets. See Illustration 5. Another parcel of real estate is not necessarily acceptable simply because it has an appraised value greater than the original real estate; it may still be subject to greater risks of market decline, environmental degradation, adverse zoning action, or the like.

In some cases it may be impossible for the mortgagor to provide adequate substitute collateral. If the mortgagee holds not merely a security interest in the real estate, but an equity interest as well by virtue of partial ownership or an option or contractual right to acquire ownership, the mortgagor has no right to substitute collateral; the mortgagee's rights in such a case are predicated on the unique qualities of the particular parcel of real estate, and cannot be disturbed. See Illustration 6.

Illustrations:

4. Mortgagor borrows $1 million from Mortgagee and gives Mortgagee a mortgage on Blackacre to secure repayment of the debt. The mortgage states "No payment prior to maturity may be made without written consent of Mortgagee." Subsequently, when the balance on the mortgage debt has been reduced to $900,000, Mortgagor wishes to obtain a release of the mortgage on Blackacre. Mortgagor offers to substitute as collateral United States government short-term securities having a value in excess of $900,000. Mortgagee is obligated to release the mortgage on Blackacre.

5. The facts are the same as in Illustration 4, except that Mortgagor offers as a substitute for the real estate a portfolio of common stocks having a value exceeding $900,000. Mortgagee is entitled to reject this proposed substitution of collateral, since the common stocks are subject to fluctuation in value and hence are not the substantial equivalent of cash.

6. The facts are the same as in Illustration 4, except that the mortgage also provides that Mortgagee has an option to purchase a 25 percent interest in Blackacre at any time after the third year of the mortgage term for a fixed price. Mortgagee is entitled to reject Mortgagor's tender of the substitute collateral.

When a mortgagor proposes to provide substitute collateral, it is the mortgagor's responsibility to pay all reasonably necessary costs associated with the substitution. These costs may include recording and release fees, legal expenses, custodian's or trustee's fees, reinvestment expenses, and fees for appraisal or other evaluation of the substitute collateral. The collateral's value for purposes of compliance with this section is its cash value after all expenses of liquidation have been paid.

REPORTERS' NOTE

Introduction, Comment a. For discussion of the prepayment issue, see Whitman, Mortgage Prepayment: A Legal and Economic Analysis, 40 UCLA L. Rev. 851 (1993); Alexander, Mortgage Prepayment: The Trial of Common Sense, 72 Cornell L. Rev. 288 (1987); Harmon, Prepayment Penalties: Predicting Controversy over Enforceability Based upon the Late Due-on-Sale Questions, 1 Real Est. Fin. L.J. 326 (1986); Weinberger, Neither an Early Nor a Late Payor Be?—Presuming to Question the Presumption Against Mortgage Prepayment, 35 Wayne L. Rev. 1 (1988); Baldwin, Note, Prepayment Penalties: A Survey and Suggestion, 40 Vand. L. Rev. 409 (1987); McNelis, Note, Prepayment Penalties and Due-on-Sale Clauses in Commercial Mortgages: What Next?, 20 Ind. L. Rev. 735 (1987); Schikora, Comment, Prepayment Penalties After Garn–St. Germain: A Minor Coup for Consumers, 1985 Det. C.L. Rev. 835; Bonanno, Due on Sale and Prepayment Clauses in Real Estate Financing in California in Times of Fluctuating Interest Rates—Legal Issues and Alternatives, 6 U.S.F. L. Rev. 267 (1972); Harmon, Comment, Secured Real Estate Loan Prepayment and the Prepayment Penalty, 51 Cal. L. Rev. 923 (1963); 1 Nelson & Whitman, Real Estate Finance Law § 6.1 et seq. (3d ed. 1993).

Prohibition on prepayment, Comment b. Cases enforcing clauses prohibiting prepayment include Trident Ctr. v. Connecticut Gen. Life Ins. Co., 847 F.2d 564, 568 (9th Cir.1988) (clause enforceable unless extrinsic evidence shows it to be contrary to the parties' intent); Houston N. Hosp. Properties v. Telco Leasing, Inc., 680 F.2d 19, 22 (5th Cir.), aff'd on reh'g, 688 F.2d 408 (5th Cir.1982) (when loan is locked-in, lender may negotiate for prepayment fee); Riveredge Assocs. v. Metropolitan Life Ins. Co., 774 F.Supp. 892, 896 (D.N.J.1991) (borrower cannot, by defaulting, force lender to accelerate loan and accept prepayment); Clover Square Assocs. v. Northwestern Mut. Life Ins. Co., 674 F.Supp. 1137, 1139 (D.N.J.1987) (lock-in clause is not an invalid restraint on alienation); Tyler v. Equitable Life Assur. Soc'y, 512 So.2d 55, 57 (Ala.1987) (lender may properly exact a fee in return for its consent to payment of locked-in loan); Gutzi Assocs. v. Switzer, 264 Cal.Rptr. 538, 542 (Cal. Ct. App. 1989) (same); McCae Management Corp. v. Merchants Nat'l Bank & Trust Co., 553 N.E.2d 884, 888 (Ind.Ct.App.1990) (when loan is locked-in, lender may negotiate for prepayment fee); Metropolitan Life Ins. Co. v. Strnad, 876 P.2d 1362 (Kan.1994) (where promissory note identified two dates on which prepayment could be made, it was construed to prohibit prepayment at other times); Arthur v. Burkich, 520 N.Y.S.2d 638, 639 (N.Y.App. Div.1987) (same); Hartford Life Ins. Co. v. Randall, 583 P.2d 1126, 1128 (Or.1978) (same).

A number of states have enacted statutes permitting free prepayment, or permitting prepayment with only a small fee, notwithstanding contrary mortgage language. Most of these statutes apply only to mortgages on owner-occupied residential property. They are summarized in the Statutory Note at the end of this section. See Resolution Trust Corp. v. Minassian, 777 F.Supp. 385, 390 n.1 (D.N.J.1991) (discussing New Jersey statute); Donahue v. LeVesque, 215 Cal.Rptr. 388 (Cal.Ct.App.1985) (statutory privilege of free prepayment applies even to a purchase-money mortgage given to a land vendor, where prepayment is made after the calendar year of the sale); Skyles v. Burge, 789 S.W.2d 116 (Mo.Ct.App.1990); Weinstein v. Investors Sav. & Loan Ass'n, 381 A.2d 53 (N.J.Super.Ct.App.Div.1977) (statutory restrictions on prepayment fees apply only to mortgages entered into after legislation's effective date); Or. Rev. Stat. § 82.160 (1987) (requiring a prominent notice in the loan agreement of a lock-in or prepayment fee, and not limited to residential mortgages); Schnitzer v. State Farm Life Ins. Co., 773 P.2d 387 (Or.Ct. App.1989).

The Uniform Consumer Credit Code (U.C.C.C.) prohibits collection of prepayment penalties (with some qualifications) on real estate loans for personal, family, household, or agricultural purposes with interest rates exceeding 12 percent. See U.C.C.C. § 2.209, 7 U.L.A. 659 (1968); U.C.C.C. § 2.509, 7A U.L.A. 96 (1974). The U.C.C.C. and variants of it are in effect in about 11 states.

The form for home mortgage notes issued by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation provides for free prepayment without fee. It states:

> I have the right to make payments of principal at any time before they are due.... I may make a full prepayment or partial prepayments without paying any prepayment charge.

However, the multifamily (apartment) mortgage note form issued by these two agencies provides for a prepayment fee.

Prepayment fees, Comment c. Cases sustaining prepayment fee clauses under state law principles include Eyde Bros. Dev. Co. v. Equitable Life Assurance Soc'y, 697 F.Supp. 1431 (W.D.Mich.1988), aff'd, 888 F.2d 127 (6th Cir.1989) (Michigan law); West Raleigh Group v. Massachusetts Mutual Life Ins. Co., 809 F.Supp. 384 (E.D.N.C.1992) (North Carolina law); Resolution Trust Corp. v. Minassian, 777 F.Supp. 385, 390 n.1 (D.N.J.1991) (New Jersey law); In re Schaumburg Hotel Owner Limited Partnership, 97 B.R. 943, 953 (Bankr.N.D.Ill.1989) (Illinois law); In re Financial Center Associates, 140 B.R. 829 (Bankr. E.D.N.Y.1992) (New York law); Sacramento Sav. & Loan Ass'n v. Superior Court, 186 Cal.Rptr. 823 (Cal.Ct. App.1982); Shadoan v. World Sav. & Loan Ass'n, 268 Cal.Rptr. 207 (Cal. Ct.App.1990); Williams v. Fassler, 167 Cal.Rptr. 545 (Cal.Ct.App.1980); Meyers v. Home Sav. & Loan Ass'n, 113 Cal.Rptr. 358 (Cal.Ct.App.1974); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 99 Cal.Rptr. 417 (Cal.Ct.App.1971); Aronoff v.

Western Fed. Sav. & Loan Ass'n, 470 P.2d 889 (Colo.Ct.App.1970); Century Fed. Sav. & Loan Ass'n v. Madorsky, 353 So.2d 868 (Fla.Dist.Ct.App.1977); Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 635 A.2d 366 (Md. 1994); Affiliated Capital Corp. v. Commercial Fed. Bank, 834 S.W.2d 521 (Tex. Ct. App. 1992); Boyd v. Life Ins. Co. of the Southwest, 546 S.W.2d 132 (Tex. Ct. Civ. App. 1977). Cf. In re Abramoff, 92 B.R. 698 (Bankr. W.D.Tex.1988) (finding a prepayment fee usurious where it was collected incident to an acceleration for default).

Several of the foregoing cases state by way of dictum that an unconscionably large prepayment fee would not be enforced, but no state court case actually so holds. See, e.g., Shadoan v. World Sav. & Loan Ass'n, supra; Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, supra; Williams v. Fassler, supra (enforcing a fee of 50% of the amount prepaid).

Several courts have sustained prepayment fees even though the prepayment was a result of the mortgagee's acceleration of the debt upon default by the mortgagor, where the documents clearly so provided. See Biancalana v. Fleming, 53 Cal. Rptr.2d 47 (Cal. Ct. App. 1996); General Mortg. Assoc. v. Campolo Realty & Mortg. Corp., 678 So.2d 431 (Fla. Dist.Ct.App.1996) (fee may be collected only if the documents "specifically" provide for recovery of the fee in addition to the lender's acceleration and collection of default interest); In re Schaumburg Hotel Owner Ltd. Partnership, 97 B.R. 943 (Bankr. N.D.Ill.1989); TMG Life Ins. Co. v. Ashner, 898 P.2d 1145 (Kan.Ct.App. 1995); Citicorp Mortgage, Inc. v. Morrisville Hampton Village Realty Ltd. Partnership, 662 A.2d 1120 (Pa. Super. Ct. 1995). Cf. Matter of LHD Realty Corp., 726 F.2d 327 (7th Cir. 1984) (mortgagee who accelerates for default waives its right to prepayment fee); Zwayer v. Ford Motor Credit Co., 665 N.E.2d 843 (Ill. App. Ct. 1996) (fee based on sum-of-the-digits methods may not be collected upon lender's acceleration for default if documents are ambiguous as to method of computation of fee).

Prepayment by bankrupt mortgagor, Comment d. The following cases apply a test of reasonableness in determining whether a prepayment fee is enforceable as a secured claim in bankruptcy under Bankruptcy Code § 506(b): In re Wiston XXIV Ltd. Partnership, 170 B.R. 453 (D.Kan. 1994) (fee collectible upon default held unreasonable and rejected as a secured claim); In re A.J. Lane & Co., 113 B.R. 821, 823 (Bankr. D.Mass.1990) (prepayment fee rejected as a secured claim); In re Imperial Coronado Partners, 96 B.R. 997, 1000 (9th Cir. 1989) (remanded for findings of fact as to reasonableness of fee); In re Kroh Bros. Dev. Co., 88 B.R. 997, 999 (Bankr.W.D.Mo.1988) (prepayment fee rejected as a secured claim); In re Morse Tool, Inc., 87 B.R. 745, 750 (Bankr.D.Mass.1988) (prepayment fee rejected as a secured claim); In re Skyler Ridge, 80 B.R. 500, 504 (Bankr.C.D.Cal.1987) (prepayment fee rejected as a secured claim); In re American Metals Corp., 31 B.R. 229, 236 (Bankr.D.Kan.1983) (personal property security; prepayment fee rejected as a secured claim). See generally Blum, The Oversecured Creditor's Right to Enforce a Prepayment Clause as Part of its Secured Claim Under 11 U.S.C. Section 506(b), 98 Comm. L.J. 78 (1993).

Several of the foregoing cases also purport to analyze the prepayment fee as a liquidated damage clause under state law and to reject enforcement of it on the basis that it fails to meet the relevant state law test, but none of them rely on any direct state authority on the point. Such authority does exist, however, in a few states; see TMG Life Ins. Co. v. Ashner, 898 P.2d 1145 (Kan.Ct.App.1995), employing liquidated damages analysis but finding the prepayment fee clause reasonable and enforceable; Bayside Gardens Apartment Ventures v. Security Pacific Bank, 1996 WL 442689 (Wash. Ct. App. 1996) (same). Cf. Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 635 A.2d 366 (Md. 1994), refusing to employ liquidated damages analysis.

Substitution of collateral, Comment e. The principal case recognizing the mortgagor's right to substitute other collateral for the mortgaged real estate is Mahoney v. Furches, 468 A.2d 458 (Pa.1983), in which the court stated:

> [E]ven where the mortgage explicitly states there is no right to prepay the note, if the mortgagor can provide the mortgagee with the benefit of his bargain under the terms of the note, he will be allowed to have a release of his land following the substitution of security or other arrangement.

Id. at 461. See also Spillman v. Spillman, 509 So.2d 442, 444 (La.Ct.App. 1987); Skyles v. Burge, 789 S.W.2d 116, 119 (Mo.Ct.App.1990). See Alexander, Mortgage Prepayment: The Trial of Common Sense, 72 Cornell L. Rev. 288, 337 n.240 (1987), endorsing this approach. The lender voluntarily offered to permit a substitution of government securities as collateral in Affiliated Capital Corp. v. Commercial Fed. Bank, 834 S.W.2d 521 (Tex. Ct. App. 1992), but the borrower was unable to provide such securities. It is not unusual for the mortgage itself to provide for substitution of collateral; see Miller v. Jeff Davis Apartments, Ltd. II, 396 S.E.2d 494 (Ga.Ct. App.1990). However, the operation of this section does not depend on the existence of such a mortgage provision.

See Ominsky, Creative Financing: How to Refinance Your Property in the Face of Lock-In Devices, A.B.A. Real Est. Fin. Newsl., Feb. 15, 1989, at 19, 22. The latter source describes a technique in which the borrower places on deposit with a title insurer a sum of money equal to the balance on the existing mortgage. The borrower then obtains a new mortgage loan (at a lower interest rate) which the title company is willing to insure as a first lien since the company has the funds on deposit to fully pay off the prior lien. The title company invests these funds in accordance with standards agreed to by the borrower, and uses the investment earnings to service the preexisting loan. If the investment earnings are not sufficient to cover the full debt service, the borrower will have to supplement the difference.

STATUTORY NOTE ON MORTGAGE PREPAYMENT

The following state statutes deal with mortgage loan prepayment fees or restrictions.

Alaska Stat. § 06.30.585. Limits prepayment penalties charged by savings associations on real estate loans to 1.5% of the amount of the payment.

Cal. Civ. Code § 2954.9. Applies to mortgages on single-family, owner-occupied homes. Permits prepayment at any time. Prepayments within the first seven years of the loan term may be subject to a prepayment charge, which may not exceed six month's interest on the amount prepaid in excess of 20% of the unpaid balance. No fee may be charged if the prepayment is related to a natural disaster for which the governor has declared an emergency, such that the dwelling cannot be occupied.

Conn. Gen. Stat. Ann. § 36–9g(c). Prohibits prepayment penalties on alternative mortgages. Section 36–224(j) allows prepayment without penalty on second mortgage loans after three years, and restricts the maximum penalty to 5% on prepayments within the first three years of the loan.

Ill. Comp. Stat. Ann., 815 ILCS 205/4(2)(a). Makes collection of prepayment penalties unlawful on loans secured by residential real estate if the interest rate exceeds 8% per annum.

Iowa Code Ann. § 535.9. Prohibits prepayment penalties on loans secured by owner-occupied single-family or two-family dwellings or agricultural land.

Kan. Stat. Ann. § 17–5512. Permits repayment at any time with a maximum prepayment charge not to exceed 1–1/2% of the amount prepaid for loans made by savings and loan associations. Section 16–207(k) prohibits charging a penalty for prepayment of home mortgages more than six months after the execution date.

La. Rev. Stat. § 9:5322. Permits partial prepayment without penalty on notes secured by rural property. The partial payments may not exceed 20% of the initial principal debt.

Mass. Gen. Laws Ann. ch. 183, § 56. Applies to mortgages on owner-occupied dwellings of three or fewer separate households. A maximum prepayment charge of the lesser of three months' interest or the remaining first year's interest is permitted. If the payment is made within 36 months of the making of the note for the purpose of refinancing at another institution, an additional charge of three months' interest is permitted.

Mich. Comp. Laws Ann. § 438.31c(2)(c). Applies to all loans secured by single-family dwellings. Permits a prepayment charge of 1% of any prepayment made within three years of date the loan is made, but prohibits all fees or penalties for prepayment thereafter; also bars any prohibition on prepayment.

Miss. Code Ann. § 75–17–31. Applies to loans secured by a single-family dwelling, a single condominium, or agricultural property. Permits a penalty of 5% of the principal balance for prepayment in the first year, declining by 1% per year to 1% in the fifth year, and no penalty after five years.

Mo. Rev. Stat. 408.036. Prohibits prepayment penalties on all real estate loans after five years. Limits the maximum prepayment penalty to 2% of the balance at the time of prepayment.

N.M. Stat. Ann. § 56–8–30. Makes unenforceable all prepayment penalties on home loans.

N.Y. Gen. Oblig. Law § 5–501(3). Applies to one to six family residences that are owner occupied. No penalty may be collected after one year from the loan date. A penalty may be collected in the first year if expressly provided for in the loan agreement.

N.C. Gen. Stat. § 24-2.4. Applies to home loans secured by first mortgages. No prepayment fees may be charged for home loans with a principal amount under $100,000. Prepayment is allowed without charge if the loan instrument imposes no restriction.

Ohio Rev. Code Ann. § 1343.01.1. Permits prepayment of residential mortgage loans after five years without penalty. Within five years of execution a penalty of 1% of the original principal amount may be imposed.

Or. Rev. Stat. § 82.160-.170. If a prepayment penalty is agreed to, the loan agreement must warn the borrower of the penalty by a statutory notice in 10-point type. A similar warning is required if the agreement permits the lender to refuse to accept prepayment.

Pa. Stat. Ann. 7, § 6020-155(g)(7). No prepayment penalty is allowed in residential mortgage loans.

R.I. Gen. Laws § 34-23-5. Applies to dwellings of not more than four units. Provides for prepayment without penalty after one year from the date of the loan, and limits the penalty during the first year te 2% of the balance at the date of prepayment.

S.D. Codified Laws Ann. § 52-8-8. Allows prepayment of a real estate loan made by savings and loan associations at any time with a maximum penalty of 1-1/2% of the payment.

§ 6.3 Limitation on Enforcement of Prepayment Fees in Connection with Casualty Insurance or Taking in Eminent Domain

An agreement that requires the mortgagor to pay an additional fee or charge when payment of the secured obligation is made with the proceeds of casualty insurance or a taking in eminent domain is not enforceable if the mortgagor requests that the proceeds be used for restoration of the real estate and would be entitled to such use under the standards of § 4.7(b).

Cross-References:

Section 4.7, Mortgagee's Right to Funds Paid Under Casualty Insurance or Taking in Eminent Domain; § 6.2, Enforceability of Prohibitions and Restrictions on Prepayment.

Comment:

This section deals with "involuntary" prepayments of a mortgage loan precipitated by a distribution made by a casualty insurance carrier resulting from damage to the real estate, or by a governmental authority under or in lieu of a condemnation of the real estate. Under § 4.7(a), the mortgagee is generally entitled to apply toward the mortgage debt the funds paid out by the insurer or the governmental entity, to the extent its security is impaired by the loss or taking, unless the parties have agreed otherwise.

This section addresses a related issue: whether a prepayment fee is collectible when the mortgagee applies such a payment toward the mortgage debt. This issue is, in first instance, a question of construction of the mortgage documents. For example, if the mortgage simply provides for a fee "in the event that a prepayment occurs," the mortgagor may argue that, once the mortgagee has demanded the insurance proceeds or condemnation award, the amount paid is not being "prepaid" and thus that the prepayment fee is inapplicable. Alternatively, the mortgagor may assert that the prepayment fee clause is intended to govern only voluntary prepayments. These arguments are ultimately answerable only by reference to the mortgage documents, and the answers will vary with the precise wording of those documents. For purposes of this section it is assumed that the language of the documents is sufficient to impose the fee.

Under § 4.7(b), in the absence of contrary agreement the mortgagee must make the proceeds of casualty insurance or a taking in eminent domain available for restoration of the premises if the mortgagor so requests and if § 4.7(b)'s standards are met: that is, restoration is reasonably feasible within the remaining term of the mortgage with the funds received by the mortgagee, together with any additional funds made available by the mortgagor, and after restoration the real estate's value will equal or exceed its value at the time the mortgage was made. If the mortgagee in fact makes the funds available for restoration, no prepayment will occur and no issue with respect to a prepayment fee will arise.

However, the restoration provisions of § 4.7(b) are subject to variation by the terms of the mortgage. If the mortgage states that the mortgagee has the right to apply casualty insurance and eminent domain awards toward the mortgage debt, with no corresponding duty to permit use of the funds for restoration of the premises, that agreement will generally be enforced by the courts. See § 4.7, Comment *e*. If the mortgagee in this setting rejects the mortgagor's request to restore the premises and applies the funds toward the debt, the thrust of the present section is that no prepayment fee may be collected even if the mortgage purports to require it.

The reason is that the mortgagee's application of the funds toward the debt in this context is not necessary to protect the mortgagee's security. This is established by the fact that the standards of § 4.7(b) are met. Hence the mortgagee has no legitimate need to demand the payment, and the rationale for the prepayment fee is absent. That rationale, as discussed in § 6.2, Comment *c*, is that a prepayment fee is compensation to the mortgagee for its assumption of the risk of loss that may result from prepayment. Obviously if the prepayment is the result of the mortgagee's own decision and is unnecessary to protect the mortgagee's legitimate security interests, the fee has not been earned and should not be collectible. This is quite different than a prepayment resulting from the mortgagee's acceleration of the debt on account of the mortgagor's default, also discussed in § 6.2, Comment c, for in that context the acceleration is necessary to protect the mortgagee's interests.

On the other hand, if restoration of the property were not feasible under the standards of § 4.7(b) and the mortgagee consequently applied the insurance or eminent domain award toward the debt, the mortgagee would indeed bear the loss from prepayment that the fee was designed to compensate. Accordingly, the prepayment fee would be collectible if the mortgage documents so provided, unless the mortgagor exercised the right to provide substitute collateral under § 6.2(b).

Illustration:

1. Mortgagee makes a loan of $80,000 to Mortgagor, who executes a promissory note to Mortgagee secured by a mortgage on Blackacre, which has a value of $100,000. The mortgage requires Mortgagor to purchase fire insurance and provides that Mortgagee at its sole option may apply toward the mortgage debt all proceeds of the fire insurance policy. For purposes of this illustration that provision is assumed to be enforceable. The mortgage further provides that in the event of any payment of the mortgage debt prior to scheduled maturity (including payment of the proceeds of a fire insurance policy), Mortgagee may demand a prepayment fee of five percent of the amount prepaid.

Mortgagor purchases and maintains the required insurance. During the ensuing five years Mortgagor makes all scheduled payments of amortization and interest, reducing the mortgage debt balance to $70,000 while Blackacre's value remains constant. A fire occurs, destroying all improvements on Blackacre and reducing its value to $30,000. The fire insurance carrier tenders $70,000.

Mortgagor desires to reconstruct the damaged premises, and requests that Mortgagee make the $70,000 available for that purpose. The evidence shows that this sum would have been sufficient to restore the improvements on Blackacre and return its value to $100,000. However, Mortgagee refuses this request, and instead applies the entire $70,000 toward payment of the debt, fully discharging it. Mortgagee also demands from Mortgagor a prepayment fee of five percent of $70,000, or $3,500. This demand is not enforceable.

In the foregoing Illustration, if an amount exceeding the insurance proceeds (say, $80,000) had been required in order to fully restore the real estate to its original value, the mortgagor would have had the option to tender $10,000 in cash from his or her other resources to "fill the gap." See § 4.7, Comment *d.* As in the Illustration, if the mortgagee refused to permit use of the insurance funds for restoration under these circumstances, the prepayment fee would be unenforceable.

It may be noted that the rationale of this section could be applied to cases involving, not an insured casualty loss or taking in eminent domain, but an acceleration by a mortgagee under a due-on-sale clause. At present, the regulations of the Office of Thrift Supervision prohibit collection of a prepayment fee incident to such an acceleration when the mortgage security is a one-to-four-family dwelling. See 12 C.F.R. § 591.5(b)(2), (3). When other types of real estate are transferred without the mortgagee's consent, the mortgagee sometimes accelerates the debt under authority of a due-on-sale clause and, in addition, claims entitlement to a prepayment fee. An initial question is whether the prepayment clause in the mortgage documents in fact applies to this sort of prepayment. If it does, a court might employ reasoning similar to that embodied in this section, allowing the mortgagee to recover the fee only if the acceleration was reasonably necessary to protect the mortgagee against increased default risk or security impairment—typically because the transferee of the real estate was not creditworthy. However, this Restatement takes no position as to whether a court should employ this form of analysis in the context of an acceleration under a due-on-sale clause.

REPORTERS' NOTE

Most courts have refused to enforce prepayment fee clauses when the prepayment was made pursuant to an acceleration resulting from a casualty insurance payment or a taking in eminent domain. These cases have generally held that the clause was not intended to cover "involuntary" prepayments, or that the mortgage's terms or the lender's exercise of the right to take the payment made the loan mature, and thus that payment was not "pre-" in the sense of being in advance of maturity. With regard to proceeds of hazard insurance, see Chestnut Corp. v. Bankers Bond & Mortg. Co., 149 A.2d 48, 50 (Pa.1959). With regard to eminent domain awards, see LandOhio Corp. v. Northwestern Mut. Life Mortg. and Realty Investors, 431 F.Supp. 475 (N.D.Ohio 1976); Associated Schools, Inc. v. Dade County, 209 So.2d 489, 489–90 (Fla.Dist.Ct.App.1968); DeKalb County v. United Family Life Ins. Co., 219 S.E.2d 707 (Ga.1975); Village of Rosemont v. Maywood–Proviso State Bank, 501 N.E.2d 859, 862 (Ill. App. Ct. 1986); Clinton Capital Corp. v. Straeb, 589 A.2d 1363 (N.J.Super.Ch.1990); Jala Corp. v. Berkeley Sav. & Loan Ass'n, 250 A.2d 150, 154 (N.J.Super.Ct.App.Div.1969); Silverman v. State, 370 N.Y.S.2d 234, 236 (N.Y.App.Div.1975). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 6.3 (3d ed. 1993).

Nonetheless, if the documents are sufficiently clear in providing that the fee must be paid in the event of an acceleration owing to eminent domain or an insured loss, there is authority sustaining collection of the fee. See Melin v. TCF Financial Corp., 1995 WL 265064 (Minn.Ct.App.1995); Village of Rosemont v. Maywood–Proviso State Bank, 501 N.E.2d 859, 862 (Ill. App. Ct. 1986) (stating in dictum, "in the event of condemnation, performance of a prepayment penalty clause will be excused unless there is clear language which expressly delineates payment of a premium upon condemnation").

Most of the cases dealing with prepayment fees in the context of acceleration under a due-on-sale clause hold that the fee is uncollectible on the ground that the prepayment is "involuntary"; see Tan v. California Fed. Sav. & Loan Ass'n, 189 Cal. Rptr. 775 (Cal.Ct.App.1983); Slevin Container Corp. v. Provident Fed. Sav. & Loan Ass'n, 424 N.E.2d 939 (Ill. App. Ct. 1981); American Federal Sav. and Loan Ass'n v. Mid–America Service Corp., 329 N.W.2d 124 (S.D. 1983). Cf. First Indiana Fed. Sav. Bank v. Maryland Devel. Co., 509 N.E.2d 253 (Ind.Ct.App.1987) (where prepayment was made under threat of acceleration under due-on-sale clause, but without actual acceleration, mortgagee was entitled to prepayment fee); First Nat. Bank of Springfield v. Equitable Life Assur. Soc., 510 N.E.2d 518 (Ill. Ct. App. 1987) (same).

§ 6.4 Redemption from Mortgage by Performance or Tender

(a) Except as provided in Subsection (d), a performance in full of the obligation secured by a mortgage, or a performance that is accepted by the mortgagee in lieu of performance in full, by one who is primarily responsible for performance of the obligation, redeems the real estate from the mortgage, terminates the accrual of interest on the obligation, and extinguishes the mortgage. Performance may be made prior to the time the obligation is due (except as restricted by agreement of the parties subject to §§ 6.1 and 6.2), or may be made at or after the time the obligation is due but prior to foreclosure.

(b) Upon receipt of performance as provided in Subsection (a), the mortgagee has a duty to provide to the person performing, within a reasonable time, an appropriate document in recordable form showing that the mort-

gage is discharged. If the mortgagee fails to do so upon reasonable request, the person performing may obtain judicial relief ordering the mortgage discharged and, unless the mortgagee acted in good faith in rejecting the request, awarding against the mortgagee any damages resulting from the delay.

(c) An unconditional tender of performance in full by one who is primarily responsible for the obligation, even if rejected by the mortgagee, if kept good, has the effect of performance under Subsections (a) and (b) above.

(d) Performance under Subseetion (a) does not extinguish a mortgage or require the issuance of a document under Subsection (b) if the person performing and mortgagee agree that the mortgage is to remain in existence.

(e) A performance in full of the obligation secured by a mortgage, or a performance that is accepted by the mortgagee in lieu of payment in full, by one who holds an interest in the real estate subordinate to the mortgage but is not primarily responsible for performance, does not extinguish the mortgage, but redeems the interest of the person performing from the mortgage and entitles the person performing to subrogation to the mortgage under the principles of § 7.6. Such performance may not be made until the obligation secured by the mortgage is due, but may be made at or after the time the obligation is due but prior to foreclosure.

(f) Upon receipt of performance as provided in Subsection (e), the mortgagee has a duty to provide to the person performing, within a reasonable time, an appropriate assignment of the mortgage in recordable form. If the mortgagee fails to do so upon reasonable request, the person performing may obtain judicial relief ordering the mortgage assigned and, unless the mortgagee acted in good faith in rejecting the request, awarding against the mortgagee any damages resulting from the delay.

(g) An unconditional tender of performance in full by a person described in Subsection (e), even if rejected by the mortgagee, if kept good has the effect of performance under Subsections (e) and (f) above.

Cross-References:

Section 1.6, Mortgagee's Duty to Disclose Balance and Status of Obligation; § 3.1, The Mortgagor's Equity of Redemption and Agreements Limiting It; § 6.1, Right of Mortgagor to Prepay in the Absence of Agreement Prohibiting Prepayment; § 6.2, Enforceability of Prohibitions and Restrictions on Prepayment; § 7.6, Subrogation; § 8.5, The Merger Doctrine Inapplicable to Mortgages.

Comment:

a. Introduction. This section deals with the equitable right of redemption from a mortgage by the mortgagor and other persons having interests in the real estate junior to the mortgage. That right exists until foreclosure of the mortgage, at which time it is extinguished if the person seeking to redeem was properly joined or notified under applicable law. In the case of judicial foreclosure, which is available in every American jurisdiction, this means that the holder of a junior interest who has been made a party to a completed foreclosure action can no longer redeem. About half of the American jurisdictions also provide a nonjudicial form of foreclosure, typically by recognizing a "power of sale" in the mortgage or an equivalent document, such as a trust deed. Here the issue is whether applicable rules requiring notice and other procedural steps have been satisfied, thus cutting off the right of redemption of persons with interests junior te the mortgage being foreclosed. In nearly half of the jurisdictions, statutes provide for some further form of redemption after foreclosure, but that sort of statutory redemption is not the subject of this section.

Equitable redemption is ultimately accomplished by performance in full of the obligation secured by the mortgage. However, redemption has two quite distinct results, depending on whether the performance is made by a person who is primarily responsible for payment of the mortgage obligation, or by someone else who holds an interest in the land subordinate to the mortgage. In the first of these situations, the mortgage is simply extinguished, as provided in Subsection (a) of this section. In the second, the mortgage is not extinguished, but by virtue of Subsection (e) is assigned by operation of law to the payor under the doctrine of subrogation; see § 7.6. Subrogation does not occur in the first situation, since one who is primarily responsible for payment of a debt cannot have subrogation by performing that duty; see § 7.6, Comment *b.*

The term "performance" is used here to reflect the fact that, while the great majority of mortgages secure financial obligations that can be discharged by the payment of money, it is possible for a mortgage to secure a nonmonetary obligation, provided it is reducible to monetary terms at the time of enforcement; see § 1.4. The full performance of a nonmonetary obligation has the same effect as full payment of a monetary obligation under this section, and the term "payor" is used in this Comment as synonymous with "person performing."

"Primarily responsible" is a concept of critical importance in this section, since upon it turns the distinction between a payment that extinguishes a mortgage (Subsection (a)) and one that assigns the mortgage to the payor through subrogation (Subsection (e)). As the term is used here, primary responsibility does not necessarily imply personal liability. For example, a nonassuming grantee of the mortgaged real estate has no personal liability on the debt but is nonetheless primarily responsible for payment, as is explained in § 5.2, Comment *c*, unless the grantor and grantee have agreed otherwise. Hence, the full payment of the mortgage obligation by a nonassuming grantee extinguishes the mortgage. See Illustration 1. The same result follows if a mortgagor whose debt is "nonrecourse" makes a full payment of the mortgage obligation, notwithstanding the absence of personal liability on the part of the mortgagor.

Illustration:

1. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee securing a debt of $60,000. Mortgagor sells Blackacre to Grantee for $100,000. Grantee expressly takes subject to (but does not assume the obligation secured by) the first mortgage and pays Mortgagor $40,000 in cash. Subsequently Grantee pays Mortgagee $60,000, the full balance owing on the mortgage debt. The mortgage is extinguished and Mortgagee has a duty to provide Grantee with an appropriate recordable document showing that the mortgage is discharged.

On rare occasions a sale of mortgaged property will occur in which the grantee pays the full purchase price in cash and the grantor promises to complete the payments on the mortgage debt. Here, in distinction to the usual "subject-to" sale, the grantee is not primarily responsible for the obligation, and such a grantee who pays the debt because the grantor has defaulted in doing so is entitled to subrogation as to the debt against the grantor.

A similar situation may arise in which the grantee is informed of, and expressly assumes or takes subject to, a first mortgage debt on the real estate, but is not aware of, and hence does not assume, an existing second mortgage. In this sort of transaction, the cash price paid by the grantee for the land will be reduced by the balance owing on the first mortgage, but not by the second mortgage balance. When the grantee subsequently discovers the existence of the second mortgage, the grantee is entitled to subrogation to the debt against the grantor. Perhaps more important, the grantee may pay the first mortgage debt and be subrogated to the first mortgage as against the second mortgage. Thus the grantee can foreclose the first mortgage to destroy the second. See § 7.6, Illustration 21. This result would seem to violate the principle that one cannot be subrogated to a mortgage debt for which he or she is primarily responsible. However, that principle is designed to prevent unjust enrichment, and on these facts no unjust enrichment will occur, since the grantee has already paid the second mortgage amount once as part of the cash portion of the purchase price for the real estate. Thus the rule prohibiting subrogation to a mortgage for which one is primarily responsible is inapplicable.

Cases often arise in which the payor of the debt has a primary responsibility to pay it, but is not the only person so responsible. For example, the payor may be one of two tenants in common, or may hold a life estate or a dower or other marital interest in the real estate. When such a person pays the mortgage debt in full, the mortgage is extinguished under Subsection (a) of this section except to the extent that another person has a duty to reimburse the payor; to that extent the mortgage remains alive and enforceable in the hands of the payor by virtue of the doctrine of subrogation. For example, when two equal tenants in common are responsible for payment, the one who actually pays the mortgage debt is entitled to contribution from the other for half of the payment; see § 7.6, Illustration 3. Thus, under Subsection (e) of this section, the paying cotenant may enforce the mortgage against the other cotenant for that amount.

When a mortgage obligation is paid in full by one who is primarily responsible for the payment, the mortgagee has a legal duty to provide an appropriate document in recordable form showing that the mortgage has been discharged. This section addresses the situation in which the mortgagee fails to do so. It establishes that the payment, or the continuing tender of payment, operates to extinguish the mortgage even if the mortgagee fails to provide a document of discharge. It also provides suitable judicial remedies against the recalcitrant mortgagee.

Under Subsection (a) a payment or tender of the mortgage obligation in full extinguishes the mortgage. This means that the mortgage is no longer a lien on the real estate in question, and that in general no action may be brought by the mortgagee on other covenants in the mortgage. For example, covenants prohibiting waste, requiring specific care or maintenance of the real estate, prohibiting transfers of title, and the like are simply irrelevant once the mortgage debt has been paid in full. Even if they have been breached by the mortgagor, the mortgagee who has been paid in full can have suffered no damages, since the covenants were designed simply to protect the security for the debt. Similarly, covenants by the mortgagor to insure the real estate or pay property taxes become irrelevant upon a payment of the debt in full. If the mortgagee has made advances for taxes or insurance premiums unpaid by the mortgagor, these amounts can be added to the balance owing on the debt under § 2.2, and reimbursed as part of a payment of the debt in full. Thus it is unnecessary for such covenants to survive a full payment.

On rare occasions, however, a mortgage may contain covenants the breach of which has damaged the mortgagee, and for which payment of the mortgage obligation in full may not provide complete redress. For example, a mortgage might contain a term prohibiting the mortgagor from competing with the mortgagee's business for a fixed time period within a certain geographic radius. If the mortgagor breached this covenant, the mortgagee might suffer lost business profits as a result. A payment of the mortgage debt would not compensate for these lost profits, and the mortgagee might bring an action for damages. The fact that the mortgage debt had been paid in full would not bar such an action, and the mortgage would not be regarded as "extinguished" for this purpose.

b. Payment must be in full. The mortgagee is not obligated to discharge the mortgage, or to give it up by subrogation, unless it has received payment in full. This includes not only the principal debt, but all legally enforceable additional charges. Such charges may include future advances, accrued interest, late fees, prepayment fees, and attorneys' fees and costs if collection or foreclosure proceedings have commenced. They may also include a reasonable trustee's fee if the mortgage is in the form of a trust deed and provides for collection of such a fee. See Illustration 2. A mortgagee may, of course, voluntarily discharge the mortgage upon payment of less than the full balance owed, but has no duty to do so.

An exception to the rule requiring payment in full arises if the mortgage contains a "partial release" clause permitting the mortgagor to demand a discharge of the mortgage on a portion of the land upon payment of some fraction of the total mortgage debt. Such clauses, which are commonly used on land to be subdivided and are generally enforceable, have the effect of authorizing a redemption of part of the land upon payment of less than the full balance owing.

In some cases a mortgage may contain a "dragnet" clause purporting to secure advances under other transactions not directly related to the mortgage itself. If under § 2.4 the mortgage in fact secures such advances, they too must be included in order for the payment to be "in full."

The payment may be made directly by the party who is primarily responsible for it, or by any agent properly acting for that person. Similarly, payment made to the mortgagee's agent is good against the mortgagee.

To be effective, the payment must conform to the requirements of the secured obligation. It must be in cash or its equivalent unless the obligation itself calls for some different form of payment or the mortgagee agrees to it. Except in these circumstances, for example, the mortgagor has no right to pay by tendering a deed of the real estate or by executing a new promissory note for the balance due on the existing obligation.

Illustration:

2. Mortgagor is indebted to Mortgagee for the principal sum of $100,000 plus interest at 12 percent per annum, secured by a mortgage on Blackacre. Mortgagor sends a check to Mortgagee for $100,000, purporting to pay the debt. However, at the time of the payment, interest has been accruing on the principal sum for six months and $6,000 interest is owed. The payment is not "in full" and does not extinguish the mortgage. Mortgagee has no obligation to execute a document discharging the mortgage.

c. Duty to provide document of discharge. When payment or tender by the person primarily responsible for the debt has extinguished the mortgage, the payor derives little comfort unless a document can be recorded to clear the public records of the mortgage lien. Hence it is the mortgagee's duty to provide such a document. The precise nature of the document will vary from one jurisdiction to another. Most commonly a separate paper, entitled "mortgage satisfaction" or the like, is used. In some states it is customary for the mortgagee to provide an endorsement on the public records, to display the promissory note, marked "paid," to the recorder's office personnel, or to return the original mortgage document. The mortgagee's duty is coextensive with local custom in this respect.

The mortgagee may need a brief period of time to consult its records and verify that the payment amount is correct, and to complete the administrative process of executing a discharge. Any delay beyond such a time, however, raises the risk that the payor will be harmed by the continued existence of the mortgage of record. The mortgagee is liable for any damage caused by such a delay, unless the mortgagee can show that it refused to discharge the mortgage in good faith—typically because a bona fide dispute existed concerning the proper amount of payment. See Illustrations 3 and 4. If the mortgagee's failure to discharge the mortgage is not based on any good faith reason, but instead is the result of negligence or intentional bad faith, liability for damages will arise.

Numerous jurisdictions have statutes providing fixed penalties for the failure of mortgagees to provide timely discharges; see the Statutory Note following this section. However, liability for actual damages under this section is additional to any such penalty, unless the relevant statute provides otherwise.

Illustrations:

3. Mortgagor is indebted to Mortgagee for the principal sum of $100,000, secured by a mortgage on Blackacre. Mortgagor sends a check to Mortgagee for $100,000 purporting to pay the debt. Mortgagee deposits the check but fails without reasonable cause to execute a discharge of the mortgage. Mortgagor has contracted with P to sell Blackacre to P free and clear of all encumbrances. Because of Mortgagee's refusal to discharge the mortgage of record, Mortgagor is unable to clear the record title to Blackacre. P therefore withdraws from the contract to purchase Blackacre. Mortgagor immediately attempts to find another purchaser. Later, after an unreasonable delay, Mortgagee discharges the mortgage of record. Mortgagor then finds another purchaser for Blackacre, but because of the delay and an ensuing decline in market value, Mortgagor sells Blackacre for $10,000 less than the price P had contracted to pay. Mortgagee is liable to Mortgagor for damages of $10,000, plus any incidental damages incurred by Mortgagor in connection with the frustrated sale.

4. The facts are the same as Illustration 3, except that Mortgagee's refusal to discharge the mortgage is based on Mortgagee's reasonable belief, based on Mortgagee's own reasonably maintained records, that Mortgagor owes an additional amount beyond the $100,000 paid by Mortgagor. In addition, Mortgagee promptly communicates to Mortgagor the reasons for its refusal to discharge the mortgage and attempts to clarify the discrepancy expeditiously. Mortgagee is not liable to Mortgagor for damages, even if the basis for Mortgagee's refusal to discharge the mortgage is shown to be incorrect.

d. Tender of payment rejected by mortgagee. Under Subsection (c), a mortgage is extinguished by mere *tender* of full payment by the person primarily responsible for payment, even if the mortgagee rejects it. The tender must be kept good in the sense that the person making the tender must continue at all times to be ready, willing, and able to make the payment. If the payor brings an action to have the mortgage canceled, the money must be paid into court to keep the tender good.

The tender must be unconditional. However, the payor's demand that the mortgagee return the mortgagor's promissory note, mark it "paid," or execute a discharge of the mortgage is not a condition of the sort that will invalidate the tender. See Illustration 5.

The rule extinguishing the mortgage when a tender is rejected has only limited modern significance. The reason is that mortgages are virtually always recorded, and the payor derives little benefit merely from the theoretical extinction of the mortgage if it is in fact still present, and apparently undischarged, in the public records. A payor in such a situation will, as a practical matter, need to file an action to redeem the mortgage or to have it declared extinguished and, as noted above, will be required to pay the funds into court in that action in order to keep the tender good. The court's decree will cancel the mortgage of record, thus giving the payor meaningful relief. At that point, the funds held by the court will be turned over to the mortgagee, and an actual payment will occur.

Nonetheless, the tender of full payment *per se* relieves the real estate of the mortgage lien. Tender is significant in at least two ways. First, the tender stops the accrual of interest, late fees, and any other charges that might otherwise result from the passage of additional time. Second, under Subsection (b) the mortgagee who wrongfully refuses a tender may be held liable for damages flowing from any unreasonable delay that results in clearing the mortgage from the real estate's title. See Illustrations 5 and 6.

Illustrations:

5. Mortgagor is indebted to Mortgagee for the principal sum of $100,000, secured by a mortgage on Blackacre. Mortgagor sends a check to Mortgagee for $100,000 purporting to pay the debt, but Mortgagee refuses to accept the check or execute a discharge of the mortgage. Mortgagor then deposits $100,000 in an escrow account established for the purpose of paying the debt, and informs Mortgagee that the funds are available upon Mortgagee's request and execution of a document discharging the mortgage. Mortgagor's tender is effective, continuing, and unconditional. The mortgage is extinguished, and no further interest will accrue on the debt.

6. The facts are the same as Illustration 5. In addition, Mortgagor has contracted with P to sell Blackacre to P free and clear of all encumbrances. Because of Mortgagee's refusal to accept the tendered payment, Mortgagor is unable to clear the record title to Blackacre. P therefore withdraws from the contract to purchase Blackacre. Mortgagor immediately attempts to find another purchaser. Later, after an unreasonable delay, Mortgagee accepts the tendered payment and discharges the mortgage of record. Mortgagor then finds another purchaser for Blackacre, but because of the delay and an ensuing decline in market value, Mortgagor is only able to sell Blackacre for $10,000 less than the price P had contracted to pay. Mortgagee is liable to Mortgagor for damages of $10,000, plus any incidental damages incurred by Mortgagor in connection with the frustrated sale.

In Illustration 5 the mortgagor kept the tender good by depositing the required funds in an escrow account. This is a proper method, but not the only method of doing so. If the mortgagor is otherwise solvent and financially responsible, he or she need not necessarily segregate the funds, but must show that they continue to be available for actual payment upon demand.

e. Mortgage not extinguished if parties so agree. Sometimes the parties to a mortgage transaction do not desire that the mortgage be extinguished, even though the borrower has made payments that reduce the balance owing on the obligation to zero. This is most commonly the case with a "line of credit" mortgage loan, under which the mortgagor has the right to borrow and repay funds on multiple occasions at his or her discretion over some fixed period of time. In such a transaction, it would be very inconvenient if the mortgage were extinguished simply because the borrower paid the outstanding balance down to zero, since future borrowing would require the execution and recording of a new mortgage.

Under Subsection (d), a payment of the full balance owing will not extinguish the mortgage if the mortgagor and mortgagee agree that it is to be preserved. This principle, while most commonly applied to line-of-credit loans, is applicable to any mortgage loan. The parties' agreement may be stated in the loan documents themselves, which may provide that the mortgagor is entitled to reduce the balance to zero and subsequently to draw additional funds on the security of the mortgage. Alternatively, they may agree on the matter at the time of the payment in question. In the absence of any express agreement, the courts may infer an agreement from the parties' conduct, such as the mortgagor's request for an additional advance after the mortgage balance has been paid to zero, and the mortgagee's granting of the request. See Illustrations 7 and 8.

One effect of extinguishment of a mortgage by payment or tender is to terminate the mortgagee's duty to extend any further advances. Even if the mortgagee originally agreed to make future advances, that agreement will ordinarily have been predicated on the continued existence of the mortgage; hence, unless the parties agree otherwise the obligation to lend does not survive if the mortgage is no longer in effect. See Illustration 8.

Illustrations:

7. Mortgagor enters into a transaction under which Mortgagee agrees to lend funds to Mortgagor under a line of credit, with repayment secured by a mortgage on Blackacre. The agreement provides that Mortgagor may borrow and repay funds at Mortgagor's discretion at any time or times during the ensuing five years, provided that the principal balance may never exceed $10,000. Mortgagor borrows $5,000 from Mortgagee and subsequently repays it in full with interest. However, Mortgagor does not communicate to Mortgagee an intention that the mortgage be extinguished. Thereafter, within the five-year period, Mortgagor borrows $8,000 from Mortgagee under the original loan agreement. The mortgage is not extinguished, and this sum, with interest, is secured by the original mortgage.

8. The facts are the same as in Illustration 7, except that when Mortgagor repays the original $5,000 principal with interest, Mortgagor requests that the mortgage be extinguished and discharged of record. The mortgage is extinguished under Subsection (a) of this section, and Mortgagee is obligated to provide an appropriate document of discharge under Subsection (b). This action also relieves Mortgagee of any obligation to lend additional funds to Mortgagor.

When a payment in full is made by a person who is primarily responsible for the obligation, but the payor and payee agree not to extinguish the mortgage, the payor might attempt to claim ownership of the mortgage, either under the principle of subrogation or by taking a formal assignment of the mortgage from the mortgagee. The payor might then purport to foreclose the mortgage against the holder of some junior lien or other interest subordinate to the mortgage. However, subrogation is inapplicable to this situation, since one who is primarily responsible for an obligation cannot have subrogation upon paying it; see § 7.6, Comment *c*. Indeed, even a formal assignment of the mortgage to the payor would confer no power on the payor to foreclose the mortgage against junior interests, since doing so would unjustly enrich the payor; see § 8.5, Comment *c(3)*.

f. Allocation of payment if payor has multiple obligations. A debtor may owe more than one debt to the same creditor. In such a case, a dispute may arise concerning against which debt a payment is to be credited. For example, if one debt is secured by a mortgage on real estate and the other is unsecured, the creditor may prefer to apply the payment against the unsecured debt. In general the choice is left to the payor, who is permitted to designato which debt is to receive the benefit of the payment. However, this right is subject to modification by the parties' contract. Thus, if loan documents executed by the debtor give the creditor the privilege of allocating the payment, the creditor may do so in the manner it regards as most advantageous, even if contrary to the debtor's wishes. See Illustrations 9 and 10. The creditor has a similar privilege if the debtor makes a payment without designating the debt to which it applies, subject to the general duty not to allocate the payment in a manner inconsistent with good faith and fair dealing.

Illustrations:

9. Mortgagor owes Mortgagee $10,000 on a promissory note secured by a mortgage on Blackacre. In addition, Mortgagor owes $10,000 to Mortgagee on an unsecured promissory note arising out of a different transaction. Mortgagor pays $10,000 to Mortgagee, designating the payment as applicable to the secured note. Mortgagee must apply the payment to the secured note, and the mortgage is extinguished.

10. The facts are the same as Illustration 9, except that the mortgage contains the following term: "Any payment received from Mortgagor may be allocated to the debt secured by this mortgage, or to any other indebtedness owed by Mortgagor to Mortgagee, at Mortgagee's discretion." Mortgagee is entitled to apply the payment to the unsecured promissory note despite Mortgagor's contrary designation. If Mortgagee does so, the mortgage and the note it secures are unaffected by the payment.

g. Redemption by one who is not primarily responsible for the mortgage obligation. Persons who hold interests in the mortgaged real estate that are subordinate to the mortgage have a strong interest in preventing foreclosure, even when they are not primarily responsible for payment, since a foreclosure will destroy their interests if they are properly joined as parties. The right of redemption is recognized in such persons to help them protect their interests. Those within this protection include junior mortgagees, the holders of junior mechanics' liens and other liens, junior lessees, and easement holders. See § 7.6, Illustrations 1–3.

The concept of redemption is applicable only to persons with interests in the real estate subordinate to the mortgage. Some individuals who have no interest in the real estate may have analogous rights of subrogation arising under § 7.6. Such parties include sureties and guarantors of the mortgage debt and mortgagors who have sold the real estate subject to, or with an assumption of, the mortgage. See § 7.6, Illustrations 12–15. While these persons may have a right to pay and be subrogated, their actions cannot properly be termed redemption, since they have no real estate interest to redeem from the mortgage.

There are two principal differences between redemption by individuals who are not primarily responsible for payment and redemption by those who are primarily responsible. First, as Subsection (e) provides, those who have no primary responsibility may not prepay the debt, but must wait until it is due before tendering payment. The reason is that a prepayment by the holder of a junior interest, such as a second mortgagee or a tenant of the mortgagor, would interfere with the relationship between the mortgagor and the mortgagee. Prepayment is a matter of contract between the two of them (see § 6.1), and third parties have no right to intrude upon it. Moreover, if the debt is not due foreclosure is not imminent and the holders of junior interests are not yet at risk; hence, they have no need to redeem.

The second distinction, mentioned above, is that redemption by a person who is not primarily responsible for payment of the debt does not extinguish the mortgage, but rather assigns both the mortgage and the debt to the payor by operation of law under the doctrine of subrogation; see § 7.6. In cases of this sort, the payor has paid, not out of duty, but to protect a real estate interest from foreclosure. Thus, the payor is entitled to reimbursement from whomever is primarily responsible for payment, and can enforce the mortgage against that person to aid in collection of the reimbursement. Subrogation in this context helps prevent the unjust enrichment of the party who is primarily responsible at the expense of the payor. See § 7.6, Illustrations 1 and 2. Since the mortgage is not extinguished, and since the payor has actually paid or tendered the balance owing to protect his or her interest, the accrual of interest on the balance ceases in favor of the mortgagee but continues unabated in favor of the payor.

With these two exceptions, redemption by the holder of a junior interest in the real estate operates in essentially the same manner as redemption by one who is primarily responsible for the obligation. Under Subsection (g) a junior interest-holder may redeem either by actual payment, or by an unconditional tender that is kept good, by analogy to Subsection (c). See Illustration 11. Redemption by a junior interest-holder must be for the full amount of the obligation, including accrued interest and other items owed, as discussed in Comment *b* above. The junior interest-holder who redeems is not entitled to a document of discharge, but rather an assignment of the mortgage.

If the mortgagee fails to give an assignment voluntarily, a court may order it to do so, or may simply issue a decree declaring that the mortgage has been assigned. In addition, if the payor can show that he or she has been damaged by the delay, the court may order an award of compensatory damages under Subsection (f). See Illustration 11.

Illustration:

11. Blackacre is owned by Mortgagor subject to two mortgages held in order of priority by Mortgagee-1 and Mortgagee-2. Mortgagor defaults in payment of the debt secured by the first mortgage, and Mortgagee-1 notifies Mortgagor that the entire debt is now due under an acceleration clause in the mortgage. Mortgagee-2 approaches Mortgagee-1 and tenders the entire balance due on the first mortgage, including accrued interest. Mortgagee-1 refuses to accept the tender. Mortgagee-2 deposits the tendered funds in an escrow account and advises Mortgagee-1 that they are being held for payment of the first mortgage debt. This continuing tender stops the accrual of any further interest in favor of Mortgagee-1 and acts as an assignment by operation of law of the mortgage and the obligation it secures from Mortgagee-1 to Mortgagee-2. Further interest will accrue in favor of Mortgagee-2. At Mortgagee-2's request in an appropriate judicial action, the court may order Mortgagee-1 to execute a written assignment of the obligation and the mortgage to Mortgagee-2. If Mortgagee-2 can show harm resulting from the delay and Mortgagee-1 did not act in good faith in refusing to accept the tendered payment and assign the mortgage, the court may order Mortgagee-1 to pay damages.

In the foregoing illustration Mortgagee-2 places the funds in an escrow account to achieve a continuing tender. However, as noted in Comment *c* above, segregation of the funds is not essential if Mortgagee-2 can show that he or she continues to be ready, willing, and able to pay.

REPORTERS' NOTE

Introduction, Comment a. On redemption, payment, and tender see generally 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 6.6–6.7 (3d ed. 1993); I G. Glenn, Mortgage §§ 50–54 (1943); W. Walsh, Mortgages §§ 39–45 (1934).

The fundamental principle of this section, that a payment in full extinguishes the mortgage, is stated in many cases. See, e.g., FDIC v. Bracero & Rivera, Inc., 895 F.2d 824 (1st Cir.1990); Judge Devel. Corp. v. Bank of New York, 814 F.Supp. 384 (D.Vt. 1993); U.S. v. Hoffman, 826 P.2d 340 (Ariz.App. 1992); Winnett v. Roberts, 225 Cal.Rptr. 82 (Cal.Ct.App.1986); C.T.W. Co. v. Rivergrove Apartments, Inc., 582 So.2d 18 (Fla.Dist.Ct. App.1991); Decker v. Decker, 89 N.W. 795 (Neb.1902); Home & City Sav. Bank v. Sperrazza, 612 N.Y.S.2d 259 (N.Y.App.Div.1994); O'Dell v. First Nat'l Bank, 855 S.W.2d 1 (Tex. Ct. App. 1991), reversed on other grounds, 856 S.W.2d 410 (Tex.1993); Fidelity Mut. Sav. Bank v. Mark, 767 P.2d 1382 (Wash.1989). See also Schultz v. Beulah Land Farm & Racing Stables, Inc., 581 N.Y.S.2d 509 (N.Y.App.Div.1992) (mortgage was extinguished by payment of debt in full by fire insurance carrier under policy purchased by mortgagee).

The essential effect of foreclosure is to cut off the right to extinguish the mortgage by payment or tender; see § 7.1; West Lumber Co. v. Schnuck, 51 S.E.2d 644 (Ga.1949).

While most mortgages secure obligations to pay money, the principle of extinguishment stated in this section also applies to other sorts of obligations. See, e.g., Whaley v. White, 7 So.2d 751 (La.Ct.App.1942) (obligation to remarry); Kline v. McElroy, 296 S.W.2d 664 (Mo.Ct.App.1956) (death of mortgagee); Jeffrey Towers, Inc. v. Straus, 297 N.Y.S.2d 450 (N.Y.App.Div.1969), aff'd, 257 N.E.2d 897 (N.Y. 1970) (obligation to complete building); In re Will of Gunderson, 211 N.W. 791 (Wis.1927) (obligation to support parents until their death).

Illustration 1 is based on Dietrich Industries v. United States, 988 F.2d 568 (5th Cir.1993). See also Pipola v. Chicco, 274 F.2d 909 (2d Cir.1960); Burgoon v. Lavezzo, 92 F.2d 726 (D.C.Cir.1937), noted in 113 A.L.R. 944; In re Hubbard, 89 B.R. 920 (Bankr.N.D.Ala.1988); Commonwealth Bldg. & Loan Ass'n v. Martin, 49 S.W.2d 1046 (Ark.1932); Prestridge v. Lazar, 95 So. 837, 838 (Miss. 1923); J. A. Tobin Constr. Co. v. Grandview Bank, 424 P.2d 81 (Okla. 1966) (purchaser took formal assignment of first chattel mortgage, was held subrogated to it as against a second chattel mortgage of which purchaser was unaware); Credit Bureau Corp. v. Beckstead, 385 P.2d 864 (Wash.1963) (prior mortgage paid by grantee's title insurer). Denying subrogation, generally on the ground that the purchaser had constructive notice of the junior lien, although it lacked actual notice because of a defective title examination, see Hieber v. Florida Nat. Bank, 522 So.2d 878 (Fla.Dist.Ct.App.1988); Bank of Canton v. Nelson, 160 S.E. 232 (Ga.1931); Smith v. Feltner, 83 S.W.2d 506 (Ky. 1935); Belcher v. Belcher, 87 P.2d 762 (Or.1939).

With respect to subrogation rights of grantees, see generally § 7.6, Comment *b*; § 8.5, Comment *c*.

Payment must be in full, Comment b. Illustration 2 is based on Lineham

v. Southern New England Prod. Credit Ass'n, 442 A.2d 585 (N.H. 1982); Goldome Realty Credit Corp. v. Harwick, 564 A.2d 463 (N.J.Super.Ch.1989); Weiss v. Weiss, 615 N.Y.S.2d 468 (N.Y.App.Div.1994); Household Finance Realty Corp. v. Delmerico, 609 N.Y.S.2d 310 (N.Y.App.Div.1994); National Sav. Bank v. Hartmann, 582 N.Y.S.2d 523 (N.Y.App.Div.1992); and Raintree Realty & Constr., Inc. v. Kasey, 447 S.E.2d 823 (N.C.Ct.App.1994). See also United Postal Sav. Ass'n v. Norbob Enter., Inc., 792 S.W.2d 898 (Mo. Ct.App.1990) (payment which purports to be in full, but which does not include a valid prepayment fee, does not entitle mortgagor to discharge of mortgage); FDIC v. Sumner, 820 P.2d 1357 (Okla.App. 1991) (full payment of one note did not entitle mortgagor to a discharge, where mortgage secured four other notes); Martin v. Fairburn Banking Co., 463 S.E.2d 507 (Ga.Ct.App.1995) (full payment of original debt did not entitle mortgagor to discharge, where other debts were secured under the mortgage's dragnet clause).

A partial payment may discharge the mortgage if the mortgagee voluntarily accepts it as doing so; see Dietrich Industries, Inc. v. United States, 988 F.2d 568 (5th Cir.1993); Winters v. Sami, 462 So.2d 521 (Fla.Dist.Ct. App.1985); Affronti v. Bodine, 508 N.E.2d 500 (Ill. App. Ct. 1987). Partial release clauses, which expressly permit a discharge of the mortgage from a portion of the real estate upon payment of less than the full balance owing on the obligation, are discussed in Annot., 41 A.L.R.3d 7 (1972).

In Polo Nat'l Bank v. Lester, 539 N.E.2d 783 (Ill. App. Ct. 1989), the mortgagee voluntarily discharged the mortgage upon payment of less than the full balance owing on the note. The court held that since the note itself was not marked paid or released to the maker, the mortgagee could still sue on it for the remaining balance. See also Provence v. Hilltop Nat'l Bank, 780 P.2d 990 (Wyo.1989), in which the mortgagee and the SBA as guarantor agreed to discharge the mortgage as to a portion of the real estate if certain additional collateral was substituted for it. The parties were unable to provide all of the additional collateral, and the court held that the mortgagee consequently had no duty to execute the discharge.

If the mortgage contains a valid dragnet clause and thus secures other debts in addition to the original obligation, these other debts must also be paid to obtain a discharge of the mortgage; see Willis v. Rabun County Bank, 291 S.E.2d 52 (Ga.Ct.App. 1982); Jones v. American Coin Portfolios, Inc., 709 P.2d 303 (Utah 1985).

Payment may be made to an authorized agent of the mortgagee; see California Fed. Bank v. Matreyek, 10 Cal.Rptr.2d 58 (Cal.Ct.App.1992) (servicing agent waived prepayment fee; borrowers' payment without fee discharged mortgage, despite servicer's obligation to pay fee to holder); Tedesco v. Bekker, 741 S.W.2d 896 (Mo.Ct.App.1987). Payment may be made by an agent of the mortgagor; see Long v. Zirkle, 811 S.W.2d 840 (Mo.Ct.App.1991).

A further promise to pay is not payment; see Fleet Real Estate Funding Corp. v. Frampton, 812 P.2d 416 (Okla.Ct.App.1991). Cf. First State Bank v. Ford, 484 So.2d 407 (Ala.1986), in which a promissory note from one of the mortgagors was voluntarily accepted as payment by the mortgagee.

Payment must be in cash or its equivalent, unless the obligation calls for (or the mortgagee agrees to) a different form of payment. Thus, a tender of the land is generally not a proper payment unless the mortgagee elects to accept it; see Bank of Boston Connecticut v. Platz, 596 A.2d 31 (Conn. Super. Ct. 1991); American Mini-Storage, Marietta Blvd., Ltd. v. Investguard, Ltd., 397 S.E.2d 199 (Ga.Ct.App.1990); Berkeley Properties, Inc. v. Balcor Pension Investors, II, 592 N.E.2d 63 (Ill. App. Ct. 1992) (conveyance of real estate was payment in full where parties had so agreed in a document executed simultaneously with mortgage); Federal Land Bank of Wichita v. Cummings, 735 P.2d 1110 (Kan.Ct.App.1987); Brown v. Financial Sav., 828 P.2d 412 (N.M.1992) (tender of real estate did not satisfy obligation even though obligation was non-recourse and mortgagee had agreed to "look ... solely to the property" for satisfaction of the debt); Albany Savings Bank, FSB v. Novak, 574 N.Y.S.2d 140 (N.Y. Sup. 1991); CUNA Mortgage v. Aafedt, 459 N.W.2d 801 (N.D.1990); Hennessey v. Bell, 775 S.W.2d 650 (Tex. Ct. App. 1988). But see Citicorp Mortgage, Inc. v. Upton, 616 A.2d 1179 (Conn. Super. Ct. 1992), holding that a rejected tender of the real estate extinguished all interest and late charges accruing after the date of the tender. The decision is unusual and may be based on the Connecticut practice of strict foreclosure.

On the other hand, the mortgagee may voluntarily accept a deed to the land in full satisfaction of the obligation. See RTC v. Kahn, 501 N.W.2d 703 (Minn.Ct.App.1993), in which the purchaser under an installment contract gave a quitclaim deed to the vendor in lieu of a proceedimg to terminate the contract. The court presumed that the deed was given "in full performance of the contract," and hence extinguished the vendor's rights under both the contract and the accompanying promissory note. See also Nash v. Miller, 441 S.E.2d 924 (Ga.Ct.App.1994), reaching the same result where the mortgagors alleged that the mortgagee had accepted the deed in full satisfaction of the debt, and the mortgagee did not contradict that allegation.

The payment must actually be made; see Cornwell v. Bank of America, 274 Cal.Rptr. 322 (Cal.Ct.App. 1990) (payment by check is conditional and ineffective until check is actually presented to drawee bank and paid); Upson v. Goodland State Bank, 823 P.2d 704 (Colo.1992) (forged request, purportedly by beneficiary, for release of deed of trust, unaccompanied by actual payment, is void and release by trustee has no legal effect); Desser v. Schatz, 581 N.Y.S.2d 796 (N.Y.App.Div.1992) (satisfaction based on false statement of mortgagor that the mortgage debt had been paid is ineffective and may be set aside by mortgagee); Reinbold v. Utah Fun Shares, 850 P.2d 487 (Utah.Ct.App.1993) (alleged payment was a "paper shuffling exercise"; no actual payment was made and mortgage was not extinguished).

A discharge executed under fraud or mistake can be reformed or set aside unless it has been relied upon by a good-faith purchaser for value. See In re Haas, 31 F.3d 1081 (11th Cir.1994); Gordon v. Gorman, 436 So.2d 851 (Ala.1983); First Nat'l Bank of Southwest Florida v. Cardinal Roofing & Siding of Florida, Inc., 639 So.2d 1101 (Fla.Dist.Ct.App.1994); Republic Nat'l Bank v. Manzini & Assoc., 621 So.2d 709 (Fla.Dist.Ct.

App.1993); United Postal Sav. Ass'n v. Norbob Enter., Inc., 792 S.W.2d 898 (Mo.Ct.App.1990) (reforming note to delete the word "canceled," which was written by mortgagee's employee due to clerical error); Los Alamos Credit Union v. Bowling, 767 P.2d 352 (N.M.1989); First Financial Sav. Bank, Inc. v. Sledge, 415 S.E.2d 206 (N.C.Ct.App.1992); Leedom v. Spano, 647 A.2d 221 (Pa. Super. Ct. 1994). See also First Nationwide Sav. v. Perry, 15 Cal.Rptr.2d 173 (Cal. Ct. App. 1992) (where mortgagee discharged mortgage by mistake and mortgagor subsequently sold real estate to bona fide purchaser, mortgagee could obtain restitution from mortgagor for unjust enrichment).

Duty to provide document of discharge, Comment c. Cases recognizing the mortgagee's duty to provide a document of discharge include Tenneco Oil Co. v. Clevenger, 363 So.2d 316 (Ala. Ct. Civ.App. 1978); Skorpios Properties, Ltd. v. Waage, 374 A.2d 165 (Conn.1976); Parke v. Gonzalez, 606 So.2d 705 (Fla.Dist.Ct.App.1992); Mickie v. McGehee, 27 Tex. 134 (1863); Knox v. Farmers' State Bank of Merkel, 7 S.W.2d 918 (Tex. Ct. Civ. App. 1928), noted in 7 Tex. L. Rev. 323 (1929). See Grossman v. Pendant Realty Corp., 634 N.Y.S.2d 61 (N.Y.App.Div.1995) (court's order to mortgagee to satisfy the mortgage was properly conditioned upon payment of balance due by mortgagors). See also La. Rev. Stat. Ann. § 9:5556–57.

Illustrations 3 and 4 are based on Hector, Inc. v. United Sav. & Loan Ass'n, 741 P.2d 542 (Utah 1987), holding the mortgagee liable for double damages (pursuant to a Utah statute) where the mortgagee refused in bad faith to discbarge the mortgage upon full payment. See also Mitchell v. Oliver, 327 S.E.2d 216 (Ga.1985) and Edenfield v. Trust Co. Mortg., 365 S.E.2d 520 (Ga.Ct.App.1988), finding that the mortgagee acted in good faith and refusing to impose damages. Tucker v. FSB Mortgage of Little Rock, 886 P.2d 498 (Okla.Ct.App. 1994), points out that the "good faith" defense applies to a mortgagee's refusal to accept a tendered payment in full, not a refusal to discharge the mortgage after accepting the payment as being in full. In Pintor v. Ong, 259 Cal.Rptr. 577 (Cal.Ct.App. 1989), an award of $15,000 in damages for the mortgagor's mental distress resulting from the mortgagee's failure to discharge the mortgage was sustained. See also South Sanpitch Co. v. Pack, 765 P.2d 1279 (Utah.Ct. App.1988) (trustee under deed of trust held liable for failure to record reconveyance).

State statutory provisions imposing a penalty for the mortgagee's failure to discharge the mortgage are generally held applicable even in the absence of a showing of actual damages; see, e.g., Kinard v. Fleet Real Estate Funding Corp., 461 S.E.2d 833 (S.C.Ct.App.1995). Likewise, these statutes generally do not bar the recovery of actual damages. See Tenneco Oil Co. v. Clevenger, 363 So.2d 316 (Ala. Ct. Civ. App. 1978); Trustors Security Service v. Title Recon Tracking Service, 56 Cal.Rptr.2d 793 (Cal.Ct.App.1996); Pintor v. Ong, 259 Cal.Rptr. 577 (Cal.Ct.App.1989); Skorpios Properties, Ltd. v. Waage, 374 A.2d 165 (Conn.1976). Contra, see Taylor v. Taylor, 363 N.E.2d 1342 (Mass. Ct. App. 1977) (statute provides sole remedy). See the statutory table at the end of this section for further detail on this matter.

Tender of payment rejected by mortgagee, Comment d. Cases defining tender include Napue v. Gor-Mey West Inc., 220 Cal.Rptr. 799 (Cal.Ct. App.1985) (mortgagor must have present ability to make the tender good); Rissman v. Kilbourne, 643 So.2d 1136 (Fla.Dist.Ct.App.1994) (letter offering to pay is insufficient; "the actual production of the thing to be paid or delivered" is necessary); Owens v. Idaho First Nat'l Bank, 649 P.2d 1221 (Idaho.Ct.App.1982) (mere spoken offer to pay insufficient; "actual present physical offer" required); Mr. U Inc. v. Mobil Oil Corp., 249 N.W.2d 909, 912 (Neb.1977) ("an offer to perform coupled with the present ability of immediate performance, so were it not for the refusal of cooperation by the party to whom the tender is made, the condition or obligation would be immediately satisfied"); Tucker v. Gayle, 709 S.W.2d 247 (Tex. Ct. App. 1986) ("an unconditional offer by a debtor to pay another, in current coin of the realm, a sum on a specified debt or obligation"). See also Cornwell v. Bank of America, 274 Cal.Rptr. 322 (Cal.Ct.App.1990) (check which was apparently lost in mail never reached mortgagee, and was not an effective tender).

A tender may be made by the authorized agent of the person who is primarily responsible for the obligation; see Long v. Zirkle, 811 S.W.2d 840 (Mo.Ct.App.1991).

Cases holding that a rejected tender extinguishes the mortgage include Judge Devel. Corp. v. Bank of New York, 814 F.Supp. 384 (D.Vt. 1993); Winnett v. Roberts, 225 Cal. Rptr. 82 (Cal.Ct.App.1986); Fostor Lumber Co. v. Weston Constructors, Inc., 521 P.2d 1294 (Colo.Ct.App. 1974); Bowman v. Poole, 91 S.E.2d 770 (Ga.1956); McFarland v. Christoff, 92 N.E.2d 555 (Ind.Ct.App.1950); Depon v. Shawye, 161 N.E. 243 (Mass.1928); Caruthers v. Humphrey, 12 Mich. 270 (1864); Mr. U Inc. v. Mobil Oil Corp., 249 N.W.2d 909 (Neb.1977); Kortright v. Cady, 21 N.Y. 343 (1860); and General Electric Credit Corp. v. Lunsford, 167 S.E.2d 414 (Va.1969). See also Mendez v. Rosenbaum, 662 P.2d 751 (Or.Ct.App. 1983) (tender was effective, where mortgagee made deliberate attempts to obstruct mortgagors' tender). See generally Annot., 93 A.L.R. 31 (1934).

A tender, like an actual payment, must be for the full balance owing, including all interest and fees. See Decker v. State Nat'l Bank, 51 So.2d 538 (Ala.1951) (tender must include amounts due under dragnet clause); Agostini v. Colonial Trust Co., 44 A.2d 21 (Del.Ch.1945) (tender was less than amount mortgagee demanded, but after recomputation of balance owed with reduced interest to account for usurious nature of loan, mortgagor was permitted to retender); Daiwa Bank, Ltd. v. LaSalle Nat'l Trust, 593 N.E.2d 105 (Ill. App. Ct. 1992) (tender must include debt, accrued interest, and costs); Lake Mortgage Co. v. FNMA, 308 N.E.2d 739 (Ind.Ct.App.1974), transfer denied and new trial ordered on other grounds, 321 N.E.2d 556 (1975); Mutual Life Ins. Co. of New York v. Hilander, 403 S.W.2d 260 (Ky.1966) (tender which included prepayment fee was effective, although fee was "paid under protest"); Trovillion v. Countrywide Funding Corp., 910 S.W.2d 822 (Mo.Ct.App.1995) (tender was insufficient, under Missouri statute, where it did not include $18 fee to cover cost of recording a release); Roberts v. Rider, 924 S.W.2d 555 (Mo.Ct.App.1996) (tender was insufficient, under Missouri statute, where it did not include attorneys' fee, despite the fact that amount of fee was disputed and lender's demanded fee was grossly excessive); National Sav. Bank of Albany v. Hartmann, 582 N.Y.S.2d 523 (N.Y.App.Div.1992) (tender must include accrued interest and late fees); Albany Sav. Bank FSB v. Seventy–Nine Columbia Street Inc., 603 N.Y.S.2d 72 (N.Y.App.Div. 1993) (tender must include full balance, where loan has been accelerated); Ingold v. Phoenix Assur. Co., 52 S.E.2d 366 (N.C.1949), noted in 8 A.L.R.2d 1439 (tender which fails to include all accrued interest is invalid); Mid–State Homes, Inc. v. Jackson, 519 P.2d 472 (Okla.1974); Portland Trust & Sav. Bank v. Lincoln Realty Co., 170 P.2d 568 (Or.1946) (offer by owner of a portion of the mortgaged land to pay "pro-rata share" of balance was not an effective tender); Home Owners' Loan Corp. v. Washington, 161 P.2d 355 (Utah 1945) (tender was effective, though it did not include attorney's fees and costs demanded by mortgagee, where demand for such fees was improper).

However, if the mortgagor tenders the balance stated to be due under an "estoppel statement" or "payoff statement" issued by the mortgagee, the tender will be good even if the statement proves to have been erroneously low, provided that the party tendering reasonably relied on the statement; cf. § 1.6. See Anderson v. Heart Fed. Sav. & Loan Ass'n, 256 Cal.Rptr. 180 (Cal.Ct.App.1989); Maddox v. Wright, 489 N.E.2d 133 (Ind.Ct.App.1986).

The tender must be in cash or its commercial equivalent unless the obligation itself calls for a different form of payment. Restatement, Second, Contracts § 249 provides:

> [P]ayment or offer of payment in any manner current in the ordinary course of business satisfies the requirement unless the obligee demands payment in legal tender and gives any extension of time reasonably necessary to procure it.

See Fleet Real Estate Funding Corp. v. Frampton, 812 P.2d 416 (Okla.Ct. App.1991) (promise to pay in the future not a valid tender); Fillion v. David Silvers Co., 709 S.W.2d 240 (Tex. Ct. App. 1986) (letter of credit not a valid tender); Lido, Int'l v. Lambeth, 601 S.W.2d 112 (Tex. Ct. App. 1980), reversed on other grounds, 611 S.W.2d 622 (Tex.1981) (postdated checks not a valid tender). On the other hand, an uncertified personal check is a valid tender if the checking account contains funds to cover it and the mortgage or note requires no more; see Martin v. STM Mortg. Co., 903 S.W.2d 548 (Mo.Ct. App.1995); TSB Exco v. E.N. Smith, III Energy Corp., 818 S.W.2d 417 (Tex. Ct. App. 1991); Smith v. Avco Mortg. & Acceptance, Inc., 465 S.E.2d 588 (Va.1996). If the amount due is in dispute, the mortgagor must tender at least the amount that is conceded to be due; Harpe v. Stone, 92 S.E.2d 522 (Ga.1956), noted in 8 Mercer L. Rev. 144, 149 (1956).

To be effective, a tender must be unconditional. See United States v. Garden Homes, 113 F.Supp. 415 (D.N.H.1953) (tender was ineffective, where it was conditioned upon mortgagee's waiver of payment of principal during a period of "temporary unoccupancy"); Soufal v. Griffith, 198 N.W. 807 (Minn. 1924); Lowry v. Northwestern Sav. & Loan Ass'n, 542 S.W.2d 546 (Mo.Ct.App.1976) (promise to pay, conditioned upon payor's ability to obtain the funds from another, was not a valid tender); Dallas v. Dallas, 582 N.Y.S.2d 835 (N.Y.App. Div.1992) (promise to pay upon payor's receipt of a future personal injury settlement was not a valid tender); Ingold v. Phoenix Assur. Co., 52 S.E.2d 366 (N.C.1949), noted in 8 A.L.R.2d 1439 (promise to pay, but without a tender into court of a draft for the full balance including interest, was not a valid tender); Johnson v. Midland Bank, 715 S.W.2d 607 (Tenn. Ct.App.1986) (tender not valid where conditioned upon mortgagee's release of mortgage on other property); Perkins v. Factory Point Nat'l Bank, 409 A.2d 578 (Vt.1979) (offer to pay out of proceeds of future sale of the real estate was not a valid tender); Hartman v. Anderson, 298 P.2d 1103 (Wash.1956) (tender not valid where conditioned upon mortgagee's granting of a second water right to mortgagors).

However, a condition merely demanding that the mortgagee provide the usual documents showing the payment and discharge does not invalidate the tender. See Brinton v. Haight, 870 P.2d 677 (Idaho App. 1994) (mortgagor's demand for an immediate document of discharge in return for the payment was not a condition that would vitiate the tender); Lanier v. Romm, 206 S.E.2d 588 (Ga. Ct.App.1974) (tender was valid and unconditional despite borrower's demand for surrender of promissory note and cancellation of mortgage); Strulowitz v. Susan B. Anthony Bldg. & Loan Ass'n, 280 A.2d 223 (N.J. Super. Ct. 1971); Wallowa Lake Amusement Co. v. Hamilton, 142 P. 321 (Or.1914).

Numerous cases hold that a rejected tender of full payment by a person primarily responsible for payment terminates the accrual of interest. See, e.g., Bank of La Fayette v. Giles, 69 S.E.2d 78 (Ga.1952); Brinton v. Haight, 870 P.2d 677 (Idaho App. 1994); Gandrud v. Bremer, 18 N.W.2d 687 (Minn.1945); Mayer v. Middlemiss, 67 N.Y.S.2d 422 (N.Y.Sup.Ct. 1946). See also First Family Mortg. Corp. v. White, 549 So.2d 1049 (Fla. Dist.Ct.App.1989) (where mortgagee erroneously released mortgage, refused mortgagor's tender of further monthly payments, and made no demand for payments for two years, trial court had equitable discretion to absolve mortgagor from liability for interest during that period, although mortgage was reinstated by court).

While a rejected tender of full payment terminates the accrual of interest, it does not discharge the obligation to pay the principal amount of the debt. See Lichty v. Whitney, 182 P.2d 582 (Cal.Ct.App.1947); Carteret Sav. Bank v. Snyder, 608 So.2d 516 (Fla.Dist.Ct.App.1992) (mortgagor's tender of monthly payments, rejected by mortgagee because of a dispute as to the proper amount, did not reduce the balance owing on the debt); Ward v. McGuire, 100 S.E.2d 276 (Ga.1957).

By the prevailing view the tender, to be effective, must be kept good as required by this section. See Decker v. State Nat'l Bank, 51 So.2d 538 (Ala.1951); Abbott v. Herron, 118 S.W. 708 (Ark.1909); Brinton v. Haight, 870 P.2d 677 (Idaho App. 1994) ("tender may be kept good by keeping the tendered money on deposit in a bank, by paying it into court or by making the tender in writing"); Crain v. McGoon, 86 Ill. 431, 29 Am. Rep. 37 (1877); McCool v. Decatur County Bank, 480 N.E.2d 596 (Ind.Ct.App.1985); French v. Winstead, 299 S.W.2d 109 (Ky.1957); Gandrud v. Bremer, 18 N.W.2d 687 (Minn.1945); Knollenberg v. Nixon, 72 S.W. 41, 44 (Mo.1902); Conservative Sav. & Loan Ass'n v. Karp, 352 N.W.2d 900 (Neb.1984); Geary v. Dade Development Corp., 329

N.Y.S.2d 569 (N.Y. 1972); Tolbert v. Fouche, 123 S.E. 859 (S.C.1924). See also Storke and Sears, Discharge of Security Transactions, 26 Rocky Mt. L. Rev. 115, 123 (1954).

Contra, holding that tender need not be kept good, see Magnus v. Morrison, 208 P.2d 407 (Cal.Ct.App.1949); Home Owners' Loan Corp. v. Washington, 161 P.2d 355 (Utah 1945).

Illustrations 5 and 6 are based on Judge Devel. Corp. v. Bank of New York, 814 F.Supp. 384 (D.Vt.1993). See also Hohn v. Morrison, 870 P.2d 513 (Colo.Ct.App.1993). In that case the mortgagor was unable to prove any actual damages, but was nonetheless permitted to recover attorney's fees from the mortgagee. The court adopted a standard of "wilfulness," analogous to the "bad faith" standard articulated in this section.

Mortgage not extinguished if parties so agree, Comment e. Illustrations 7 and 8 are based on Barclay's Bank of New York v. Market Street Mortg. Corp., 592 N.Y.S.2d 874 (N.Y.App.Div.1993) (line-of-credit loan is discharged when payment in full is accompanied by borrower's request for discharge). See also Household Realty v. Martin, 1994 WL 60043 (Conn.Super.Ct.1994) (oral request by borrower's attorney to line-of-credit mortgagee to release mortgage, accompanied by payment of full balance owing, extinguished mortgage); Prudential Home Mortg. Co. v. Johnson, 1993 WL 117723 (Conn.Super.Ct.1993) (same); In re Mortgage of Leslie, 1994 WL 89346 (Del.Super.Ct.1994) (check for full balance sent to line-of-credit mortgagee, unaccompanied by any request that mortgage be satisfied, did not extinguish mortgage); Tedesco v. CDC Fed. Credit Union, 306 S.E.2d 397 (Ga.Ct.App.1983) (payment reducing line-of-credit balance to zero does not entitle borrower to discharge of mortgage unless borrower gives up the right to demand further advances); Turner v. Givens, 166 So. 367 (Miss. 1936) (letter written after full payment established parties' intent to keep mortgage alive); Raintree Realty & Constr., Inc. v. Kasey, 447 S.E.2d 823 (N.C.Ct.App.1994) (under statute, discharge of line-of-credit loan occurs only upon reduction of balance to zero and a request by borrower for a discharge); Beneficial Mort. Co. v. Kilbourn, 1994 WL 758321 (Ohio.Ct.App.1994) (notation on payment check, "pay-off first mortgage," was insufficient to notify line-of-credit mortgagee that mortgagor intended to discharge mortgage). Some states have statutes stating this principle; see, e.g., La. Civ. Code Ann. art. 3298.

A typical provision in a line-of-credit mortgage preserving it against extinction when the balance is paid to zero is found in Waller v. Maryland Nat'l Bank, 620 A.2d 381, 393 (Md. Ct. App. 1993), vacated and remanded on other grounds, 631 A.2d 447 (Md.Ct.App.1993):

> The fact that the balance hereunder may be reduced to zero from time to time pursuant to the Loan Documents (as hereinafter defined) will not affect the continuing validity of this note, or the Loan Documents, and the balance may be increased to the principal sum after any such reduction to zero.

Allocation of payment if payor has multiple obligations, Comment f. Illustrations 9 and 10 are based on Farm Credit Bank of St. Louis v. Biethman, 634 N.E.2d 1312 (Ill. App. Ct. 1994) (where payor does not specify to which debt payment is to be applied, payee may apply it as payee chooses); Van Dusseldorp v. State Bank of Bussey, 395 N.W.2d 868 (Iowa 1986) (same); In re Presque Isle Apartments, L.P., 112 B.R. 744 (Bankr.W.D.Pa.1990) (even in absence of payor's direction as to application of payment, payee-mortgagee was bound to apply payment in manner specified in the mortgage documents); United Orient Bank v. Lee, 504 A.2d 1215 (N.J. Super. Ct. 1986) (in the absence of any contrary agreement, payor's direction controlled application of funds); Restatement, Second, Contracts § 258, Comment *a*.

The duty of good faith and fair dealing is stated in Restatement, Second, Contracts § 205 and U.C.C. § 1-203 (1995). However, no case has been found in which a court discerned a breach of the duty by virtue of a lender's allocation of a payment by a borrower. See S. Burton & E. Anderson, Contractual Good Faith § 7.2ff. (1995), at 275, suggesting that a court should not enforce the remedial terms of a contract "unless they will accomplish their intended purpose without imposing needless costs on the other side." It is conceivable that some payment allocations by a creditor might lead a court to refuse enforcement of mortgage remedies on this basis.

Redemption by one who is not primarily responsible for the mortgage obligation, Comment g. Redemption is a concept applicable only to persons with interests in the mortgaged real estate; see Dawson v. Overmyer, 40 N.E. 1065 (Ind.1895); Smith v. Austin, 9 Mich. 465 (1862); G. Osborne, Mortgages § 304 (1951).

Illustration 11 is based on Bowman v. Poole, 91 S.E.2d 770 (Ga.1956). See also G. B. Seely's Son, Inc. v. Fulton-Edison, Inc., 382 N.Y.S.2d 516 (N.Y.App.Div.1976) (junior tenant may redeem mortgage and be subrogated to it); Dominion Financial Corp. v. 275 Washington St. Corp., 316 N.Y.S.2d 803 (N.Y.Sup.Ct.1970) (same).

Cases finding a duty on the part of a mortgagee to give a written assignment to a junior interest-holder who redeems the mortgage include United States v. Boston & Berlin Transportation Co., 237 F.Supp. 1004, 1008 (D.N.H.1964); Motes v. Roberson, 32 So. 225 (Ala.1902); Global Realty Corp. v. Charles Kannel Corp., 170 N.Y.S.2d 16 (1958) (redemption by junior tenant); Payne v. Foster, 135 N.Y.S.2d 819 (N.Y.App.Div.1954) (redemption by holder of remainder); Simonson v. Lauck, 93 N.Y.S. 965 (N.Y.App.Div.1905) (redemption by a third party at the request of a tenant in common of the real estate); Averill v. Taylor, 8 N.Y. 44 (1853). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law § 10.8 (3d ed. 1993); Annot., 93 A.L.R. 89 (1934).

A subordinate lienholder whose lien covers less than the entire parcel of real estate encumbered by the senior lien may attempt to redeem based on a *pro tanto* payment rather than payment of the full balance, but such attempts are nearly always rejected by the courts; see Annot., 46 A.L.R.3d 1362 (1972).

STATUTORY TABLE MORTGAGE DISCHARGE PENALTIES

The following table provides information about state statutes that impose penalties on mortgagees who do not provide a document of satisfaction or discharge in a timely fashion after receiving full payment of the mortgage debt. The table indicates the event that initiates the grace period allowed for the mortgagee to provide or record a satisfaction, the duration of the period, and the penalty that attaches if the mortgagee fails to comply.

Jurisdiction	Statutory citation	Grace period commences upon	Grace period	Penalty
Alabama	Ala. Code § 35-10-21	Full payment and written request	30 days	$200
Alaska	Alaska Stat. § 34.20.050	Full performance, written request, and tender of reasonable charges	10 days	$300 plus actual damages
Arizona	Ariz. Rev. Stat. Ann. § 33-712	Satisfaction	30 days	Actual damages
		Written request, certified mail	30 additional days	$1,000 plus actual damages
Arkansas	Ark. Code Ann. § 18-40-010	Full satisfaction and request	60 days	Any sum, not exceeding the mortgage amount, recoverable in a civil action
California	Cal. Civ. Code § 2941	Satisfaction	Mortgages: 30 days	$300 plus actual damages
		Receipt by trustee of original note, deed of trust, request for reconveyance, and fees	Deeds of trust: 21 days	
Colorado	Col. Rev. Stat. § 38-25-124	Satisfaction and receipt of reasonable costs	90 days	Liable to the owner of the real property encumbered
Connecticut	Conn. Gen. Stat. § 49-8	Satisfaction and written request	30 days	Actual damages or $200 for each week beyond 30 days, whichever is greater
Delaware	Del. Code Ann. tit. 25 § 2111	Satisfaction or performance		Not more than $1,000 for wilful failure to satisfy mortgage
			60 days	Recorder of deeds shall file complaint with Attorney General
Florida	Fla. Stat. Ann. ch. 705	Payment and written demand	30 days	Guilty of misdemeanor
Georgia	Ga. Code Ann. § 44-14-3	Payment in full	60 days	$500 plus actual damages and attorneys' fees
Hawaii	Haw. Rev. Stat. § 506-8	Full satisfaction and request in writing	60 days	Treble damages and attorneys' fees
Idaho	Idaho Code § 45-915	Satisfaction and demand	None mentioned	$100 plus actual damages
Illinois	Ill. Rev. Stat. ch. 765 § 905/2	Payment of the debt	One month	$200 plus attorneys' fees
Indiana	Ind. Code § 32-8-1-2	Full payment and written demand	15 days	Not to exceed $500 plus costs and attorneys' fees

Jurisdiction	Statutory citation	Grace period commences upon	Grace period	Penalty
Iowa	Iowa Code § 655.2	Satisfaction in full and request in writing	30 days	$100 plus attorneys' fees; inapplicable if § 535B.11 applies
	Iowa Code § 535B.11 (residential property)	Written notice from Superintendent of the Division of Banking	Mortgage servicers: 15 days	Not to exceed $50 for each day after 15 days
Kansas	Kan. Stat. Ann. § 58-2309a	Payment and demand	20 days	$500 plus attorneys' fees and any additional damages
Kentucky	Ky. Rev. Stat. § 382.365	Satisfaction	30 days	$50, actual expenses in securing the release, attorneys' fees and costs
Louisiana	La. Rev. Stat. Ann. § 9:5385	Full satisfaction and written demand	30 days	All damages, costs, and attorneys' fees
Maine	Me. Rev. Stat. Ann. tit. 33, § 551	Full performance and request	7 days	Not less than $10 nor more than $50
Maryland	Md. Real Prop. Code Ann. § 7-106	Satisfaction and written request	30 days	All costs and expenses of the action, including attorneys' fees
Massachusetts	Mass. Gen. L. Ann. ch. 183 § 55	Full performance, request, and tender of reasonable charges	7 days	All damages
Michigan	Mich. Comp. Laws § 565.44	Full performance, request, and tender of reasonable charges	7 days	$100 plus actual damages and double costs in court's discretion
Minnesota	Minn. Stat. Ann. § 507.41	Full performance, request, and tender of reasonable charges	10 days	Actual damages
Mississippi	Miss. Code Ann. § 89-5-21	Full payment and request	1 month	$50 plus any sum not exceeding the mortgage money
Missouri	Mo. Rev. Stat. § 443.130	Satisfaction, request, and tender of costs	30 days	10% of the mortgage amount, plus any other damages
Montana	Mont. Code Ann. § 71-1-212	Full performance and request	30 days	$100 plus actual damages
Nebraska	Neb. Rev. Stat. § 76-252	Satisfaction and written request	60 days	The greater of $1,000 or actual damages, plus costs and attorneys' fees
Nevada	Nev. Rev. Stat. § 106.290 (mortgages)	Full performance, request, and tender of reasonable charges	7 days	$100 plus actual damages
	Nev. Rev. Stat. § 107.077 (deeds of trust)	Written notice that debt has been paid or discharged	21 days for beneficiary; 45 days for trustee after receipt of documents from beneficiary	$100 plus actual damages, attorneys' fees, and costs
New Hampshire	N.H. Rev. Stat. Ann. § 479:7, :8	Satisfaction	60 days	"shall be guilty of a violation" with fine not to exceed $500
New Jersey	N.J. Rev. Stat. § 46:18 -11.2, -11.3	Written notice, 30 days after receipt of payment and fees	15 business days	$50 per day, not to exceed $1,000, or actual damages if greater

Jurisdiction	Statutory citation	Grace period commences upon	Grace period	Penalty
New York	N.Y. Real Prop. Acts § 1921	Payment of amounts due	90 days	The greater of $500 or the economic loss caused (1-6-family owner-occupied residence)
North Carolina	N.C. Gen. Stat. § 45-36.3	Payment or satisfaction	60 days	$500 to mortgagor, $500 to purchaser of property
North Dakota	N.D. Cent. Code § 30-01-27	Satisfaction and demand	Immediately	All damages plus $100
Ohio	Ohio Rev. Stat. Ann. § 5301.36	Satisfaction of residential mortgage	90 days	$250 plus other available legal remedies
Oklahoma	Okla. Stat. Ann. tit. 46, § 15	Payment of the debt plus written request	50 days plus 10 days after written request	1% of the principal debt, not to exceed $100 for each day after expiration of the 10-day period
Oregon	Or. Rev. Stat. § 86.140 (mortgages)	Full performance, tender of reasonable charges, and request	30 days	$500 plus actual damages
	Or. Rev. Stat. § 86.720 (deeds of trust)	Performance of the obligation	30 days for beneficiary to send request to trustee; 30 additional days for trustee to reconvey	
Pennsylvania	Pa. Stat. Ann. tit. 21, §§ 681-82	Full satisfaction, request, and payment of reasonable charges	45 days	Forfeiture of any sum not exceeding the mortgage money
Puerto Rico	P.R. Stat. tit. 30, § 1878	Performance or tender, plus request	10 days	All damages
Rhode Island	R.I. Gen. Laws § 34-26-5	Satisfaction, request, and tender of reasonable charges	10 days	All damages, attorneys' fees, and triple costs
South Carolina	S.C. Code Ann. § 29-3-320	Payment, request, and tender of fees	3 months	Not exceeding one-half of the amount of the debt
	S.C. Code Ann. § 29-3-325 (financial institutions)	Receipt of full amount of obligation, and demand	90 days	$100 for each 10 days after demand[1]
Tennessee	Tenn. Code Ann. § 66-25-102	Full payment and written request	45 days	$100. If not satisfied within 30 days of a second request, a sum not to exceed $1,000. Expenses, court costs, and attorneys' fees may also be recovered
Utah	Ut. Code Ann. § 57-1-38	Final payment	90 days	Treble damages, attorneys' fees, and costs
Vermont	Vt. Stat. Ann. tit. 27, § 464	Performance, tender of reasonable charges, and request	10 days	Damages occasioned thereby
Virginia	Va. Code Ann. § 6.1.330.82; § 55-66.3	Payment or satisfaction	90 days	$300. If not paid within 10 business days after demand, must pay court costs and attorneys' fees

Jurisdiction	Statutory citation	Grace period commences upon	Grace period	Penalty
Virgin Islands	V.I. Code Ann. tit. 28, § 128	Full performance, tender of reasonable charges, and written request	10 days	Not to exceed $100 plus actual damages
Washington	Wash. Rev. Code § 61.16.030	Satisfaction and request or demand	60 days	Damages and attorneys' fees
Wisconsin	Wis. Stat. § 706.05	Full performance	30 days, or 7 days after written request	$100 per day, up to $2,000, plus actual damages (for violation of 7-day rule only)
Wyoming	Wyo. Stat. § 34-1-132	Full performance and request in writing	30 days	0.1% of principal amount per day, not to exceed $100 per day, plus actual damages

[1] See Kinard v. Fleet Real Estate Funding Corp., 461 S.E.2d 833 (1995), holding that remedies under this section are alternative to those of § 29-3-20 at the option of the plaintiff, provided that both apply. The court held that, while no showing of actual damages was required in order to recover a penalty under § 29-3-20, consideration should be given to the existence of actual injury, and to the attitude and conduct of the mortgagee, in determining whether the full penalty amount (half the amount of the debt) should be awarded. On the facts of the case, the court determined that assessment of the full penalty was justified.

CHAPTER 7

PRIORITIES

Introductory Note: Chapter 7 consists of eight sections dealing with common and sometimes troublesome mortgage priority issues and related concerns.

Section 7.1 restates the fundamental mortgage law axiom that a valid foreclosure of a senior lien terminates not only the owner's equity of redemption, but all junior interests whose holders are joined as well. It also states the basic principle that interests senior to the mortgage being foreclosed are not terminated.

Section 7.2 reaffirms the well-recognized rule that purchase money mortgages, whether given to a vendor or a third party, take priority over liens or other interests attaching to the real estate through the purchaser-mortgagor prior to the latter's acquisition of title. It defines "purchase money mortgage" broadly. For example, a construction mortgage, the proceeds of which are used only for the improvement of real estate, qualifies for purchase money status if it is executed as part of the same transaction in which title to the real estate is acquired.

Section 7.3 deals with a variety of priority disputes between a senior mortgagee and intervening lienholders that arise when the senior mortgage is replaced or modified. In general, the section takes the position that intervening liens are promoted in priority only to the extent that they are materially prejudiced by the replacement or modification transaction. Moreover, the section gives broad authority to the mortgagor and mortgagee to reserve the right in the senior mortgage, as against lienors and others who thereafter acquire an interest in the real estate, to make even prejudicial modifications to the mortgage or the obligation it secures. In addition, because modification provisions often operate much like future advances provisions, § 7.3(d) gives the mortgagor the right to issue a "cut-off" notice to the mortgagee terminating any mortgage modification provision. Upon receipt by the mortgagee, the right to modify is ended, and any subsequent modifications will be governed by the general "material prejudice" principle enunciated by this section.

Section 7.4 restates the basic principle that foreclosure sale surplus should be paid to those whose interests are terminated by the foreclosure in order of their preforeclosure priority. The holder of the equity of redemption is entitled only to what remains after all other foreclosed interests have been satisfied. Moreover, the parties to a senior mortgage may not use mortgage terms to vary the foregoing principles.

Section 7.5 deals with the difficult issues surrounding mortgage provisions that purport to bind after-acquired parcels of real estate. While the section recognizes the validity of such a provision between the mortgagor and mortgagee, as to third parties who take an interest in subsequently acquired real estate, the provision is treated as unrecorded until the mortgagee records a notice that specifically identifies the after-acquired real estate and refers to the mortgage containing the provision. Until such a notice is recorded, third parties dealing with mortgagor's after-acquired real estate will not be on constructive notice of the provision.

Section 7.6 provides for subrogation in favor of one who pays off a mortgage obligation. The payor steps into the shoes of the mortgagee who was paid, where necessary to prevent unjust enrichment. This section abandons the "volunteer" rule and instead provides a nonexclusive list of situations in which subrogation is appropriate. Where a mortgage is paid by another lender who reasonably expected to receive the security and priority of the mortgage being paid, the payor is entitled to subrogation even if it had actual knowledge of any intervening liens.

Section 7.7 recognizes the enforceability of mortgage subordinations. However, where a mortgage is being subordinated to an interest to be created in the future, § 7.7 provides that the interest must be described with reasonable specificity. This proviso is intended to avoid the unfairness of subordinating one's mortgage to an interest with vagne or indeterminate terms.

Section 7.8 deals with the foreclosure of wraparound mortgages, a subject that has been difficult and controversial. It provides that the wraparound mortgagee can foreclose only for the "net" balance due on the wraparound debt—that is, the difference between the wraparound debt's face balance and the balance owing on the underlying debt. Any surplus above this amount must be paid to junior interest holders or the mortgagor under the principles of § 7.4. This approach preserves the integrity of the foreclosure process and avoids unjust enrichment.

§ 7.1 Effect of Mortgage Priority on Foreclosure

A valid foreclosure of a mortgage terminates all interests in the foreclosed real estate that are junior to the mortgage being foreclosed and whose holders are properly joined or notified under applicable law. Foreclosure does not terminate interests in the foreclosed real estate that are senior to the mortgage being foreclosed.

Cross-References:

Section 4.1, Mortgage Creates Security Interest Only; § 4.2, Mortgaging Rents; § 4.5, Priorities Between Competing Receivers; § 4.9, Acquisition of Foreclosure Title by the Holder of the Equity of Redemption or Other Junior Interests: Effect upon Junior Interests; § 6.4, Redemption from Mortgage by Performance or Tender; § 7.2, Purchase Money Mortgage Priority: § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; § 7.4, Effect of Priority on the Disposition of Foreclosure Surplus; § 7.5, Mortgaging After-Acquired Real Estate; § 7.6, Subrogation; § 7.7, Subordination; § 7.8, Foreclosure of Wraparound Mortgages.

Comment:

a. Valid foreclosure terminates junior interests. This section focuses on how the priority of mortgages and other interests in real estate affects the foreclosure process. Because the actual priority rules themselves transcend mortgage law, they are not treated in detail by this Restatement. Generally, the priority of mortgages and other interests in real estate is determined by the chronological order of their creation. However, this principle is subject to a multitude of limitations. Foremost of these are the recording acts, which in every state allow qualifying subsequent takers of real estate interests to prevail over those holding prior unrecorded interests. The chronological priority rule is also limited by subordination agreements, bankruptcy, mechanics' lien legislation, and principles governing mortgages providing for future advances, as well as other legislation and common-law concepts. See, e.g., §§ 2.1, 2.2, 2.3, and 7.7.

It is a fundamental principle of mortgage law that a valid judicial foreclosure of a senior mortgage terminates not only the owner's title and equitable redemption rights, but also all other junior interests whose holders were made parties defendant. A power of sale (nonjudicial) foreclosure that complies with applicable statutory notice and related requirements accomplishes the same result. Thus, a purchaser at a foreclosure sale not only acquires the previous owner's interests in the real estate, but a title free and clear of all other properly joined interests that were junior to the foreclosed lien. See Illustrations 1–4. Only in the rare instance where the mortgagor is the foreclosure purchaser do fairness and policy considerations dictate a departure from the foregoing principle. See § 4.9. It is equally axiomatic that the title deriving from a foreclosure sale, whether judicial or by power of sale, will be subject to all mortgages and other interests that are senior to the mortgage being foreclosed. See Illustrations 4–8. Therefore, in calculating an appropriate foreclosure bid a prospective purchaser should subtract any senior liens from the fair market value of the real estate. In this connection, a foreclosing junior lienor may make the holders of senior liens parties to a judicial foreclosure action for the limited purpose of determining the amount of those liens. Similarly, in the power of sale foreclosure context, a foreclosing junior mortgagee is entitled to ascertain that information by means of a judicial proceeding. See § 1.6. The foregoing principles serve the purpose of putting the foreclosure purchaser into the shoes of the mortgagor at the time the mortgage being foreclosed was executed.

As the foregoing emphasizes, when a valid foreclosure takes place, the mortgagor's equitable redemption right (the equity of redemption) is destroyed. However, a significant number of states, by a variety of legislative methods, recognize a concept called *statutory redemption*. This type of legislation permits the mortgagor or the latter's successor in interest and, in some instances, junior lienors to redeem after a foreclosure sale for various periods, as short as a few months in some states and as long as a year or more in others. Because this statutory redemption right ripens only *after* there has been a valid foreclosure, it is not terminated by the foreclosure process, unlike its equitable counterpart.

Illustrations:

1. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor later defaults in payment on the obligation secured by the mortgage to Mortgagee–1. Mortgagee–1 validly accelerates that obligation and forecloses its mortgage, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of the interests of Mortgagor and Mortgagee–2.

2. The facts are the same as Illustration 1, except that Mortgagor does not give a mortgage to Mortgagee–2. Instead, J obtains a judgment against Mortgagor which becomes a lien on Blackacre after Mortgagee–1's mortgage is recorded. The foreclosure sale purchaser owns Blackacre free and clear of the interests of Mortgagor and J.

3. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then delivers a deed to E, granting E a roadway easement over Blackacre. The easement deed is immediately recorded. Mortgagor later defaults in payment on the obligation secured by the mortgage to Mortgagee–1. Mortgagee–1 validly accelerates that obligation and forecloses its mortgage, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of the interests of Mortgagor and E.

4. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor, as lessor, and Lessee then execute a five-year written lease on Blackacre. The lease is immediately recorded. Mortgagor later defaults in payment on the obligation secured by the mortgage to Mortgagee–1. Mortgagee–1 validly accelerates that obligation and forecloses its mortgage, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of the interests of Mortgagor and Lessee.

5. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor later defaults in payment on the obligation secured by the mortgage to Mortgagee–2. Mortgagee–2 validly accelerates that obligation and forecloses its mortgage, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of Mortgagor's interest, but subject to Mortgagee–1's mortgage.

6. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then delivers a deed te E granting E a roadway easement over Blackacre. The easement deed is immediately recorded. Mortga-

gor then borrows money from Mortgagee-2 and gives Mortgagee-2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor later defaults in payment on the obligation secured by the mortgage to Mortgagee-2. Mortgagee-2 validly accelerates that obligation and forecloses its mortgage, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of Mortgagor's interest, but subject to Mortgagee-1's mortgage and E's easement.

7. The facts are the same as Illustration 6, except that instead of giving E an easement on Blackacre, Mortgagor delivers Lessee a five-year written lease on Blackacre. The lease is promptly recorded. The foreclosure sale purchaser owns Blackacre free and clear of Mortgagor's interest, but subject to Mortgagee-1's mortgage and Lessee's lease.

8. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee-2 and gives Mortgagee-2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then delivers Lessee a five-year written lease on Blackacre which lease is promptly recorded. Thereafter Mortgagor delivers a deed to E granting E a roadway easement over Blackacre. The easement deed is promptly recorded. Mortgagor defaults on the obligation secured by the mortgage to Mortgagee-2. Mortgagee-2 validly accelerates the obligation and forecloses on Blackacre, properly joining or notifying all subordinate parties. The foreclosure sale purchaser owns Blackacre free and clear of the interests of Mortgagor, Lessee, and E, but subject to Mortgagee-1's mortgage.

b. Omitted parties in a judicial foreclosure. In a foreclosure by judicial action the foreclosing mortgagee normally makes the mortgagor and all holders of junior interests in the mortgaged real estate parties-defendant. Moreover, junior interests that arise after the commencement of the foreclosure are treated as parties to the action by virtue of the *lis pendens* doctrine. Where the holder of a junior interest is not made a party in the foregoing fashion, that interest is neither terminated nor otherwise prejudiced by the foreclosure.

Where the omitted party is the mortgagor or any other person who is "primarily responsible" for the mortgage obligation (see § 6.4, Comment *a*), that person's equitable redemption right is the same as before the foreclosure and the purchaser at the foreclosure sale succeeds to the rights of the foreclosing mortgagee. The omitted party may therefore exercise that equitable redemption right by payment or tender of the mortgage obligation to the foreclosure purchaser. When such redemption occurs, the mortgage is extinguished. See § 6.4 and Comment *a*. This action redeems the land from the mortgage and the foreclosure purchaser has no further rights with respect to the land.

Where the omitted party is a junior lienor, however, that person has two principal remedies: foreclosure and redemption. First, the junior may foreclose its lien, with a resulting judicial sale. Such a sale will be subject to the previously foreclosed senior mortgage which is revived for this purpose. The sale under the junior lien will convey the original mortgagor's interest to the purchaser at the second sale. The original mortgagee's interest (revived for this purpose) remains in the purchaser at the earlier sale. The amount of the revived original mortgage is the balance that was owing on it at the time of the first foreclosure sale.

The second remedy available to the omitted junior lienor is redemption. The junior may tender to the senior foreclosure purchaser the obligation that was owed on the senior mortgage at the time of its foreclosure. In doing so, the junior lienor thus becomes the holder of two liens, a "revived" senior and a junior and he or she may foreclose either of them. Note that because redemption by a junior lienor is not by a person who is "primarily responsible" on the mortgage obligation (see § 6.4, Comment *g*), the senior mortgage is not extinguished, but rather "assigned" to the junior and the latter becomes subrogated to it.

Ultimately, however, the senior foreclosure purchaser has superior rights vis-à-vis the omitted junior lienor. First, the purchaser, as an assignee of the senior mortgage, may re-foreclose it, only this time making sure that the junior lienor is made a party-defendant. The proceeds of this sale will be used to satisfy both liens in order of their priority, with any additional surplus going to the re-foreclosing party.

In addition, the senior foreclosure purchaser may simply pay off the junior lien and clear it from his or her title. This is because the senior foreclosure purchaser succeeds not only to the rights of the foreclosing mortgagee, but to the rights of the foreclosed mortgagor as well. Since the mortgagor would have had the right to satisfy the junior obligation, the senior foreclosure purchaser has the same right. More important, even if the junior lienor asserts the right to redeem the senior obligation, the redemption by the senior foreclosure purchaser will have priority simply because he or she stands in the shoes of the foreclosed mortgagor. Consequently, redemption by an omitted junior is always an act that the senior sale purchaser has the power to nullify.

Finally, the senior foreclosure purchaser in certain limited circumstances may be entitled to strict foreclosure against the omitted junior lienor. Under this remedy, the omitted junior may be compelled to redeem the senior mortgage obligation from the senior foreclosure purchaser or be barred from any further claim against the foreclosed real estate. Because strict foreclosure deprives the omitted junior of the right to participate in a public foreclosure sale and to receive any potential surplus from it, there is a presumption against this remedy. Thus, strict foreclosure should be available only where the senior purchaser can establish that the omission was the result of inadvertence or mistake and that the fair market value of the mortgaged real estate does not exceed the amount of encumbrances senior to the junior lien.

This Restatement does not deal with the rights of junior interests who are not properly notified where the foreclosure is by power of sale.

REPORTERS' NOTE

Valid foreclosure terminates junior interests, Comment a. For a consideration of the priority rules governing mortgages and other interests in real estate under the recording acts, see R. Cunningham, W. Stoebuck and D. Whitman, Property §§ 11.9–11.11 (2d ed. 1993).

For cases supporting the axiom that a valid foreclosure of a mortgage terminates junior mortgages and other interests subordinate to the mortgage being foreclosed, see, e.g., Sumitomo Bank v. Davis, 6 Cal.Rptr.2d 381 (Cal. App. 1992) (foreclosure sale "removes liens from the property junior to the one being foreclosed"); First Interstate Bank v. Tanktech, Inc., 864 P.2d 116 (Colo.1993) (junior lease terminated by foreclosure of senior deed of trust); Eagle Admixtures, Ltd. v. Hannon, 867 P.2d 111 (Colo.Ct.App.1993) (junior lease extinguished by foreclosure of senior deed of trust); Redding v. Stockton, Whatley, Davin & Co., 488 So.2d 548 (Fla.Dist.Ct.App.1986) (foreclosure of senior mortgage extinguishes junior lease); Western Fertilizer and Cordage Co. v. City of Alliance, 504 N.W.2d 808 (Neb.1993) (junior lien extinguished by foreclosure of senior mortgage); Hembree v. Mid-America Fed. Sav. & Loan Ass'n, 580 N.E.2d 1103 (Ohio.Ct.App.1989) (foreclosure will "cut off the rights in the property of all parties to the action. That includes the mortgagor, the [foreclosing] mortgagee, subsequent holders of title, junior lienholders, and all other claimants whose claims or interests in the property attached subsequent to the mortgage."); ICM Mortgage Corp. v. Jacob, 902 S.W.2d 527 (Tex. Ct. App. 1994) (junior lease terminated by foreclosure of senior deed of trust); Motel Enter., Inc. v. Nobani, 784 S.W.2d 545 (Tex. Ct. App. 1990) (foreclosure under a prior deed of trust terminates a junior easement); Reilly v. Firestone Tire and Rubber Co., 764 F.2d 167 (3d Cir.1985) (junior lease extinguished by senior lien foreclosure); United States v. Roberts, 788 F.Supp. 555 (S.D.Fla.1991) (easement terminated by foreclosure of prior mortgage). It is also clear that just as judicial foreclosure terminates junior interests of persons who are made parties defendants, so too will such interests be terminated by a power of sale foreclosure that satisfies the applicable statutory notice and related requirements. See G. Nelson and D. Whitman, Real Estate Finance Law § 7.19 (3d ed. 1994).

For cases supporting the undisputed rule that a purchaser at the foreclosure sale of a junior mortgage takes title subject to all senior encumbrances and interests, see, e.g., R-Ranch Markets #2, Inc. v. Old Stone Bank, 21 Cal.Rptr.2d 21 (Cal. Ct.App.1993) (senior lease not extinguished by foreclosure of junior deed of trust); Sumitomo Bank v. Davis, 6 Cal.Rptr.2d 381 (Cal. Ct. App. 1992) (foreclosure of junior lien does not affect senior liens); Heritage Fed. Credit Union v. Giampa, 622 N.E.2d 48 (Ill. App. Ct. 1993) (foreclosure of a junior mortgage does not cut off senior mortgage). See 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 1.1, 7.2, 7.12, 7.14 (3d ed. 1993).

For authority supporting the right of junior lienor who is foreclosing judicially to make senior lienors parties to the action for the limited purpose of ascertaining the amount of the senior liens, see Missouri, K. & T. Trust Co. v. Richardson, 78 N.W. 273 (Neb. 1899); Foster v. Trowbridge, 46 N.W. 350 (Minn.1890); 1 G. Nelson & D. Whitman, Real Estate Finance Law 590–591 (3d ed. 1993). See § 1.6(b)(3). A similar right to determine the amount of senior liens exists for a junior mortgagee foreclosing by power of sale. See § 1.6(b)(3).

For the proposition that the purpose of foreclosure is to give the foreclosure purchaser the same title that mortgagor had when the foreclosed mortgage was executed, see, e.g., Sumitomo Bank v. Davis, 6 Cal. Rptr.2d 381 (Cal. Ct. App. 1992) ("What is sold by judicial foreclosure is the property owner's interest in the property at the time of the mortgage or deed of trust being foreclosed."); Dover Mobile Estates v. Fiber Form Prod., Inc., 270 Cal.Rptr. 183 (Cal. Ct. App. 1990) ("Title conveyed by a trustee's deed relates back to the date when the deed of trust was executed. The trustee's deed therefore passes title held by the trustor at the time of execution."); Scharaga v. Schwartzberg, 540 N.Y.S.2d 451 (N.Y.App.Div.1989) ("[T]he purpose of a foreclosure sale is to end the right to redeem of all persons having interests in the property subject to the mortgage and to vest in the purchaser upon the sale 'the title to the property as it stood at the time of the execution of the mortgage.'"); Motel Enter., Inc. v. Nobani, 784 S.W.2d 545 (Tex. Ct. App. 1990) (deed of trust foreclosure "has the effect of passing all right, title, and interest that the mortgagor held at the time the deed of trust was executed, free and clear of the rights of any subsequent purchaser"). This purpose of foreclosure has been explained as follows:

> Two ... purposes [of foreclosure] are often articulated. First, it is said that foreclosure should, if successful, terminate the rights of all interested parties who have a right to redeem from or are 'subject to'

the mortgage being foreclosed. To state this proposition however is to beg the question 'why'? The answer is found in the more fundamental and descriptive purpose of foreclosure, which is to give the foreclosure sale purchaser essentially the same title to the land as that possessed by the mortgagor when the foreclosed mortgage was executed.

1 G. Nelson & D. Whitman, Real Estate Finance Law 582 (3d ed. 1993). See also San Francisco v. Lawton, 18 Cal. 465 (1861); Dye v. Lewis, 324 N.Y.S.2d 172 (N.Y. Sup. 1971); Valentine v. Portland Timber and Land Holding Co., 547 P.2d 912 (Wash.Ct.App.1976).

The difference between the "equity of redemption" or "equitable redemption" and statutory redemption has been described as follows:

> When courts utilize the terminology of the [equity of redemption or equitable redemption], they are referring to the mortgagor's right after default in every jurisdiction ... to perform his obligation under the mortgage and have the title to his property restored free and clear of the mortgage....
>
> Statutory redemption, on the other hand, is, as the name implies, a creature of legislative grace. In about half the states, the mortgagor, his successors in interest and, in many instances, junior lienors are permitted for a specific period after a valid foreclosure sale to redeem 'from the sale' by paying to the foreclosure sale purchaser the foreclosure sale price plus, in some instances, certain additional amounts. It is a helpful oversimplification to look upon 'redemption from the mortgage' in its variety of terminology as a right that exists after default until there has been a valid foreclosure. Statutory redemption rights, on the other hand, ripen only *after* there has been a valid foreclosure.

1 G. Nelson and D. Whitman, Real Estate Finance Law § 7.1 (3d ed. 1993).

Omitted parties in a judicial foreclosure, Comment b. Junior interests that arise after a judicial foreclosure is commenced are typically bound by the foreclosure under the operation of the *lis pendens* doctrine even though they never were made formal parties to the proceeding. See, e.g., Agribank, FCB v. Rodel Farms, Inc., 623 N.E.2d 1016 (Ill. App. Ct. 1993); Land Associates Inc. v. Becker, 656 P.2d 927 (Or.1982); Resolution Trust Corp. v. Warwick Nurseries, Ltd., 675 A.2d 730 (Pa. Super. Ct. 1996).

When the mortgagor or other person who is "primarily responsible" for the mortgage obligation is omitted from a judicial foreclosure action, that person's equitable redemption right is not cut off. Such an omitted party may then redeem the land by paying the amount of the mortgage obligation to the foreclosure sale purchaser. If such a redemption occurs, the mortgage is extinguished and, as a result, any interest of the foreclosure sale purchaser in the land is cut off. See 1 G. Nelson and D. Whitman, Real Estate Law 593 (3d ed. 1993).

For cases supporting the view that an omitted junior lienor may foreclose its mortgage subject to the senior mortgage, which is revived for this purpose, see, e.g., Lenexa State Bank & Trust Co. v. Dixon, 559 P.2d 776 (Kan.1977); Pease Company v. Huntington National Bank, 495 N.E.2d 45 (Ohio.Ct.App.1985); Note, 88 U. Pa. L. Rev. 994 (1940).

The other remedy available to the omitted junior lienor is redemption of the "revived" senior lien. See, e.g., Baldi v. Chicago Title & Trust Co., 446 N.E.2d 1205 (Ill. App. Ct. 1983); United States Department of Housing and Urban Development v. Union Mortgage Co., Inc., 661 A.2d 163 (Me. 1995); Western Bank, Santa Fe v. Fluid Assets Development Corp., 806 P.2d 1048 (N.M.1991); More v. United States, 505 F.Supp. 612 (N.D.Fla. 1980). Note, however, that this right to redeem, while equitable, does not, as in the case of an omitted mortgagor or other party who is primarily responsible for the mortgage, redeem the *land* from the mortgage. Rather, the junior may tender to the foreclosure purchaser the balance which was owed on the senior lien at the time of foreclosure, and by so doing, in effect, compel an assignment of a revived senior lien to the junior lienor. The junior is then the holder of both liens and may foreclose either or both of them. See 1 G. Nelson and D. Whitman, Real Estate Finance Law 595–596 (3d ed. 1993).

Ultimately, however, the rights of the foreclosure sale purchaser, as the successor in interest of both the mortgagor and the foreclosing mortgagee, are superior to those of the omitted junior lienor. Two remedies are clearly available to the foreclosure purchaser: redemption and re-foreclosure. This redemption right is superior to either of junior lienor's remedies:

> If the omitted junior has not taken any further action, it is obvious that the senior sale purchaser may simply pay off the junior lien and thereby clear his title. This is because * * * the senior foreclosure purchaser succeeds not only to the rights of the mortgagee, but to the rights of the foreclosed mortgagor as well. Since the mortgagor would have had the right to pay off the junior lien, the senior foreclosure purchaser will have the same right.

Id. at 597.

> Even if the junior lienor redeems the senior debt from the original sale purchaser, the position of the parties is not really changed significantly. The senior buyer can simply pay off the senior lien in the junior's hands, using the very dollars which the junior paid the buyer when *he* redeemed.

Id. at 597. See, e.g., Portland Mortgage Co. v. Creditors Protective Ass'n, 262 P.2d 918 (Or.1953); Citicorp Mortgage, Inc. v. Pessin, 570 A.2d 481 (N.J. Super. Ct. 1990).

When the foreclosure sale purchaser opts not to redeem the omitted junior lien, the other alternative for the senior sale purchaser is to re-foreclose the first mortgage. This action is taken standing in the shoes of the original mortgagee. See, e.g., Deming National Bank v. Walraven, 651 P.2d 1203 (Ariz.Ct.App.1982); Polster v. General Guaranty Mortgage Co., 180 S.2d 484 (Fla.Ct.App. 1965); United States Department of Housing and Urban Development v. Union Mortgage Co., Inc., 661 A.2d 163 (Me.1995); Western Bank, Santa Fe v. Fluid Assets Development Corp., 806 P.2d 1048 (N.M.1991); Ahern v. Pierce, 653 N.Y.S.2d 620 (N.Y.App.Div.1997); First Federal Savings & Loan Ass'n v. Nath, 839 P.2d 1336 (Okla.1992).

A third potential remedy for the senior foreclosure purchaser is strict foreclosure. There is some authority suggesting that the remedy is automatically available. See Tejedo v. Secretary of Veterans Affairs, 673 So.2d 959 (Fla.Dist.Ct.App.1996). On the other hand, there are also cases suggesting that strict foreclosure simply may not be used in the omitted junior lien setting. See United States Department of Housing and Urban Development v. Union Mortgage Co., 661 A.2d 163 (Me.1995). Other cases follow a flexible rule that, in general, requires that the omission be through inadvertence or mistake untinged by bad faith. See, e.g., Citicorp Mortgage, Inc. v. Pessin, 570 A.2d 481 (N.J. Super. 1990) (strict foreclosure granted to mortgagee-purchaser who bought without actual knowledge of the junior lienor and where no fault was found on the part of the junior lienor); Sears, Roebuck & Co. v. Camp, 1 A.2d 425 (N.J. 1938). Yet other decisions focus on whether the fair market value of the foreclosed real estate exceeds the amount of encumbrances senior to the omitted junior. See, e.g., Mesiavech v. Newman, 184 A. 538 (N.J. 1936); Miles v. Stehle, 36 N.W. 142 (Neb.1888). Comment *b* adopts a position that combines the latter two approaches in that it focuses both on whether the foreclosing mortgagee or sale purchaser were actually aware of the junior's existence prior to the sale and on whether the real estate is worth enough to justify a second sale.

For further consideration of the omitted party problem in the judicial foreclosure setting, see Platt, The Dracula Mortgage: Creature of the Omitted Lienholder, 67 Or. L. Rev. 287 (1988); Bowmar, Mortgage Foreclosure In New York: Omitted Lienors, 22 Real Prop. Prob. & Trust J. 509 (1987); Note, Rights of Junior Lienholders in Wisconsin, 43 Marq. L. Rev. 89 (1959).

Where the foreclosure is by power of sale and a junior interest holder is not properly notified, the rights of the parties are not as clear-cut as in the judicial foreclosure context. Logically, the rights of a power of sale foreclosure purchaser in such a setting should rise no higher than those of a purchaser at a judicial foreclosure sale where there is an omitted party. Indeed, in a few states statutes mandate that improperly notified power of sale junior interests be treated like their judicial foreclosure counterparts. See, e.g., West's Rev. Code Wash. Ann. § 61.24.040(7) ("these recitals [that the foreclosure complied with legal requirements] shall not affect the lien or interest of any person entitled to notice under RCW 61.24.040(1), if the trustee fails to give the required notice to such person. In such case, the lien or interest of such omitted person shall be treated as if such person was the holder of the same lien or interest and was omitted as a party defendant in a judicial foreclosure proceeding"). However, in other states, the situation is complicated by the presence of presumption statutes that are aimed at enhancing the finality of power of sale foreclosure and the marketability of titles it produces. See, e.g., West's Ann. Cal. Civ. Code § 2924; West's Colo. Rev. Stat. Ann. § 38-39-115; Rev. Code Mont. § 52-410; Nev. Rev. Code Ann. § 107.030(8); Utah Code Ann. § 57-1-28. Some courts have suggested that such legislation may insulate a bona fide purchaser from the claims of a junior interest who was not properly notified, a result that clearly is inconsistent with the rights of omitted interests in the judicial foreclosure setting.

> [A foreclosure] is void where there is a notice defect and no conclusive presumption.... A sale is void where there is a notice defect and conclusive presumption language and recitals in the deed which es-

tablishes on its face the irregularity of the sale. This could occur where there were postponements of a sale which show that proper notice could not have been given. A sale is voidable where there is a notice defect and conclusive presumption language and there is no bona fide purchaser for value. Where the evidence establishes that the trustee conveyed title to a bona fide purchaser and the trustee's deed contains the language specified in [the statute], the sale is not voidable.... Any failure to comply with procedural requirements does not affect the validity of sale to a bona fide purchaser for value.

Homestead Savings v. Darmiento, 281 Cal.Rptr. 367, 374 (Cal.Ct.App.1991). See also Glidden v. Municipal Authority of Tacoma, 758 P.2d 487 (Wash. 1988), decided prior to the enactment of West's Rev. Code Wash. Ann. § 61.24.040(7) quoted above (if foreclosure sale purchaser is a bona fide purchaser, presumption statute creates conclusive presumption of correctness of sale even as to a junior lienor who did not receive notice required by power of the sale foreclosure legislation). For further consideration of legislation dealing with presumptions of validity of power of sale foreclosure, see 1 G. Nelson & D. Whitman, Real Estate Finance Law 534–535 (3d ed. 1993).

§ 7.2 Purchase Money Mortgage Priority

(a) A "purchase money mortgage" is a mortgage given to a vendor of the real estate or to a third party lender to the extent that the proceeds of the loan are used to:

(1) acquire title to the real estate; or

(2) construct improvements on the real estate if the mortgage is given as part of the same transaction in which title is acquired.

(b) A purchase money mortgage, whether or not recorded, has priority over any mortgage, lien, or other claim that attaches to the real estate but is created by or arises against the purchaser-mortgagor prior to the purchaser-mortgagor's acquisition of title to the real estate.

(c) A purchase money mortgage given to a vendor of real estate, in the absence of a contrary intent of the parties to it and subject to the operation of the recording acts, has priority over a purchase money mortgage on that real estate given to a person who is not its vendor.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 7.5, Mortgaging After-Acquired Real Estate; § 7.7, Subordination.

Comment:

a. Introductory note. In real estate transactions, it is common for a vendor of real estate to convey title to the purchaser, receive part of the purchase price in cash, and take back a mortgage on the real estate to secure a promissory note for the balance of the purchase price. Such a mortgage is frequently referred to as a "vendor purchase money mortgage." In an alternative and more common form of the transaction, third party institutional financing is used to "cash out" the vendor. In this situation, the vendor receives part of the purchase price in cash from the purchaser and the balance in cash from a third party lender who takes the purchaser's promissory note secured by a mortgage on the purchaser's newly acquired real estate. This type of mortgage is usually termed a "third party purchase money mortgage." Some land transactions utilize both types of purchase money mortgages. This section focuses on the priority accorded purchase money mortgages of either type over other liens or claims arising through the purchaser that antedate the purchase money transaction, and also on the priority relationship between the two types of purchase money mortgages.

b. Purchase money mortgage priority over other liens or claims arising against the purchaser-mortgagor. Under this section the vendor's purchase money mortgage is senior to any previous judgment liens that arise against the purchaser-mortgagor. This is true even though a judgment attaches as a lien to the judgment debtor's after-acquired real estate and the vendor takes the mortgage with actual knowledge of the judgment. See Illustration 1. This rule applies even if the mortgage is not executed simultaneously with the deed to the mortgagor, so long as the mortgage and the conveyance of title are intended to be part of one transaction. See Illustration 2. Moreover, although the purchase money mortgage must be recorded in order to protect the mortgagee against *subsequent* interests that arise through the purchaser-mortgagor, such recording is unnecessary to protect against claims against mortgagor that antedate the purchase money mortgage.

Because this long-established rule makes it unnecessary for a purchase money lender to examine for preexisting judgments and other liens against the purchaser-mortgagor, it reduces title risk in connection with such transactions and thus encourages purchase money financing by vendors. Moreover, the rule is justified on grounds of fundamental fairness. The vendor-mortgagee should prevail because the lien creditor has not extended credit or perfected the lien in reliance on the right to be repaid out of any specific property, much less out of the real estate previously owned by the vendor. This is obvious, since the judgment was obtained before the debtor acquired the real estate to which the judgment lien attached. This principle is not limited to judgment lienors; those whose claims are based on mortgages of after-acquired property, community property, or similar rights should fare no better against the vendor. See Illustrations 3–4. But for the willingness of the vendor to part with the real estate, it would have been completely unavailable to those persons for the satisfaction of their claims. To give such claimants priority over the vendor would confer on them a pure windfall.

This section extends the same priority preference to third party purchase money lenders. See Illustrations 5–7. The policy reasons for this result are much the same and are equally as strong as in the vendor context. Because third party lending is the dominant source of purchase money land financing in this country, a rule which facilitates such lending is especially beneficial to the national real estate economy. Applying the rule to benefit third party lenders is plainly fair. While it is true that such lenders, unlike vendors, do not give up ownership of specific real estate, they nevertheless part with money with the expectation that they will have security in that real estate. Without this advance of money, the purchaser-mortgagor would never have received the property and the other claimants would never have had the opportunity to satisfy their claims from such a convenient source. As in the vendor purchase money context, this section seeks to avoid conferring a windfall on those claimants.

The following Illustrations sometimes refer to a creditor's "obtaining a judgment lien." In some states simply "docketing" a judgment is sufficient to create a lien on the debtor's real estate located in the county of docketing. In other states, the docketing alone does not create a lien. Rather, for the judgment to become a lien, either the judgment itself or an abstract of it must be recorded in the county real estate records where the debtor's land is located. Where the term "obtains a judgment lien" is used in the Illustrations, it is assumed that the creditor has taken sufficient steps under local law to create a lien on the debtor's real estate.

The purchase money mortgagee need not record its mortgage in order to be protected against mortgages, liens, or other claims attaching to the real estate that arise against the purchaser-mortgagor prior to the latter's acquisition of title. Nevertheless, recording is necessary in order to protect the purchase money mortgagee against liens or other interests that arise against the purchaser-mortgagor *subsequently* to the latter's acquisition of title. See Illustration 8.

Illustrations:

1. On February 1, J obtains a judgment lien for $15,000 against R. On March 1, V, the owner of Blackacre, and R enter into a contract for the sale of Blackacre to R. The contract provides for a purchase price of $50,000. R agrees to pay $10,000 in cash at the settlement date and V agrees to take back a

promissory note and mortgage on Blackacre for the balance of the price. On April 1, the date of settlement, V conveys Blackacre to R and R pays $10,000 in cash to V. Several days later, R delivers to V a promissory note for $40,000 secured by a mortgage on Blackacre. At the time V takes the mortgage, V has actual knowledge of J's judgment. V's mortgage is never recorded. V's $40,000 mortgage on Blackacre is senior to J's judgment lien.

2. The facts are the same as Illustration 1, except that R delivers the $40,000 promissory note and mortgage to V several weeks after the settlement date. A court is warranted in finding that the sale of Blackacre and the giving of the mortgage to V are part of one transaction. Upon such a finding, V's $40,000 purchase money mortgage on Blackacre is senior to J's judgment lien.

3. R gives E a mortgage on Blackacre containing an after-acquired property clause that provides, "The lien of this mortgage is effective against any real estate, wherever situated, hereafter acquired by Mortgagor so long as the obligation secured hereby remains unsatisfied." Several months later R purchases title to Whiteacre by paying part of the purchase price in cash and the remainder by giving a mortgage on Whiteacre to V, the seller. V has actual knowledge of E's mortgage on Blackacre and its after-acquired property clause. V's mortgage is never recorded. V's mortgage on Whiteacre is senior to E's lien on Whiteacre arising under the after-acquired property clause contained in the mortgage on Blackacre.

4. On March 1, V, the owner of Blackacre, and R, a married person, enter into an earnest money contract for the sale of Blackacre to R. Blackacre is located in a state recognizing community property. The contract provides for a purchase price of $50,000. R agrees to pay $10,000 in cash at the closing date and V agrees to take back a promissory note and mortgage on Blackacre for the balance of the purchase price. On April 1, the date of settlement, V conveys Blackacre to R and R pays V $10,000 in cash. The latter amount is withdrawn by R from a community property bank account R maintains with S, R's spouse. Three days later, R delivers to V a promissory note for $40,000 secured by a mortgage on Blackacre. S signs neither the promissory note nor mortgage. V's mortgage is never recorded. V's mortgage is senior to any community property interest S may claim in Blackacre.

5. The facts are the same as Illustration 1, except that R borrows $40,000 from Bank and gives Bank, rather than V, a promissory note and mortgage on Blackacre to finance the bal-

ance of the purchase price. At the time Bank takes its mortgage, it has actual knowledge of J's judgment. Bank never records its mortgage. Bank's purchase money mortgage on Blackacre is senior to J's judgment lien.

6. The facts are the same as Illustration 3, except that the remainder of the purchase price for Whiteacre is financed by giving a mortgage on Whiteacre to Bank, rather than to V. Bank has actual knowledge of E's mortgage on Blackacre and its after-acquired property clause. Bank's purchase money mortgage on Whiteacre is senior to E's lien on Whiteacre arising under the after-acquired property clause contained in the mortgage on Blackacre.

7. The facts are the same as Illustration 4, except that R borrows $40,000 from Bank and gives Bank, rather than V, a promissory note and mortgage on Blackacre to finance the balance of the purchase price. Bank's purchase money mortgage is senior to any community property interest S may claim in Blackacre.

8. The facts are the same as Illustration 1, except that two months after V takes its mortgage, purchaser-mortgagor borrows $10,000 from Bank and gives the latter a promissory note for that amount secured by a mortgage on Blackacre. Bank takes its mortgage without notice of V's unrecorded mortgage and immediately records its mortgage. V's $40,000 mortgage is senior to J's judgment lien and junior to Bank's mortgage.

c. Qualifying for purchase money mortgage status. This section defines "purchase money mortgage" broadly. A mortgage qualifies for this status to the extent that its proceeds are used to acquire title to the mortgaged real estate. Thus, where the proceeds are used in their entirety to acquire Blackacre, the full amount of the mortgage loan will qualify as a purchase money mortgage. See Illustration 9. On the other hand, to the extent that all or a part of the proceeds are used by the mortgagor for other purposes, the mortgage will not be treated as a purchase money mortgage. See Illustration 10.

Many construction mortgages also qualify for purchase money mortgage status. This is clearly the case where the loan proceeds are used in part to acquire title to the mortgaged real estate and in part to construct improvements on it. In such a situation, the entire amount of the loan will be classified as a purchase money mortgage. See Illustration 11. Even where the proceeds of the loan are used exclusively for improving the mortgaged real estate, the mortgage will receive purchase money treatment so long as it is given as part of the same transaction in which title to the real estate is acquired. In order to satisfy the foregoing requirement, the mortgagor must commence negotiations with the construction lender prior to mortgagor's acquisition of title, and the actual loan must be made incident to the mortgagor's acquisition of title or within a reasonable time thereafter. See Illustrations 12–14.

Illustrations:

9. J obtains a judgment lien against R. Thereafter V conveys Blackacre to R for $50,000. R pays $10,000 of the purchase price from R's own funds and obtains the balance by giving Bank a promissory note for $40,000 secured by a mortgage on Blackacre. Bank's $40,000 mortgage on Blackacre is wholly a purchase money mortgage, and is senior to J's judgment lien to the extent of its full $40,000 balance.

10. J obtains a judgment lien against R. Thereafter V conveys Blackacre to R for a $50,000 price. R pays $20,000 of the purchase price from R's own funds, and obtains the balance of the price as part of a larger loan transaction that R consummates with Bank. Under the latter agreement, Bank lends R $40,000 in return for which R gives Bank a $40,000 promissory note secured by a mortgage on Blackacre. $30,000 of the loan proceeds are used to pay the balance of the purchase price for Blackacre and the remainder is used to pay R's general personal expenses. Bank's mortgage qualifies for purchase money protection to the extent of $30,000, but not to the extent of the remaining $10,000. Thus, Bank's mortgage is senior to J's judgment lien to the extent of $30,000 and junior to it to the extent of $10,000.

11. J obtains a judgment lien against R. Thereafter Bank agrees to lend $150,000 to R to be used to acquire title to Blackacre, a vacant lot, from V and to construct a house on it. Upon V's conveyance of Blackacre to R, R executes and delivers to Bank a promissory note for $150,000 secured by a mortgage on Blackacre. $25,000 of the loan proceeds is paid to V upon the latter's conveyance of Blackacre to R, and the remaining $125,000 is used to construct a house on Blackacre. Bank's mortgage is senior to J's judgment lien to the extent of the entire $150,000 advanced by Bank.

12. J obtains a judgment lien against R. Thereafter, R enters into a contract to purchase Blackacre, a vacant lot, from V for $25,000 cash. Prior to the settlement of the purchase, R contacts Bank and applies for a construction loan to build a house on Blackacre. V thereafter conveys Blackacre to R and R pays V the $25,000 purchase price in cash from R's own funds. A few days

after the conveyance, Bank agrees to make a $100,000 loan to R to construct a house on Blackacre. A week thereafter, R delivers to Bank a promissory note for $100,000 secured by a mortgage on Blackacre. Over the next several months, all of the $100,000 is used for the construction of the house on Blackacre. Bank's mortgage is senior to J's judgment lien to the extent of the entire $100,000 advanced by Bank.

13. The facts are the same as Illustration 12, except that R does not deliver the promissory note and mortgage to Bank until several months after R takes title to Blackacre. A court is warranted in finding that R's acquisition of title and the giving of the mortgage to Bank were not part of the same transaction. Upon such a finding, Bank's mortgage is junior to J's judgment lien.

14. J obtains a judgment lien against R. Thereafter, pursuant to an agreement between V and R, V conveys Blackacre, a vacant lot, to R for $25,000 cash, the latter amount coming from R's own funds. One month later, R contacts Bank for the first time about a construction loan. Bank immediately agrees to a loan and R then delivers to Bank a $100,000 promissory note secured by a mortgage on Blackacre. Over the next several months, all of the $100,000 is used for the construction of the house on Blackacre. Bank's $100,000 mortgage is junior to J's judgment lien.

d. The preference for vendor purchase money mortgages over third party purchase money mortgages. It is common, especially in residential transactions, for purchase money mortgages to be given both to the vendor and to a third party lender, such as a bank or other institution. As between a purchase money mortgage to a third party lender and one to a vendor, if both lenders have notice of the other's mortgage, the vendor's mortgage will be superior to its third party counterpart. This result follows from the rule of § 7.2(c). The recording acts do not vary this result, since in the great majority of states they award priority only to a subsequent purchaser *without notice*, and here each mortgagee has notice of the other. See Illustration 15.

So too will the vendor prevail under the rule of § 7.2(c) where each lender lacks notice of the other's mortgage. See Illustration 16. Here again, the recording acts do not vary this result, since they operate to award priority only to a *subsequent* purchaser without notice, and here neither mortgagee can meaningfully be said to be subsequent to the other, since both mortgages arise from the same transaction.

However, where only one of the parties has notice of the other, the recording acts, rather than the principle of § 7.2(c), should govern and should award priority to the party lacking notice. Even though delivery of the mortgages is essentially simultaneous, the party lacking notice must in fairness be treated as the subsequent taker and thus eligible for the protection of the recording acts. Thus, in a jurisdiction having a notice type recording act, the lender who takes its mortgage without notice of the other's mortgage prevails. See Illustrations 17–18. In a race-notice type jurisdiction, the lender who takes without notice must also record first in order to prevail.

The preference for vendor purchase money mortgagees is arguably counterintuitive, at least from an economic perspective. After all, both the third party lender and the vendor make the sale transaction possible, and both rely upon the security of the same specific property for payment. Moreover, third party purchase money mortgagees, especially in residential transactions, often invest a substantially greater economic stake in the mortgaged property than that retained by the vendor.

Nevertheless, the equities favor the vendor. Not only does the vendor part with specific real estate rather than money, but the vendor would never relinquish it at all except on the understanding that the vendor will be able to use it to satisfy the obligation to pay the price. This is the case even though the vendor may know that the mortgagor is going to finance the transaction in part by borrowing from a third party and giving a mortgage to secure that obligation. In the final analysis, the law is more sympathetic to the vendor's hazard of losing real estate previously owned than to the third party lender's risk of being unable to collect from an interest in real estate that never previously belonged to it.

The priority principle of this subsection is subject to modification by agreement of the parties. For example, many institutional lenders either desire or are required by law to hold first mortgages. As against a vendor's purchase money mortgage, a third party institutional lender can accomplish this by requiring that the vendor's mortgage include terms specifically referring to the third party lender's mortgage and declaring its subordination to it. See Illustration 19; § 7.7, infra. Because the vendor usually has a strong incentive to sell the real estate, such subordination terms will normally be easily obtained. Alternatively, a declaration of subordination may be placed in the vendor's deed to the mortgagor. Similarly, a reference in the purchase agreement to vendor's taking back a "second mortgage" will suffice to give priority to third party lender's mortgage. See Illustration 20. Subordination by the vendor to a third party mortgagee may sometimes be found by virtue of the fact that the latter's mortgage was recorded prior to the former's, if the evidence indicates that the particular order of recording was consciously used as a means of establishing priority. Under such circumstances it may be appropriate for a court to treat the order of recording as evidence of the parties' intent and to adopt the priority thus indicated. See § 7.7, Comment *a*.

Illustrations:

15. R enters into a contract to purchase Blackacre from V for $100,000. The contract provides for R to pay $10,000 in cash at the closing, for V to take back a mortgage for $10,000 from R, and for the balance of $80,000 to be provided through third party financing. The contract does not specify the priority of the vendor mortgage as against the third party mortgage. When R applies for a loan from Bank, R discloses that part of the purchase price is to be financed by a loan from V. Thus, both mortgagees have notice of one another's mortgages. At the closing, V conveys Blackacre to R. Bank delivers $80,000 in cash to V, takes back a promissory note and mortgage on Blackacre for that amount from R, and immediately records the mortgage. Two days later R delivers a $10,000 promissory note and mortgage to V. The latter mortgage makes no reference to Bank's mortgage. V promptly records the mortgage. V's mortgage is senior to Bank's mortgage.

16. The facts are the same as Illustration 15, except that the contract makes no reference to third party financing and provides that R is to pay V $90,000 in cash at the closing. Moreover, R represents to V that the $90,000 is to come from R's personal assets and V has no other knowledge of Bank's mortgage. In addition, R does not provide Bank with a copy of the purchase contract and does not disclose to Bank that V will take back a mortgage. Rather, R represents to Bank that the portion of the purchase price in excess of the Bank's loan will come from R's personal funds. Thus, neither mortgagee has notice of the other's mortgage. V's mortgage is senior to Bank's mortgage.

17. The facts are the same as Illustration 15, except that the contract provides that $20,000 of the purchase price will come from R's personal funds and makes no reference to vendor financing. Moreover, Bank takes delivery of its mortgage without acquiring notice of V's mortgage. Bank's mortgage is senior to V's mortgage.

18. The facts are the same as Illustration 15, except that the contract provides for R to provide $90,000 of the purchase price from R's personal funds and makes no reference to third party financing. Moreover, V takes delivery of V's mortgage without

acquiring notice of Bank's mortgage. V's mortgage is senior to Bank's mortgage.

19. The facts are the same as Illustration 15, except that the V's deed to R contains the following language: "V's mortgage is to be subordinate to an $80,000 mortgage on this property in favor of Bank." V's mortgage is junior to Bank's mortgage.

20. The facts are the same as Illustration 15, except that the purchase agreement between V and R states that "V agrees to take back a second mortgage on Blackacre for $10,000 at the date of settlement." V's mortgage is junior to Bank's mortgage.

REPORTERS' NOTE

Introductory note, Comment a. For a general consideration of purchase money land financing see 3 Glenn, Mortgages §§ 343–349 (1943); 1 G. Nelson and D. Whitman, Real Estate Finance Law §§ 9.1–9.2 (3d ed. 1993).

Purchase money priority over other liens or claims arising against the purchaser-mortgagor, Comment b. There is widespread support for the proposition that a mortgage given to a vendor or third party to finance all or any part of the purchase price of land is senior to any other lien or claim attaching to the land through the purchaser-mortgagor. See, e.g., Belland v. O.K. Lumber, Inc., 797 P.2d 638 (Alaska 1990); Sunshine Bank of Fort Walton Beach v. Smith, 631 So.2d 965 (Ala. 1994); Garrett Tire Center, Inc. v. Herbaugh, 740 S.W.2d 612 (Ark.1987); Mercantile Collection Bureau v. Roach, 15 Cal. Rptr. 710 (Cal.Ct.App.1961); County of Pinellas v. Clearwater Fed. Sav. & Loan Ass'n, 214 So.2d 525 (Fla.Dist. Ct.App.1968); Associates Discount Corp. v. Gomes, 338 So.2d 552 (Fla. Dist.Ct.App.1976); Aetna Casualty & Sur. Co. v. Valdosta Fed. Sav. & Loan Ass'n, 333 S.E.2d 849 (Ga.Ct. App.1985); Liberty Parts Warehouse, Inc. v. Marshall County Bank, 459 N.E.2d 738 (Ind.Ct.App.1984); Midland Savings Bank FSB v. Stewart Group, 533 N.W.2d 191 (Iowa 1995); Resolution Trust Corp. v. Bopp, 850 P.2d 939 (Kan.Ct.App.1993); Hill v. Hill, 345 P.2d 1015 (Kan.1959); Libby v. Brooks, 653 A.2d 422 (Me.1995); Stewart v. Smith, 30 N.W. 430 (Minn. 1886); Commerce Sav. Lincoln, Inc. v. Robinson, 331 N.W.2d 495 (Neb. 1983); Fleet Mortgage Corp. v. Stevenson, 575 A.2d 63 (N.J. Super. Ct. 1990); Slate v. Marion, 408 S.E.2d 189 (N.C. Ct. App. 1991), review denied, 412 S.E.2d 75 (N.C. 1991); Giragosian v. Clement, 604 N.Y.S.2d 983 (N.Y.App.Div.1993); Hursey v. Hursey, 326 S.E.2d 178 (S.C.App. 1985); United States v. Dailey, 749 F.Supp. 218 (D.Ariz.1990); Royal Bank of Canada v. Clarke, 373 F.Supp. 599 (D.Virgin Islands 1974).

In some states purchase money mortgage priority is recognized by statute. See, e.g., West's Ann. Cal. Civ. Code § 2928; 42 Pa. Stat. § 814(1). Most cases apply such statutes to third party as well as vendor purchase money mortgages. See Mercantile Collection Bureau v. Roach, 15 Cal.Rptr. 710 (Cal.Ct.App.1961); Home Owners' Loan Corp. v. Humphrey, 85 P.2d 7 (Kan.1938); Kneen v. Halin, 59 P. 14 (Idaho 1899); Hopler v. Cutler, 34 A. 746 (N.J.Ch.1896). Contra: Heuisler v. Nickum, 38 Md. 270 (1873); Stansell v. Roberts, 13 Ohio 148 (1844).

The purchase money mortgage also is superior to liens attaching through after-acquired property clauses contained in previously executed mortgages by mortgagor on other real estate. See Associates Discount Corp. v. Gomes, 338 So.2d 552 (Fla.Dist.Ct. App.1976) (dictum); Pinellas v. Clearwater Fed. Savings & Loan Association, 214 So.2d 525 (Fla.Dist.Ct.App. 1968) (dictum); Faulkner County Bank & Trust Co. v. Vail, 293 S.W. 40 (Ark.1927); Chase Nat'l Bank v. Sweezy, 281 N.Y.S. 487 (1931), aff'd, 185 N.E. 803 (N.Y.1933). Contra, Hickson Lumber Co. v. Gay Lumber Co., 63 S.E. 1048 (N.C.1909). See also Libby v. Brooks, 653 A.2d 422 (Me. 1995) (vendor purchase money mortgage has priority over a mortgage created by the equitable doctrine of estoppel by after-acquired property).

The purchase money priority rule has not only been applied against simple judgment liens, it has also been victorious over liens representing arguably stronger public policy concerns. See, e.g., Pinellas v. Clearwater Fed. Sav. & Loan Ass'n, 214 So.2d 525 (Fla.Dist.Ct.App.1968) (state welfare lien); Fleet Mortgage Corp. v. Stevenson, 575 A.2d 63 (N.J. Super. Ct. 1990) (state medical assistance lien); Midland Savings Bank FSB v. Stewart Group, 533 N.W.2d 191 (Iowa 1995) (mechanic's lien); Gaston Grading & Landscaping v. Young, 449 S.E.2d 475 (N.C.Ct.App. 1994) (mechanic's lien). However, because mechanics' liens are heavily regulated by statute, generalizations as to their priority vis-à-vis purchase money mortgages are difficult. See generally Annot., Priority as Between Mechanic's Lien and Purchase-Money Mortgage, 73 A.L.R.2d 1407, 1413 (1960).

Moreover, federal legislation gives the purchase money mortgagee priority over previously filed tax liens against the mortgagor. See 26 U.S.C.A. § 6323(c); Slodov v. United States, 436 U.S. 238, 257–58 & n.23, 98 S.Ct. 1778, 1790–91, 56 L.Ed.2d 251 (1978):

> [A] federal tax lien is subordinate to a purchase-money mortgagee's interest notwithstanding that the agreement is made and the security interest arises after notice of the tax lien. The purchase-money mortgage priority is based upon recognition that the mortgagee's interest merely reflects his contribution of property to the taxpayer's estate and therefore does not prejudice creditors who are prior in time.

The purchase money mortgagee also prevails over a vendor's lien. Thus, suppose a seller of real estate takes a promissory note from the purchaser for part of the purchase price, but fails to take a mortgage to secure it. As part of the same transaction, purchaser

> gives a purchase money mortgage to a third party to finance another significant part of the purchase price. Because the vendor did not take a mortgage, he or she cannot take advantage of the purchase money mortgagee status, but rather has only an equitable vendor's lien on the real estate. Consequently, the purchase money doctrine will be applied to give the purchase money mortgagee priority over the vendor even though the mortgagee

took with knowledge of the vendor's lien.

1 G. Nelson & D. Whitman, Real Estate Finance Law 802–803 (3d ed. 1993). See Brock v. First South Sav. Ass'n in Receivership, 10 Cal.Rptr.2d 700 (Cal.Ct.App.1992); BancFlorida v. Hayward, 689 So.2d 1052 (Fla. 1997); Johnson v. Fugate, 293 P.2d 559 (Okla.1956).

Moreover, the purchase money mortgage priority also prevails over a variety of other non-lien interests arising through the purchaser-mortgagor. See, e.g., Associates Discount Corp. v. Gomes, 338 So.2d 552 (Fla. Dist.Ct.App.1976) (dower, dictum); Stow v. Tifft, 15 Johns. 458, 8 Am. Dec. 266 (N.Y.1818) (dower); Wheatley's Heirs v. Calhoun, 39 Va. 264 (1841) (dower); Kneen v. Halin, 59 P. 14 (Idaho 1899) (community property); Davidson v. Click, 249 P. 100 (N.M.1926) (community property); Associates Discount Corp. v. Gomes, 338 So.2d 552 (Fla.Dist.Ct.App.1976) (homestead); Martin v. First Nat'l Bank, 184 So.2d 815 (Ala.1966) (homestead); Foster Lumber Co. v. Harlan County Bank, 80 P. 49 (Kan. 1905) (homestead).

It is clear that the purchase money mortgage need not be executed simultaneously with purchaser-mortgagor's acquisition of title, so long as the two events are part of one transaction. See Sunshine Bank of Fort Walton Beach v. Smith, 631 So.2d 965 (Ala.1994) (mortgage executed 11 months after sale deemed to be purchase money mortgage); Stewart v. Smith, 30 N.W. 430 (Minn.1886) ("An examination of the cases will show that the real test is not whether the deed and mortgage were in fact executed at the same instant, or even on the same day, but whether they were parts of one continuous transaction, and so intended to be, so that the two instruments should be given contemporaneous operation in order to promote the intent of the parties"); Swenson v. Ramage, 762 P.2d 851 (Mont.1988) (mortgage given to vendor by mortgagor eight months after conveyance deemed to be purchase money mortgage); Ray v. Adams, 4 Hun. 332 (N.Y. 1875) (a year elapsed after the purchaser received title before he executed the previously agreed mortgage to secure mortgagee, who had loaned part of the purchase price; nevertheless, mortgagee prevailed over a judgment against purchaser before he obtained title); Wheatley's Heirs v. Calhoun, 37 Am. Dec. 654 (Va.1841) (purchase money mortgage to vendor, executed 10 months after the conveyance, held to have priority over the dower rights of the widow of the grantee).

Section 7.2, Comment *b*, justifies purchase money mortgage priority on the basis of fundamental fairness. However, other rationales have been advanced as well as criticized:

> The traditional and frequently stated explanation [for the purchase money mortgage preference] is that of transitory seizin. The idea is that title shot into the mortgagee so fleetingly—*quasi uno flattu*, in one breath, as it were—that no other interest had time to fasten itself to it: the grantee-mortgagor must be regarded as a mere conduit. Such a theory breaks down in lien states where the fee remains permanently in the grantee-mortgagor. It also is inconsistent with the cases of quite common occurrence in which some considerable time elapses between the conveyance to the mortgagor and the execution of the mortgage. If the reason were to be taken literally it would require

the execution of the deed of purchase and the execution of the mortgage to be practically simultaneous, something which is ordinarily not feasible and not required by the cases.... [Also], if the theory has validity, it would seem it should apply to any case where the grantee mortgaged the property the instant he got the conveyance rather than confining it to mortgages for the purchase price in favor of the vendor or a third party lender. And, further, some theory other than transitory seizin would seem necessary to explain the priority of the vendor's purchase money over that of the third party lender of part of the purchase money insofar, at least, as the latter's priority is said to rest upon the same doctrine. After all, in this latter context the title could just as well readily shoot through the grantee-mortgagor as a conduit into the third party as to double back on its course and return to the vendor.

A better statement of the reason for the rule is that the title comes to the purchaser already charged with the encumbrance in favor of the grantor-mortgagor; that regardless of the form all that the transaction ever transfers is the redemption right. While such a conclusion would square with the decisions where the purchase money mortgage goes to the vendor, it is more difficult to apply it to the mortgage going to a third party lender of the purchase price, although it has been advanced in such a case. Furthermore, it would seem that the opposite conclusion could have been reached just as easily. Indeed, it would have been easier to do so, since in form there is a transfer of the full title with reservation, and the grantee then by a separate mortgage instrument creates a charge on it. So, unless the matter is considered more carefully, one is left unsatisfied as to why this one of two perfectly possible conclusions has been chosen.... [One] answer suggests that the purchase money mortgage always takes the place of an equitable interest in the property that precedes any lien or interest of any kind attaching to the purchaser's estate at the time of acquiring title. Where there is a prior contract of sale, this equitable interest consists of a specifically enforceable contract right to have the purchase money mortgage given on taking title and the equitable estate under the purchase contract is subject to this right. Where there is no prior contract the vendor retains on conveying title without receiving payment an equitable vendor's lien. When the purchase money mortgage is given it merely replaces and takes the priority of one or the other of these prior equities, and this is so whether it is given at once or subsequently, provided it is part of the same transaction. The third party lender of the purchase money is simply an extension of this. She is said to be in a position of an assignee of prior equitable rights of the vendor.

1 G. Nelson & D. Whitman, Real Estate Finance Law 803–04 (3d ed. 1993).

Qualifying for purchase money mortgage status, Comment c. The term "purchase money mortgage" is defined broadly in this section. The definition, of course, encompasses at its core "a mortgage executed at the time of purchase of land and contemporaneously with the acquisition of the legal title, or afterward, but as part of the same transaction, to secure an unpaid balance of the purchase price"; Beneficial Homeowner Service Corp. v. Beneficial Homeowner Service Corp., 605 N.Y.S.2d 435, 436 (N.Y.App.Div.1993). In addition, the definition extends to a mortgage whose proceeds are used for both acquiring title to the mortgaged real estate and for constructing improvements on it. See Resolution Trust Corp. v. Bopp, 850 P.2d 939 (Kan.Ct.App.1993); Hand Trading Co. v. Daniels et al., 190 S.E.2d 560 (Ga. Ct.App.1972). The rationale for this position is explained in *Bopp* as follows:

> [Mortgagee] contends that to deny construction loans purchase money protection would place too great a burden on lenders, discourage them from making construction loans, or force them in a position of creating duplicate paperwork and piecemeal mortgages, depending on the stage of construction of a residence or building. To use the instant case as an example, to split the mortgage would deny the lender its expected security interest and would, under modern lending practices, have a chilling effect on this type of business activity.

Resolution Trust Corp. v. Bopp, 850 P.2d 939, 941 (Kan.Ct.App.1993). Contra: BancFlorida v. Hayward, 689 So.2d 1052 (Fla.1997); Carteret Sav. Bank v. Citibank Mortgage Corp., 632 So.2d 599 (Fla.1994); Westinghouse Elec. Co. v. Vann Realty Co., 568 S.W.2d 777 (Mo.1978) (where part of the mortgage secured the purchase price of the land and part secured apartment buildings to be built on the land, the part that was used to acquire title was purchase money, but the rest was not); Syracuse Sav. & Loan Ass'n v. Hass, 234 N.Y.S. 514 (N.Y.Sup.Ct.1929); Dalton Moran Shook Inc. v. Pitt Dev. Co., 440 S.E.2d 585 (N.C.Ct.App.1994).

Note, however, that this section requires that the mortgage proceeds *actually be used* for the construction of improvements on the mortgaged real estate. It rejects the view of some courts that purchase money status should extend to funds that were contractually designated for the construction of improvements, but were actually used for other purposes. See Resolution Trust Corp. v. Bopp, 850 P.2d 939 (Kan.Ct.App.1993) (mortgage qualifies as purchase money mortgage to the extent that funds are actually expended or were contracted to be expended on the land or residence).

More important, even mortgage loans whose proceeds are used only for the construction of improvements may sometimes qualify as purchase money mortgages. This will be the case where the construction mortgage is properly viewed as being part of the same transaction in which the mortgagor acquires title to the mortgaged real estate. Such loans will qualify where the lender and mortgagor commence negotiations prior to the latter's acquisition of title and the loan is made and funds advanced incident to title acquisition or within a reasonable time thereafter. While no case law has been found to support the extension of purchase money protection to such lenders, it seems fair to view them as being an integral part of the purchase transaction.

The preference for vendor purchase money mortgages over third party purchase money mortgages, Comment d. For cases recognizing the preference for the vendor purchase money mortgage, see Giragosian v.

Clement, 604 N.Y.S.2d 983 (N.Y.App. Div.1993); Boies v. Benham, 28 N.E. 657 (N.Y.1891); Farmers Trust Co. v. Bomberger, 523 A.2d 790 (Pa. Super. Ct. 1987); Crystal Ice Co. v. First Colonial Corp., 257 S.E.2d 496 (S.C. 1979). Cf. Friarsgate, Inc. v. First Federal Savings & Loan Ass'n of South Carolina, 454 S.E.2d 901 (S.C.Ct.App.1995). The rationale for this preference has been articulated as follows:

> [T]he vendor has the edge because the property she is relying on for payment was previously hers up to the time of sale and mortgage back; there never was an instant when she relinquished a hold on it; and she would never have parted with it at all except on the belief and faith that if her buyer defaulted she could either recapture the property or get paid out of it. And this is normally so even though she may know that her buyer is going to finance the deal in part by borrowing some of the purchase money from another and give him a mortgage on the property. Other mortgagees, on the other hand, even including lenders of purchase money, parted only with money in which they retained no interest whatsoever, and placed their reliance for repayment of their debts on getting a security interest in other property not only never previously owned by them but not even owned by the mortgagor at the time the money was loaned, even though they might not have known that fact. The difference in attitude toward the hazard of losing property previously owned and that of not getting an interest in property which had never before belonged to the claimant is an old and important one. Here it justifies preferring the vendor purchase money mortgagee over even the third party lender of the purchase money.

1 G. Nelson and D. Whitman, Real Estate Finance Law 805–06 (3d ed. 1993).

In light of the foregoing vendor preference, reliance by the third party lender on the recording acts will often be in vain. See id. at 808–09. Ultimately the third party purchase money lender can be assured of priority over the vendor in such a situation only by having the latter expressly subordinate his or her lien to that of the third party lender. Id. at 809. See § 7.7, infra.

§ 7.3 Replacement and Modification of Senior Mortgages: Effect on Intervening Interests

(a) If a senior mortgage is released of record and, as part of the same transaction, is replaced with a new mortgage, the latter mortgage retains the same priority as its predecessor, except

(1) to the extent that any change in the terms of the mortgage or the obligation it secures is materially prejudicial to the holder of a junior interest in the real estate, or

(2) to the extent that one who is protected by the recording act acquires an interest in the real estate at a time tbat the senior mortgage is not of record.

(b) If a senior mortgage or the obligation it secures is modified by the parties, tbe mortgage as modified retains priority as against junior interests in the real estate, except to the extent that the modification is materially prejudicial to the holders of such interests and is not within the scope of a reservation of right to modify as provided in Subsection (c).

(c) If the mortgagor and mortgagee reserve the right in a mortgage to modify the mortgage or the obligation it secures, the mortgage as modified retains priority even if the modification is materially prejudicial to the holders of junior interests in the real estate, except as provided in Subsection (d).

(d) If a mortgage contains a reservation of the right to modify the mortgage or the obligation as described in Subsection (c), the mortgagor may issue a notice to the mortgagee terminating that right. Upon receipt of the notice by the mortgagee, the right to modify with retention of priority under Subsection (c) becomes ineffective against persons taking any subsequent interests in the mortgaged real estate, and any subsequent modifications are governed by Subsection (b). Upon receipt of the notice, the mortgagee must provide the mortgagor with a certificate in recordable form stating that the notice has been received.

Cross-References:

Section 2.1, Future Advances; § 2.2, Expenditures for Protection of the Security; § 2.3, Priority of Future Advances; § 5.3, Discharge of Transferor from Personal Liability; § 7.1, Effect of Mortgage Priority on Foreclosure; § 7.2, Purchase Money Mortgage Priority; § 7.6, Subrogation; § 7.7, Subordination; § 7.8, Foreclosure of Wraparound Mortgages.

Comment:

a. Introductory note. Replacement of senior mortgages is commonplace. For example, construction lenders who also provide permanent financing sometimes release the construction mortgage of record and either immediately or within a short period record a permanent mortgage even though the original mortgage obligation has not been satisfied. Similarly, a lender may make an initial one-year mortgage loan to a farmer, and subsequently "renew" the loan by replacing the mortgage with a series of successive additional one-year mortgages.

In addition, a senior mortgagee and a mortgagor frequently agree to a variety of modifications in the terms of the mortgage and the obligation it secures. Such modifications may entail an extension of the term, a change in the interest rate, and, less frequently, an increase in the principal amount of the mortgage obligation. Often such modifications arise out of mortgagor default or financial distress. Some changes, however, are unrelated to those factors. For example, in lieu of acceleration under a due-on-sale clause, a mortgagee may consent to a transfer of the mortgaged real estate upon the purchaser agreeing to an increased interest rate. Or a senior mortgagee may consent to an extension of the mortgage obligation to enable the mortgagor to deal with market conditions in a setting in which the mortgagor's business condition is clearly healthy.

Each of the foregoing transactions and their variants can create priority problems vis-à-vis intervening junior lienors and other interests. Requiring the consent of the holders of junior interests for such transactions might deny the parties needed flexibility in dealing with changing economic and business conditions. This section aims at resolving those problems in a manner that protects the legitimate expectations of the holders of junior interests, while at the same time denying them the ability to veto workouts or other flexible restructuring arrangements between mortgagors and senior lenders.

b. Replacement mortgages. Under § 7.3(a) a senior mortgagee that discharges its mortgage of record and records a replacement mortgage does not lose its priority as against the holder of an intervening interest unless that holder suffers material prejudice. Not all changes in the terms of the mortgage or obligation will be materially prejudicial. For example, the first mortgagee may release a fixed rate mortgage and replace it with a mortgage of the same principal amount and interest rate, but with a longer amortization period. To promote an intervening lienor to senior lien status would confer on that lienor an undeserved windfall. See Illustration 1.

There is a strong presumption under this section that a time extension on a senior mortgage or obligation, standing alone, is not materially prejudicial to intervening interests. A finding of material prejudice is justified only in the rare situation where the time extension can fairly be said to place the junior interest in a substantially weaker position. The typical junior lienholder is normally grateful to have a time extension forestall the destruction of its lien by a senior foreclosure. A junior lienholder may also assert that because time extensions usually cure existing senior mortgage defaults, they deprive the junior lienor of its equitable right to redeem from that senior mortgage. Such a concern, however, is largely hypothetical because the junior lienor is rarely willing to make the financial investment in the mortgaged real estate that such redemption requires. In the last analysis, the approach of this section, which normally does not penalize the senior mortgagee for granting extensions to the mortgagor, is probably beneficial to most junior lienholders as well.

Other sorts of changes that may be made in the terms of a replacement mortgage are not so benign. Obviously an increase in the principal amount will prejudice the holders of junior interests; see Illustration 2. Unless the original mortgage validly secures future advances (see § 2.1, supra), it would be unfair to subordinate the intervening lienor to a replacement mortgage balance that it would have no reason to anticipate. This result is consistent with the treatment afforded an intervening lienor under Subsection (b) of this section, where the principal amount of a senior mortgage obligation is increased by a modification rather than as part of a replacement transaction.

The treatment just discussed should also apply where the original mortgage represents a construction loan that states a specific principal amount. While a construction mortgage is a species of future advances mortgage, where the recorded document states a specific maximum balance, the intervening lienor should not be bound by a replacement mortgage to the extent that it exceeds that specified maximum. See Illustrations 3–4.

Where the original mortgage clearly states that it secures future advances and specifies no maximum monetary amount, the intervening lienor is not materially prejudiced. Since the intervenor takes its lien on notice that future advances are possible, it cannot validly claim injury based on the fact that the replacement mortgage exceeds the pre-release balance of its predecessor. See Illustration 5.

In addition to increases in the loan balance, other sorts of modifications may materially prejudice intervening interest holders. For example, an increase in the interest rate will do so if the rate under the original mortgage was fixed. To the extent of the higher balance owing on the obligation as a result of such an increase, the senior mortgage will lose priority to intervening interests. The reason is that the junior interest-holder's margin of protection in the real estate is reduced to the extent that a higher interest rate, like an additional principal advance, increases the amount of the senior mortgage obligation. Moreover, in both of these settings, if the junior holder is forced to satisfy the senior mortgage in order to protect its position, the amount required for that purpose will be more than could reasonably have been contemplated at the time the junior interest was created.

An additional case in which the replacement mortgage will lose priority is that in which one acquires an intervening interest after the release of record of the senior mortgage and prior to the recordation of its replacement. If the holder of the intervening interest qualifies under the applicable recording act (typically by being a good-faith purchaser for value, and in some states by recording first as well), the operation of the act will give it senior status as against the replacement mortgage. See Illustration 6.

Of course, there may be situations where the senior mortgagee actually intends to subordinate the replacement mortgage to an intervening lien. See § 7.7. However, such an intent to subordinate will not be inferred in the absence of a clear statement or other proof to that effect. This will be the case even where the senior mortgagee has actual knowledge of an intervening lien at the time the replacement is recorded. Compare § 7.6, Comment *e*, dealing with subrogation rights of third party lenders who discharge preexisting mortgages, and stating an analogous rule.

Illustrations:

1. Mortgagor borrows $50,000 from Mortgagee–1 and gives Mortgagee–1 a promissory note for that amount secured by a mortgage on Blackacre. The mortgage obligation carries a fixed rate of interest and is to be amortized by fixed payments over 15 years. The mortgage is immediately recorded. Thereafter, Mortgagor borrows $10,000 from Mortgagee–2 and gives Mortgagee–2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Two years later, when the balance on Mortgagee–1's mortgage is $49,000, Mortgagor and Mortgagee–1 agree to a replacement mortgage. Mortgagee–1 releases its original mortgage of record and Mortgagor delivers to Mortgagee–1 a new promissory note for $49,000 secured by a mortgage on Blackacre. The mortgage obligation carries the same fixed rate of interest as its predecessor and is evenly amortized over 20 years. A few days later, Mortgagee–1 records the replacement mortgage. The latter mortgage is senior to Mortgagee–2's mortgage.

2. The facts are the same as Illustration 1, except that the replacement mortgage delivered to Mortgagee–1 secures a $60,000 obligation. Mortgagee–1's replacement mortgage is senior to Mortgagee–2's mortgage except to the extent of $11,000 and interest accruing thereon.

3. Mortgagor borrows $50,000 from Mortgagee-1 to construct a house on Blackacre, which Mortgagor owns, and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The mortgage states that it secures a $50,000 obligation, and it is immediately recorded. The obligation is fully due and payable one year later. Two months later, mortgagor borrows $10,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. During the construction process Mortgagee-1 makes several advances under its loan to Mortgagor, and when the house is completed several months later, the full $50,000 has been advanced. Thereafter, Mortgagee-1 agrees to provide the permanent financing for Mortgagor. It, therefore, releases of record its construction mortgage from Blackacre. Several days later, it takes from Mortgagor a promissory note for $50,000, secured by a mortgage on Blackacre. The latter obligation is evenly amortized over 30 years and carries the same interest rate as its predecessor construction mortgage. Mortgagee-1's mortgage is senior to Mortgagee-2's mortgage.

4. The facts are the same as Illustration 3, except that the permanent mortgage given to Mortgagee-1 secures a $60,000 obligation because mortgagor borrows an additional $10,000 from Mortgagee-1. Mortgagee-1's mortgage is senior to Mortgagee-2's mortgage except to the extent of $10,000 and interest accruing thereon.

5. Mortgagor borrows $15,000 from Mortgagee-1 and gives Mortgagee a promissory note for that amount secured by a mortgage on Blackacre. The mortgage states "this mortgage shall also secure all future loans or advances made by Mortgagee to Mortgagor." The obligation is due and payable in five years. The mortgage is immediately recorded. Two months later, Mortgagor borrows $10,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. A year later, Mortgagor and Mortgagee-1 agree to restructure their loan agreement. As a result of this agreement, Mortgagee-1 lends an additional $20,000 to Mortgagor. Mortgagee-1 then releases its original mortgage of record and, a few days later, Mortgagor delivers to Mortgagee-1 a $35,000 promissory note secured by a mortgage on Blackacre. The latter mortgage obligation carries the same interest rate and the full $35,000 is due and payable five years thereafter. It does not secure future advances. The mort-

gage is promptly recorded. Mortgagee-1's $35,000 mortgage is senior to Mortgagee-2's mortgage.

6. The facts are the same as Illustration 1, except that Mortgagee-2 takes and records its mortgage after the release of record of Mortgagee-1's mortgage, but before Mortgagee-1 takes and records its later mortgage. Mortgagee-2 has no knowledge of the later mortgage to Mortgagee-1. Mortgagee-2's mortgage is senior to Mortgagee-1's replacement mortgage.

c. Modification of senior mortgages: effect on intervening interests. A modification of a mortgage will ordinarily cause it to lose priority to junior interests to the extent that the modification is materially prejudicial to those interests. See Subsection (b). Even when material prejudice exists, however, no loss of priority will occur if the mortgage contains a clause reserving the right to modify, the modification is within the scope of the clause, and the clause's operation has not been terminated by notice from the mortgagor; see Subsections (c) and (d).

Not all modifications will materially prejudice junior interests. For example, mortgagees commonly consent to an extension of the mortgage maturity date or to a rescheduling or "stretching out" of installment payments. Absent an increase in the principal amount or the interest rate of the mortgage, such modifications normally do not jeopardize the mortgagee's priority as against intervening interests. See Illustrations 7–8. Extensions of maturity generally reduce the likelihood of foreclosure of the senior mortgage and thus are beneficial, rather than prejudicial, to the interests of junior lienors. See the discussion in Comment *a.*

Illustrations:

7. Mortgagor borrows $50,000 from Mortgagee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The obligation carries a fixed rate of interest and is evenly amortized over 15 years. The mortgage is promptly recorded. One year later, Mortgagor borrows $15,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Five years later, Mortgagor and Mortgagee-1 agree to modify Mortgagee-1's mortgage to extend the amortization period from 15 years to 25 years. The interest rate remains the same. The modification agreement is recorded. Mortgagee-1's mortgage, as modified, is senior to Mortgagee-2's mortgage.

8. Mortgagor borrows $50,000 from Mortgagee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The obligation carries a fixed rate of interest and is amortized on a 30-year basis with the full amount of the obligation becoming due and payable in five years. The mortgage is promptly recorded. One year later, Mortgagor borrows $15,000 from Mortgagee-2 and gives Mortgagee a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. When Mortgagee-1's mortgage becomes fully due and payable at the end its five-year amortization period, Mortgagor is unable to make the "balloon" payment. Mortgagor and Mortgagee-1 agree te modify Mortgagee-1's mortgage so that the full amount of the obligation becomes due and payable two years later. Mortgagor agrees to make interest payments monthly during the extension period. The interest rate remains the same. The modification agreement is promptly recorded. Mortgagee-1's mortgage, as modified, is senior to Mortgagee-2's mortgage.

Where the senior mortgage modification consists of either an increase in the interest rate or the principal amount, the junior lienor will gain priority over the earlier mortgage to the extent of the modification. See Illustrations 9-10. This result is based on the view that such transactions prejudice the interests of the junior lienholder, for the reasons discussed in Comment *a*.

Illustrations:

9. The facts are the same as Illustration 8, except that Mortgagor and Mortgagee-1 agree to an increase in the mortgage interest rate from 8 percent to 12 percent during the extension period. Mortgagee-1's mortgage is senior to Mortgagee-2's mortgage except to the extent that the increase in the interest rate enlarges the obligation secured by Mortgagee-1's mortgage.

10. Mortgagor borrows $50,000 from Mortgagee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The obligation carries a fixed rate of interest and is evenly amortized over 15 years. The mortgage is promptly recorded. One year later, Mortgagor borrows $15,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Five years later, Mortgagor borrows an additional $10,000 from Mortgagee-1 at the same interest rate as in the original mortgage obligation and delivers to Mortgagee-1 a promissory note for that amount. The latter note

is fully and evenly amortized over the remaining term of the original promissory note to Mortgagee–1. Mortgagor and Mortgagee–1 enter into a modification agreement that makes Mortgagee–1's original mortgage security for the additional $10,000. The modification agreement is promptly recorded. Mortgagee–1's mortgage is senior to Mortgagee–2's mortgage except to the extent of $10,000 and interest accruing thereon.

d. Senior mortgage terms reserving the right to modify. A senior mortgagee may find it advantageous to include a provision in the senior mortgage that authorizes the mortgagor and mortgagee to make future modifications in the mortgage and the obligation it secures. The purpose of such a provision is to put subsequent lienors and other parties on notice of the potential for modification, and therefore to defeat any claim that the senior's priority has been lost or diminished if a modification occurs.

Paragraph (c) of this section makes it clear that such a senior mortgage provision protects the mortgagee against loss of priority as against subsequent lienors in the same way that future advances mortgagees are protected against such loss under Chapter 2 of this Restatement. Under § 2.1(c), future advances are effective "as against a person acquiring an interest in the mortgaged property subsequent to the mortgage" if an agreement for future advances exists and the "mortgage states that future advances are secured." Moreover, under § 2.3(a), "all such advances have the priority of the original mortgage." Thus, such advances, whether the mortgagee is contractually obligated to make them or not, take the priority of the original mortgage and are senior in priority to a subsequent party who acquires its interest in the real estate before the advances are made.

The present section is based on the premise that the combination of a provision in a senior mortgage authorizing future modifications, together with the subsequent agreement of the mortgagor and mortgagee to modify that mortgage, operate much like a future advances mortgage under which future advances are actually made. This is especially the case where the subsequent agreement is to increase either the interest rate or the principal amount of the senior mortgage. These types of modifications increase the obligation secured by the original mortgage and thus function like a future advance. Thus, to the extent that the mortgage obligation is increased because of either type of modification, that increase will have the same priority as the original mortgage. See Illustrations 11–12. This is so even though such modifications would be deemed prejudicial to intervening lienors if there were no senior mortgage language authorizing future modification. See Illustrations 9–10, supra.

Illustrations:

11. Mortgagor borrows $50,000 from Mortgagee–1 and gives Mortgagee–1 a promissory note for that amount secured by a mortgage on Blackacre. The obligation carries a seven percent interest rate and is evenly amortized over a 15–year period. The mortgage contains the following provision: "This mortgage shall also secure all extensions, amendments, modifications, or alterations of the secured obligation including amendments, modifications, or alterations that increase the amount of the secured obligation or the interest rate on the secured obligation." The mortgage is promptly recorded. One year later, Mortgagor borrows $15,000 from Mortgagee–2 and gives Mortgagee–2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Two years later, Mortgagor and Mortgagee–1 agree to modify the mortgage obligation to extend the period of amortization from 15 years to 25 years and to increase the interest rate from seven percent to nine percent. The modification agreement is promptly recorded. Mortgagee–1's mortgage, as modified, is senior to Mortgagee–2's mortgage.

12. The facts are the same as Illustration 11, except that the modification agreement also increases the principal amount of the obligation of Mortgagee–1's mortgage by $10,000. Mortgagee–1's mortgage, as modified, is senior to Mortgagee–2's mortgage.

e. Mortgagor's notice to terminate the right to modify. Where the mortgagor and mortgagee reserve the right to modify the senior mortgage, the mortgagor's ability to obtain further financing from other lenders may be jeopardized. Third parties will often be unwilling to advance credit when the amount secured by the senior mortgage is uncertain due to its potential for modification. Because modification provisions can operate in much the same fashion as future advances provisions, the mortgagor, by analogy to § 2.3(b), has the right to issue a "cut-off notice" to the mortgagee terminating the priority-retention effect of the mortgage modification provision. Upon receipt of the notice, the modification provision will no longer be effective to preserve the priority of future modifications against those taking subsequent interests in the mortgaged real estate; any subsequent modifications will be governed by § 7.3(b). See Illustrations 13–14. Upon receipt of the cut-off notice from the mortgagor, the senior mortgagee must provide the mortgagor with a certificate in recordable form stating that the mortgagor's notice has been received. If the mortgagee fails to provide the certificate within a reasonable time after receipt of the notice, mortgagor may file a judicial action against mortgagee for appropriate relief including specific performance, damages, or other suitable remedy. Mortgagor may also record his or her own certificate that notice was sent, or may record the notice itself. It must be recognized, however, that the mortgagor's recording of such a certificate is by nature self-serving and may not be acceptable to prospective junior lenders.

The purpose of § 7.3(d) is to encourage subsequent lenders to rely on the "cut-off notice" and therefore be willing to advance credit to the mortgagor. While the underlying theory of this subsection is analogous to estoppel, no actual showing of reliance on the notice by an intervening lienor is necessary.

Illustrations:

13. Mortgagor borrows $50,000 from Mortgagee-1 and gives Mortgagee-1 a promissory note for that amount secured by a mortgage on Blackacre. The obligation carries a seven percent interest rate and is evenly amortized over a 15-year period. The mortgage contains the following provision: "This mortgage shall also secure all extensions, amendments, modifications, or alterations of the secured obligation, including amendments, modifications, or alterations that increase the amount of the secured obligation or the interest rate on the secured obligation." A year later, Mortgagor delivers a notice to Mortgagee-1 stating that the above mortgage modification provision is terminated. Mortgagee-1 provides Mortgagor with a certificate stating that Mortgagor's notice has been honored. The certificate is promptly recorded. Two years later, Mortgagor borrows $15,000 from Mortgagee-2 and gives Mortgagee-2 a promissory note for that amount secured by a mortgage on Blackacre. The latter mortgage is promptly recorded. Thereafter, Mortgagor and Mortgagee-1 agree to modify their mortgage obligation to increase the interest rate from 7 percent to 10 percent. The modification agreement is promptly recorded. Mortgagee-1's mortgage is senior to Mortgagee-2's mortgage except to the extent that the increase in interest rate enlarges the obligation secured by Mortgagee-1's mortgage.

14. The facts are the same as Illustration 13, except that instead of increasing the interest rate, the mortgage modification agreement increases the principal amount of the obligation of Mortgagee-1's mortgage by $10,000. Mortgagee-1's mortgage is senior to Mortgagee-2's mortgage except to the extent of the $10,000 and interest accruing thereon.

REPORTERS' NOTE

Introductory note, Comment a. See generally Kratovil & Werner, Mortgage Extensions and Modifications, 8 Creighton L. Rev. 595 (1975); Meislin, Extension Agreements and the Rights of Junior Mortgagees, 42 Va. L. Rev. 939 (1956); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 9.4 (3d ed. 1993).

Replacement mortgages, Comment b. Courts routinely adhere to the principle that a senior mortgagee who discharges its mortgage of record and takes and records a replacement mortgage, retains the predecessor's seniority as against intervening lienors unless the mortgagee intended a subordination of its mortgage or "paramount equities" exist. See, e.g., Stephens Wholesale Bldg. Supply Company, Inc. v. Birmingham Fed. Sav. and Loan Ass'n, 585 So.2d 870 (Ala.1991); Bay Minette Production Credit Ass'n v. Citizens' Bank, 551 So.2d 1046 (Ala.1989); Home Federal Savings & Loan Association v. Citizens Bank of Jonesboro, 861 S.W.2d 321 (Ark.Ct.App.1993); Farmers & Merchants Bank v. Riede, 565 So.2d 883 (Fla.Dist.Ct.App.1990); Rebel v. National City Bank, 598 N.E.2d 1108 (Ind.Ct.App.1992); Jackson & Scherer, Inc. v. Washburn, 496 P.2d 1358 (Kan.1972); Financial Acceptance Corp. v. Garvey, 380 N.E.2d 1332 (Mass. Ct. App. 1978); Guleserian v. Fields, 218 N.E.2d 397 (Mass.1966); Piea Realty Co. Inc. v. Papuzynski, 172 N.E.2d 841 (Mass.1961); Greenfield v. Petty, 145 S.W.2d 367 (Mo. 1940); Mackiewicz v. J.J. & Associates, 514 N.W.2d 613 (Neb.1994); Nebraska State Bank v. Pedersen, 452 N.W.2d 12 (Neb.1990); Commercial Fed. Sav. & Loan Ass'n v. Grabenstein, 437 N.W.2d 775 (Neb.1989); Commerce Sav. Lincoln, Inc. v. Robinson, 331 N.W.2d 495 (Neb.1983); Houston Lumber Co. v. Skaggs, 613 P.2d 416 (N.M.1980); Resolution Trust Corp. v. Barnhart, 862 P.2d 1243 (N.M.Ct.App.1993) ("where a senior mortgagee discharges its mortgage of record and contemporaneously takes a new mortgage, the senior mortgagee's lien is not subordinated to intervening liens in the absence of (1) evidence of an intent to subordinate, or (2) paramount equities in favor of junior lienholders that justify subordinating the senior mortgagee's lien."); Norstar Bank v. Morabito, 607 N.Y.S.2d 426 (N.Y.App.Div. 1994); Kellogg Bros. Lumber v. Mularkey, 252 N.W. 596 (Wis.1934); Marine Bank Appleton v. Hietpas, Inc., 439 N.W.2d 604 (Wis.Ct.App.1989) ("It is a well-accepted rule that a new mortgage that secures an old debt does not extinguish the original lien absent evidence of the parties' intent to do so or of paramount equities that would require that result"); In re Earl, 147 B.R. 60 (Bankr.N.Y.1992); Kratovil & Werner, Mortgage Extensions and Modifications, 8 Creighton L. Rev. 595, 600–603 (1975); Lloyd, Refinancing Purchase Money Security Interests, 53 Tenn. L. Rev. 1 (1985); Annots., 98 A.L.R. 843 (1935); 33 A.L.R. 149 (1924). Of course, a loss of priority is even more unlikely where the original mortgage is not discharged of record. See Hummel v. Hummel, 896 P.2d 1203 (Okla.Ct.App. 1995); Skaneateles Savings Bank v. Herold, 376 N.Y.S.2d 286 (N.Y.App. Div.1975), aff'd, 359 N.E.2d 701 (N.Y. 1976).

Under Subsection (a), intent on the part of the senior mortgagee to subordinate to intervening liens will not be inferred. Only express and unambiguous evidence of such intent will suffice. Indeed, courts frequently deal with the intent issue by recognizing a presumption that the mortgagee intended a result that would be most beneficial to its security interest. See, e.g., Commercial Fed. Sav. & Loan Ass'n v. Grabenstein, 437 N.W.2d 775 (Neb.1989); Kratovil & Werner, Mortgage Extensions and Modifications, 8 Creighton L. Rev. 595, 601–02 (1975). Of course, prudent mortgagees obviate the intent issue by carefully spelling out in the new document the parties' intent that the replacement mortgage retain the same priority as its predecessor. See 1 G. Nelson & D. Whitman, Real Estate Finance Law § 9.4 (3d ed. 1993).

While the cases frequently refer to a "paramount equities" exception to the rule that a replacement mortgage retains the priority of its predecessor, Subsection (a) does not incorporate that expression. This is because the "paramount equities" concept is grounded in notions of detrimental reliance. See Houston Lumber Co. v. Skaggs, 613 P.2d 416 (N.M.1980); Kellogg Bros. Lumber v. Mularkey, 252 N.W. 596 (Wis.1934). *Houston Lumber* is instructive in this regard. In that case the mortgagee loaned mortgagor $37,000 for the construction of a home. When the construction was complete, the mortgagee released the construction mortgage and simultaneously recorded a long-term mortgage to take its place. Mechanics lienors, whose lien claims arose after the recording of the construction mortgage, but prior to the replacement transaction, asserted priority over the permanent mortgage. The New Mexico Supreme Court reversed a trial court judgment for the mechanics lienors. It stressed that the lien claimants "did not know the construction loan had been released and replaced by a permanent financing arrangement. The majority of the work had been completed prior to the change of financing. There is no showing that [they] detrimentally relied on the release in any way. Therefore, we fail to see how the paramount equities favor [them]." Id. at 417.

On the other hand, under Comment *b* and Illustration 2 the replacement mortgage loses its priority to intervening liens to the extent that the principal amount or interest rate of its predecessor is increased. See Skaneateles Savings Bank v. Herold, 376 N.Y.S.2d 286 (N.Y.App.Div.1975) aff'd, 359 N.E.2d 701 (N.Y. 1976) (increased principal). However, at least one recent case refused to subordinate to any degree a senior mortgage's priority to an intervening judgment lien even though the replacement mortgage interest rate was substantially increased. See Bay Minette Production Credit Ass'n v. Citizens' Bank, 551 So.2d 1046 (Ala.1989).

Modification of senior mortgages: effect on intervening lienors, Comment c. Mortgagees frequently consent to an extension of the mortgage maturity date or a "stretching out" of the amortization schedule. Absent an increase in the interest rate or principal amount of the mortgage obligation, courts routinely hold that such modifications do not defeat the mortgagee's priority as against intervening lienors. The assumption is that such transactions reduce the likelihood of foreclosure of the senior mortgage and that they are therefore beneficial to the interests of junior lienors. See, e.g., Crutchfield v. Johnson & Latimer, 8 So.2d 412 (Ala. 1942); Lennar Northeast Partners v. Buice, 57 Cal.Rptr.2d 435 (Cal.Ct. App.1996); Eurovest Ltd. v. 13290

Biscayne Island Terrace Corp., 559 So.2d 1198 (Fla.Dist.Ct.App.1990); State Life Insurance Co. v. Freeman, 31 N.E.2d 375 (Ill.Ct.App.1941); Guleserian v. Fields, 218 N.E.2d 397 (Mass.1966); Shultis v. Woodstock Land Dev. Assoc., 594 N.Y.S.2d 890 (N.Y.App.Div.1993); Skaneateles Savings Bank v. Herold, 376 N.Y.S.2d 286 (N.Y.App.Div.1975), aff'd, 359 N.E.2d 701 (N.Y. 1976); Resolution Trust Corp. v. BVS Development, Inc., 42 F.3d 1206 (9th Cir.1994); In re Fowler, 83 B.R. 39 (Bankr.Mont. 1987); In re Earl, 147 B.R. 60 (Bankr. N.D.N.Y.1992); Kratovil & Werner, Mortgage Extensions and Modification, 8 Creighton L. Rev. 595, 607 (1975); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 9.4 (3d ed. 1993). Contra, Citizens and Southern National Bank v. Smith, 284 S.E.2d 770 (S.C.1981) (extension of senior mortgage results in loss of its priority as against intervening lienor).

On the other hand, courts usually regard an increase in the mortgage interest rate or principal amount as causing a *pro tanto* loss of priority to any intervening liens. See, e.g., Bank of Searcy v. Kroh, 114 S.W.2d 26 (Ark.1938); Fleet Bank of New York v. County of Monroe Industrial Development Agency, 637 N.Y.S.2d 870 (N.Y.App.Div.1996); Shultis v. Woodstock Land Dev. Assoc., 594 N.Y.S.2d 890 (N.Y.App.Div.1993) ("Any prejudice visited upon [junior lienor] as a result of the interest increase was successfully abated by giving it priority over the amount representing the increased interest due and owing plaintiffs as a result of the unauthorized second modification."); Prudential Insurance Co. v. Nuernberger, 284 N.W. 266 (Neb.1939); Werner v. Automobile Fin. Co., 12 A.2d 31 (Pa. 1940); Mergener v. Fuhr, 208 N.W. 267 (Wis.1926); Barbano v. Central-Hudson Steamboat Co., 47 F.2d 160 (2d Cir.1931). The basis for *pro tanto* loss of priority has been explained as follows:

> This result is premised on the assumption that such transactions prejudice the interests of such junior lienholders. Suppose, for example, that a modification agreement results in an increase of the interest rate on a $10,000 mortgage balance from 11 percent to 14 percent. If, as is likely, this increases the mortgage payments, this enhanced debt burden increases the risk of default and foreclosure as to both senior and junior mortgagees. Moreover, the junior lienor's margin of protection in the real estate is reduced to the extent that the higher interest rate increases the amount of the senior debt. Similarly, if the principal balance of the senior debt is increased from $10,000 to $12,000, prejudice to the junior lienor is obvious. The mortgagor's higher total debt burden could increase the likelihood of default and foreclosure for all liens on the property, and the junior's margin of protection in the mortgaged real estate is reduced. Moreover, in both of the above modifications, if the junior lienor is forced to satisfy the senior mortgage in order to protect his or her position, the amount required for such a satisfaction will be more than could have been contemplated at the time the junior interest was acquired.

1 G. Nelson & D. Whitman, Real Estate Finance Law 816–17 (3d ed. 1993). Contra: Dorothy Edwards Realtors, Inc. v. McAdams, 525 N.E.2d 1248 (Ind.Ct.App.1988), appeal after remand, 591 N.E.2d 612 (1992);

Strong v. Stoneham Co-op. Bank, 310 N.E.2d 607 (Mass. Ct. App. 1974); Commerce Sav. Lincoln, Inc. v. Robinson, 331 N.W.2d 495 (Neb.1983). Cf. N.J. Stat. Ann. §§ 46:9–8.1d(1), 8.2.

Conversely, a decrease in the senior mortgage interest rate is not deemed to prejudice the interest of junior lienholders. See Big Land Inv. Corp. v. Lomas & Nettleton Fin. Corp., 657 P.2d 837 (Alaska 1983).

Courts occasionally suggest that a modification of the senior mortgage can be so substantial that complete rather than *pro tanto* loss of priority should result. One recent decision raises this possibility as follows:

> It is well established that while a senior mortgagee can enter into an agreement with the mortgagor modifying the terms of the underlying note or mortgage without first having to notify any junior lienors or to obtain their consent, if the modification is such that it prejudices the rights of the junior lienors or impairs the security, their consent is required.... Failure to obtain the consent in these cases results in the modification being ineffective as to the junior lienors ... and the senior lienor relinquishing to the junior lienors its priority with respect to the modified terms.... *While this sanction ordinarily creates only the partial loss of priority noted above, in situations where the senior lienor's actions in modifying the note or mortgage have substantially impaired the junior lienors' security interest or effectively destroyed their equity, courts have indicated an inclination to wholly divest the senior lien of its priority and to elevate the junior liens to a position of superiority.*

Shultis v. Woodstock Land Dev. Assoc., 594 N.Y.S.2d 890, 892 (N.Y.App. Div.1993) (emphasis added). For similar language, see Lennar Northeast Partners v. Buice, 57 Cal.Rptr.2d 435 (Cal.Ct.App.1996); Fleet Bank of New York v. County of Monroe Industrial Development Agency, 637 N.Y.S.2d 870 (N.Y.App.Div.1996). This sanction may be appropriate in an extreme case where, for example, where there is a substantial increase in the interest rate and an evenly amortized 30–year payment schedule is changed to a balloon mortgage due within one year, (see Gluskin v. Atlantic Savings & Loan Ass'n., 108 Cal.Rptr. 318 (Cal.Ct.App.1973)) or where the modification to the senior mortgage so substantially increases the mortgage obligation that there is no value whatever in the real estate to secure the junior lien.

Senior mortgage terms reserving the right to modify, Comment d. Little judicial authority exists concerning the enforceability of terms in senior mortgages reserving the right to modify. Scholarly commentary is divided. Compare Kratovil & Werner, Mortgage Extensions and Modifications, 8 Creighton L. Rev. 595, 610 (1975) ("[M]any mortgages contain a clause which provides that the lender may increase the interest rate on the giving of any extension. The mere fact that this provision is included in the original mortgage as recorded will not be sufficient to secure the property for that increased interest over those who take their interest prior to the extension") with Meislin, Extension Agreements and the Rights of Junior Mortgagees, 42 Va. L. Rev. 939, 955–56 (1956) ("Inferior mortgages should be held to anticipate [that] ... [modification] is liable to take place at increased rates of interest, rates which do not exceed the legal ceiling, where it exists, (and, where it does not, at or below upper limits reasonably capable of advance approximation.")).

The foregoing issues are best addressed by reference to an analogous situation—the treatment of junior lienholders as against future advances made pursuant to mortgage terms authorizing such advances. Under §§ 2.1–2.3 of this Restatement, so long as the original mortgage states that future advances are secured, such advances, whether obligatory or optional, take the priority of the original mortgage and are senior to any intervening lienholder who acquires its interest before the advances are made. Indeed, even "dragnet clauses" are generally effective to secure future obligations owing from mortgagor to mortgagee and to give them priority as against intervening lienors. See §§ 2.3, 2.4. Thus, by analogy, subsequent interest rate or principal increases or other mortgage modifications made pursuant to specific mortgage language authorizing them should be afforded priority over intervening lienors at least to the same extent that optional future advances made pursuant to mortgage language will be superior to such intervening interests.

Moreover, such intervening lienors are no worse off under the approach taken by this section than they currently are when the senior lien is an adjustable rate mortgage. In both situations subsequent lienholders are on notice that the senior debt can be increased and its payment terms modified. They can temper their lending decisions accordingly. See 1 G. Nelson & D. Whitman, Real Estate Finance Law 818 (3d ed. 1993).

Mortgagor's notice to terminate the right to modify, Comment e. Because senior mortgage terms reserving the right to modify render the junior lender unable to predict how much of the mortgaged real estate's value will ultimately be available to secure any loan it may make to the mortgagor, such terms can have the undesirable effect of discouraging junior mortgage lending. Because the same problem arises when the senior mortgage secures future advances, this section, like § 2.3 of this Restatement, recognizes the mortgagor's right to issue a "cut-off" notice to the mortgagee, stating that the mortgage modification provision is terminated. Upon receipt of this notice by the mortgagee, subsequent modifications of the senior obligation or mortgage will be ineffective against subsequent lienors. Because § 2.3 and about a dozen state statutes give this "cut-off" option to the mortgagor in the future advances setting, it is also appropriate to do so in the analogous mortgage modification context. See § 2.3, Comment *b* and accompanying Reporters' Note.

§ 7.4 Effect of Priority on the Disposition of Foreclosure Surplus

When the foreclosure sale price exceeds the amount of the mortgage obligation, the surplus is applied to liens and other interests terminated by the foreclosure in order of their priority and the remaining balance, if any, is distributed to the holder of the equity of redemption.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 7.2, Purchase Money Mortgage Priority; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; § 7.5, Mortgaging After-Acquired Real Estate; § 7.7, Subordination; § 7.8, Foreclosure of Wraparound Mortgages.

Comment:

a. Foreclosure surplus as the remainder of the security. It is axiomatic that a mortgagee forecloses in order to use the mortgaged real estate to satisfy the mortgage obligation. Sometimes, however, the foreclosure will produce an amount in excess of the mortgage obligation. For purposes of this section the term "mortgage obligation" includes not only the amount due and owing on the mortgage debt, but also the costs of sale, attorneys' fees, and other similar items allowable under local law and the terms of the mortgage. The major principle underlying this section is that when a surplus occurs, it represents what remains of the equity of redemption and is, as such, a substitute *res*. The surplus stands in the place of the foreclosed real estate, and the liens and interests that previously attached to the real estate now attach to the surplus.

b. Foreclosed junior interests entitled to surplus in order of their pre-foreclosure priority. From the principle articulated in Comment *a*, two important corollaries flow. First, the liens and other interests terminated by the foreclosure attach to the surplus in order of the priority they enjoyed prior to the foreclosure. Payment of the surplus will be governed by that priority. Moreover, foreclosed junior lienors are entitled to surplus even though their liens are not in default at the time of foreclosure. See Illustration 1. Second, the claim of the holder of the foreclosed equity of redemption to the surplus is subordinate to the claims of all other holders of liens and interests terminated by the foreclosure. See Illustration 2.

Illustrations:

1. The following liens exist on Blackacre in order of their priority: a first mortgage in favor of Mortgagee–1 for $75,000; a second mortgage in favor of Mortgagee–2 for $25,000; and a judgment lien in favor of J for $10,000. Mortgagee–1 validly forecloses its mortgage and the sale yields $105,000. At the time of foreclosure Mortgagee–2's mortgage is not in default. After the first mortgage obligation is satisfied, a $30,000 surplus remains. The surplus is first applied to pay Mortgagee–2's claim in full, and the balance of $5,000 is applied toward J's judgment. The foreclosed holder of the equity of redemption receives nothing.

2. The facts are the same as Illustration 1 except that the foreclosure sale yields $115,000. After the first mortgage obligation is satisfied, a $40,000 surplus remains. The surplus is first applied to pay Mortgagee-2's claim in full, and then to pay J's lien in full. The balance of $5,000 is paid to the foreclosed holder of the equity of redemption.

A different disposition of surplus is necessary where a junior lien secures a contingent obligation. In such a situation it would be inappropriate to pay surplus to a junior mortgagee who ultimately may never be entitled to it. This can be the case, for example, where a mortgage is used to secure a guaranty. In this setting the surplus should be paid into court or into an escrow account and appropriately invested until the extent of mortgagor's liability, if any, is determined. See Illustration 3.

Illustration:

3. Debtor borrows $100,000 from Lender and gives Lender a promissory note for that amount. Mortgagor, a relative of Debtor, executes and delivers to Lender Mortgagor's personal guaranty of Debtor's obligation to Lender. To secure the guaranty, Mortgagor delivers to Lender a mortgage on Blackacre, land owned by Mortgagor which is already subject to a senior mortgage. While Debtor's obligation to Lender is still unsatisfied, the senior mortgage on Blackacre is validly foreclosed and the foreclosure sale produces a surplus. Lender has no present right to the surplus. Rather, the surplus should be paid into court or an escrow account and appropriately invested until it is determined the extent to which mortgagor becomes liable under the guaranty.

Non-lienors who hold interests in the real estate that are terminated by foreclosure are also entitled to share in any foreclosure surplus. Such persons include junior easement holders and lessees. To the extent that surplus is available, such persons are entitled to receive, in order of their pre-foreclosure priority, the fair market value of their interests as of the date of foreclosure. See Illustrations 4–5. Fair market value for the foregoing purpose is determined in the same manner as in eminent domain proceedings. On the other hand, general creditors of the mortgagor or those holding security interests in mortgagor's other assets have no claim to surplus.

Illustrations:

4. Mortgagee-1 holds a first mortgage on Blackacre for $75,000. The holder of the equity of redemption then grants Eaton

a roadway easement over Blackacre benefiting Eaton's adjoining land, which easement is junior to Mortgagee–1's mortgage. Mortgagee–1 then validly forecloses its mortgage and the sale yields $25,000 in excess of the obligation on its mortgage. This surplus is first applied to pay Eaton the fair market value of the easement terminated by the foreclosure and, if any of the surplus still remains, the balance is paid to the foreclosed holder of the equity of redemption.

5. The facts are the same as Illustration 4 except that instead of granting an easement, the holder of the equity of redemption grants Tenant a leasehold interest in Blackacre. The surplus is first applied to pay Tenant the fair market value of leasehold terminated by the foreclosure and, if any of the surplus still remains, the balance is paid to the foreclosed holder of the equity of redemption.

c. Senior lienors have no lien claim to junior foreclosure surplus. Senior lienors have no lien claim to a surplus produced by the foreclosure of a junior mortgage. Unlike their junior lien counterparts, their liens are unaffected by foreclosure and remain on the foreclosed real estate. They remain free to foreclose on the real estate, and thus there is no justification for transferring any part of their liens to the junior foreclosure surplus. This is true even where obligations secured by senior liens are in default. See Illustration 6.

Illustration:

6. Mortgagee–1 holds a first mortgage on Blackacre for $75,000. Mortgagee–2 holds a second mortgage on Blackacre for $50,000. Mortgagee–3 holds a third mortgage on Blackacre for $10,000. Thereafter the holder of the equity of redemption grants Eaton a roadway easement over Blackacre benefiting Eaton's adjoining land, which easement is junior to the foregoing mortgages. Mortgagee–2 then validly forecloses its mortgage and after its obligation is satisfied by proceeds of sale, a $25,000 surplus remains. This surplus is first applied to satisfy Mortgagee–3's mortgage obligation, then to pay Eaton the fair market value of the easement terminated by the foreclosure, and then, if any of the surplus still remains, the balance is paid to the foreclosed holder of the equity of redemption. Mortgagee–1 has no claim on the surplus.

d. Effect of language in the senior mortgage or other agreement by varying the disposition of surplus. The parties to a senior mortgage may not use mortgage terms or any other agreement to vary the foregoing principles governing the disposition of a surplus. For example, where mortgage language directs that surplus be paid to the "mortgagor" or to the "mortgagor, heirs, successors and assigns," the mortgagor's claim to surplus will not be enhanced. Rather, foreclosed junior lienholders and other junior interests simply will be treated as "successors" or "assigns" of the mortgagor for surplus disposition purposes. See Illustration 7. Even where the senior mortgage states unambiguously that the mortgagor's claim to surplus supersedes those of junior lienors and other foreclosed interests the latter will not lose the benefits conferred on them by this section. See Illustration 8. However, this Comment does not affect the validity of language in a junior mortgage or any other agreement executed contemporaneously with it or thereafter by which the parties to the junior mortgage agree to the disposition of a senior foreclosure surplus. Moreover, in the unique context of wraparound mortgages, a provision allocating the foreclosure surplus to the senior or "underlying" mortgagee is recognized; see § 7.8, Comment *b*.

Illustrations:

7. The following liens exist on Blackacre in order of their priority: a first mortgage in favor of Mortgagee–1 for $75,000; a second mortgage in favor of Mortgagee–2 for $25,000; and a judgment lien in favor of J for $10,000. The first mortgage contains the following term: "In the event this mortgage is foreclosed, after the obligation of this mortgage is satisfied, any surplus will be paid to the mortgagor, heirs, successors, and assigns." Mortgagee–1 validly forecloses its mortgage and the sale yields $105,000. After the first mortgage obligation is satisfied, a $30,000 surplus remains. The surplus is first applied to pay Mortgagee–2's claim in full, and the remaining $5,000 is to be paid to J. The foreclosed holder of the equity of redemption receives nothing.

8. The facts are the same as Illustration 6, except that the first mortgage contains the following term: "In the event this mortgage is foreclosed, after the obligation of this mortgage is satisfied, any surplus shall be paid to the mortgagor and not to the holder of any lien or other interest subordinate to this mortgage." Mortgagee–1 then validly forecloses on its mortgage and the sale yields $105,000. After the first mortgage obligation is satisfied, a $30,000 surplus remains. The surplus is first applied to pay Mortgagee–2's claim in full, and the remaining $5,000 is to be paid to J. The foreclosed holder of the equity of redemption receives nothing.

REPORTERS' NOTE

Foreclosure surplus as the remainder of the security, Comment a. See Morsemere Fed. Sav. & Loan Ass'n v. Nicolaou, 206 N.J.Super. 637, 503 A.2d 392 (1986); Brown v. Crookston Agric. Ass'n, 26 N.W. 907, 907 (Minn. 1886):

> In the contemplation of equity, by the sale of the whole estate, under foreclosure proceedings affecting and binding the junior mortgagee, the land is converted into money, and this fund being treated as a substitute for the mortgaged estate, the lien of the junior mortgagee is transferred from the land to the surplus of the money arising from the sale. The rights of the parties, as they before existed, are not transposed by the sale, and the court will apply the fund in accordance with their rights as they existed in respect to the land.

See Western Sav. Fund Soc'y of Philadelphia v. Goodman, 247 A.2d 151 (N.J. Super. Ct. 1968); Adirondack Trust Company v. Snyder, 518 N.Y.S.2d 337 (N.Y.Sup.Ct.1987); Roosevelt Sav. Bank v. Goldberg, 459 N.Y.S.2d 988 (N.Y.Sup.Ct.1983); First Fed. Sav. & Loan Ass'n v. Brown, 434 N.Y.S.2d 306 (N.Y.App.Div.1980), appeal after remand, 448 N.Y.S.2d 302 (N.Y.App.Div.1982); Mall v. Johnson, 412 N.Y.S.2d 773 (N.Y.Sup.Ct.1979); Security Trust Co. of Rochester v. Miller, 338 N.Y.S.2d 1015 (N.Y.Sup. Ct.1972); Sadow v. Poskin Realty Corp., 312 N.Y.S.2d 901 (N.Y.Sup.Ct. 1970); Third Nat'l Bank v. McCord, 688 S.W.2d 446 (Tenn.Ct.App.1985); In re Roberts, 91 B.R. 57 (E.D.Mo. 1988); Webster v. Wishon, 675 F.Supp. 552 (W.D.Mo.1986); Tobler v. Yoder & Frey Auctioneers, Inc., 462 F.Supp. 788 (S.D.Ga.1978); 1 G. Nelson & D. Whitman, Real Estate Finance Law 669 (3d ed. 1993):

> The major underlying principle is that the surplus represents the remnant of the equity of redemption and security wiped out by the foreclosure. Consequently, the surplus stands in the place of the foreclosed real estate and the liens and interests that previously attached to that real estate now attach to the surplus.

See also 1 G. Glenn, Mortgages 520 (1943):

> In other words, the lien of the junior encumbrancers cannot follow the land because they are parties to the record and the [foreclosure] decree cuts them off from the land, but for that very reason their rights may be asserted against the surplus fund in court.

Foreclosed junior interests entitled to surplus in order of their pre-foreclosure priority, Comment b. For authority that foreclosed interests attach to surplus in order of their pre-foreclosure priority, see cases cited in Reporters' Note to Comment *a*, supra; United States v. Sneed, 620 So.2d 1093 (Fla.Dist.Ct.App.1993); General Bank v. Westbrooke Pointe, Inc., 548 So.2d 736 (Fla.Dist.Ct.App. 1989); First Colonial Bank For Savings v. Bergeron, 646 N.E.2d 758 (Mass.App.Ct.1995); Republic Nat'l Life Ins. Co. v. Lorraine Realty Corp., 279 N.W.2d 349 (Minn.1979); Builders Supply Co. v. Pine Belt Sav. & Loan Ass'n, 369 So.2d 743 (Miss. 1979); Davidson v. D.H. Hansen Ranch, Inc., 766 P.2d 258 (Mont. 1988); Arizona Motor Speedway, Inc. v. Hoppe, 506 N.W.2d 699 (Neb.1993) (relying on Neb. Rev. Stat. § 76–

1011); Banks–Miller Supply Co. v. Smallridge, 175 S.E.2d 446 (W.Va. 1970).

The cases are clear that the foreclosed holder of the equity of redemption's claim to surplus is junior to those of all other valid interests terminated by the foreclosure. See, e.g., Imperial–Yuma Prod. Credit Ass'n v. Nussbaumer, 528 P.2d 871 (Ariz.Ct.App.1974); Pacific Loan Management Corp. v. Superior Court, 242 Cal.Rptr. 547 (Cal. Ct. App. 1987) (junior lienor who created surplus by purchasing at sale of a senior mortgage entitled to surplus as against the mortgagor); General Bank v. Westbrooke Pointe, Inc., 548 So.2d 736 (Fla.Dist.Ct.App.1989); Sens v. Slavia, Inc., 304 So.2d 438 (Fla.1974), on remand, 306 So.2d 550 (Fla.Dist. Ct.App.1975); Kankakee Fed. Sav. and Loan Ass'n v. Mueller, 481 N.E.2d 332 (Ill.Ct.App.1985) (junior mortgagee entitled to surplus as against mortgagors even though junior mortgagee was made a party, but defaulted in the senior foreclosure proceeding); Citibank Nevada v. Wood, 753 P.2d 341 (Nev.1988); Adirondack Trust Co. v. Snyder, 518 N.Y.S.2d 337 (N.Y.Sup.Ct.1987) (junior judgment lienholders prevail over mortgagor as to senior foreclosure surplus); Webster v. Wishon, 675 F.Supp. 552 (W.D.Mo.1986); Note, Rights in the Proceeds of a Foreclosure Sale—The Court Helps Those Who Help Themselves, 51 N.C. L. Rev. 1100 (1973).

There is some disagreement as to whether foreclosed junior lienors should share in surplus where their liens are not in default at the time of foreclosure. Some courts have favored junior lienors in this regard. See Fagan v. People's Sav. & Loan Ass'n, 57 N.W. 142 (Minn.1893); Moss v. Robertson, 77 N.W. 403 (Neb. 1898). A few statutes appear to give junior lienors that are not in default the right to be paid from a surplus. See, e.g., Ariz. Rev. Stat. § 33–727. That is the position of this section. In re Castillian Apartments, 190 S.E.2d 161 (N.C.1972), takes a contrary view, but in a somewhat unique fact situation. In that case a senior mortgage foreclosure produced a substantial surplus. The junior mortgage, however, was not in default and contained no language that would have authorized acceleration whenever a senior lien went into default. In addition, because the junior lien obligation was deemed to be usurious, under local law the lender forfeited all right to receive interest on it. Consequently, the North Carolina Supreme Court approved a lower court determination that the surplus should not be paid to the junior lienor and that it instead should be invested in a certificate of deposit for the junior lienor's benefit but with interest to be paid to the mortgagor.

The situation described in the foregoing paragraph is relatively uncommon for several reasons. First, if the mortgagor has allowed senior debt to go into default and foreclosure, the chances are strong that the junior debt is in default as well. Where this is the case, it would only be in the extremely rare situation where the junior mortgage documents contain no acceleration clause that the junior obligation would not be fully due and owing. Moreover, unsatisfied junior judgment liens are automatically deemed to be in default and fully due and owing. Finally, even if the mortgagor has not otherwise defaulted on junior debt, many junior mortgages provide as a ground for acceleration that any default or foreclosure with respect to a senior encumbrance will give the junior mortgagee the option to accelerate the junior obligation.

Foreclosed junior interests other than junior lienholders are also entitled to share in a senior foreclosure surplus. Such interests include easement holders and junior lessees. See, e.g., Anderman v. 1395 E. 52nd Street Realty Corp., 303 N.Y.S.2d 474 (N.Y.Sup.Ct.1969) (easement holder). The maximum amount of recovery from surplus for such an interest is the fair market value for eminent domain purposes of that interest at the time of foreclosure. As to easement holders, where the easement is appurtenant to a dominant tenement, this amount should be "the difference in the value of the dominant estate with the easement and its value without the easement.... An easement in gross, not being appurtenant to other property, has a market value all its own and may be so evaluated." 4 P. Nichols, The Law of Eminent Domain 12D.02[1] at 12D-5,-6 (Rev. 3d ed. 1993). As to lessees, the foregoing commentator provides the following formula:

> In determining the compensation to which a lessee is entitled it is necessary to compute the value of the use and occupancy of the balance of the lessee's term, taking into consideration the effect thereon of the lessee's right of renewal, if any, and deducting therefrom the agreed rental which the lessee would have paid pursuant to the terms of the lease.

Id., 12D.04[4] at 12D-52. See Bloomfield Township v. Rosanna's, 602 A.2d 751 (N.J. Super. Ct. 1992). Moreover, "most jurisdictions apply a discount factor when considering the present value being apportioned, since the value to the lessee of its unexpired term is measured by the present worth of the excess of fair rental value, or economic rent, over the rental stipulated in the lease, or contract rent, for the remainder of the term." McKirdy, How to Value a Leasehold in an Eminent Domain Case, 10 Prac. Real Est. Law. 11, 12 (1994).

As the foregoing illustrates, this section affords priority claims to surplus only to those who held liens or other interests (such as leases or easements) in the foreclosed real estate. Thus, excluded from this group are the equity of redemption holder's general creditors and those who hold security interests in his or her personal property or other real estate. See Kingsley State Bank v. Waters, 854 P.2d 311 (Kan.Ct.App.1993).

Statutes governing the disposition of foreclosure surplus are common. Some simply codify the principles of this section. See, e.g., Ariz. Rev. Stat. § 33-727 ("If there are other liens on the property sold, or other payments secured by the same mortgage, they shall be paid in their order"); West's Ann. Cal. Civ. Code § 2924j(e) (after payment of expenses and the lien being foreclosed, any excess goes to "satisfy the outstanding balance of obligations secured by any junior liens or encumbrances in order of their priority"); Or. Rev. Stat. § 87.765. Others purport on their face to give the surplus to the holder of the equity of redemption or "his legal representative or assigns" and make no specific reference to the rights of the holders of junior lienholders. See, e.g., Mass. Gen. Law c. 183, § 27; Minn. Stat. Ann. § 580.10; Ind. Code 1971 § 34-1-53-10; West's Rev. Code Wash. Ann. § 61.12.150. However, such statutory language has usually been interpreted to give junior interests rights in the surplus and priority over the holder of the equity of redemption. See, e.g., Brown v. Crookston Agric. Ass'n, 26 N.W. 907, 908 (Minn.1886), where the Minnesota Supreme Court stated:

> The term "assigns" is of sufficiently broad signification to include the second mortgagee. To the word "assignment" this, among other definitions, has been given: "A transfer or making over to another of the whole of any property, real or personal, in possession or in action, or of any estate or right therein," ... and "assigns" has been deemed to comprehend all those who take, either immediately or remotely, from or under the assignor, whether by conveyance, devise, descent, or act of law.... We discover no reason, in view of the very comprehensive meaning of the word "assigns," to suppose that this statute was intended to change the established rule of equity, which was also recognized at law, as to exclude, in favor of the mortgagor, junior encumbrancers from sharing in the surplus proceeds of prior foreclosure sales.

See White v. Shirk, 51 N.E. 126 (Ind. Ct.App.1898); Fuller v. Langum, 33 N.W. 122 (Minn.1887); First Colonial Bank for Savings v. Bergeron, 646 N.E.2d 758 (Mass. Ct. App. 1995) ("The junior mortgagee, of course, is considered to be a successor or assignee of the mortgagor, and therefore is entitled to surplus proceeds under the statute"). A few statutes do not mention priorities, but merely authorize the payment of surplus to the clerk of court. See, e.g., N.J. Stat. Ann. 2A:50–37; Utah Code Ann. § 57–1–29.

If a vendor under a contract for deed forecloses the contract, because this Restatement treats such contracts as mortgages (see § 3.4), any surplus over the amount needed to satisfy the contract balance belongs to the vendee. See Davidson v. D.H. Hansen Ranch, Inc., 766 P.2d 258 (Mont.1988). However, if there are liens on the vendee's interest, those lienors have priority over the vendee as to any such surplus. 1 G. Nelson & D. Whitman, Real Estate Finance Law 669 n.2 (3d ed. 1993).

Senior lienors have no lien claim to junior foreclosure surplus, Comment c. Because senior liens are unaffected by the foreclosure of a junior mortgage, they have no right to share in the surplus. See Bohra v. Montgomery, 792 S.W.2d 360 (Ark.Ct.App. 1990); Walsky v. Fairmont Arms, Inc., 276 N.Y.S.2d 931 (N.Y.App.Div. 1967); Armand's Engr'g, Inc. v. Town and Country Club, Inc., 324 A.2d 334 (R.I.1974); First Wisconsin Trust Co. v. Rosen, 422 N.W.2d 128, review denied, 428 N.W.2d 554 (Wis.1988) (holders of senior real estate tax liens not entitled to share in surplus created by foreclosure of junior mortgage); United States v. Sage, 566 F.2d 1114 (9th Cir.1977). Cf. Davis v. Huntsville Prod. Credit Ass'n, 481 So.2d 1103 (Ala.1985) ("A first mortgagee has no right to any surplus upon foreclosure of the second mortgage, particularly in the absence of default of the first mortgage").

A typical case is *Armand's Engr'g, Inc.*, supra. There the foreclosed mortgagor was insolvent and two senior mortgagees attempted to utilize the surplus created by the foreclosure of a junior mortgage to pay down part of the senior mortgage debt. The court held that since the senior liens were unaffected by the foreclosure, they had no right to the surplus.

Occasionally, a court, in "special circumstances," may award surplus to a non-foreclosing senior lienor. In one case, where the trustee under the deed of trust and the foreclosure purchaser-junior lienor agreed prior to the foreclosure sale that the purchase price would include an amount necessary to discharge a defaulted senior mortgage, it was held that the trustee was justified in paying the excess over the junior mortgage obligation to the senior lienor rather than the mortgagor. Shaikh v. Burwell, 412 S.E.2d 924 (N.C.Ct.App.1992), review denied, 418 S.E.2d 667 (N.C.1992). See also Kaplan v. Ruffin, 193 S.E.2d 689 (Va.1973). Cf. Jefferson v. Berks Title Ins. Co., 472 A.2d 893, 894 (D.C.App.1984), for the questionable statement that "if there is a senior encumbrance or lien on the property, such as the federal estate tax lien in this case, the trustee must satisfy that lien before applying the sale proceeds to the obligation secured by the deed of trust."

Effect of language in the senior mortgage or other agreement varying the disposition of surplus, Comment d. Mortgagor and mortgagee may not use mortgage language or any other agreement to vary the disposition of surplus provided for in the rules enunciated by this section. For example, mortgage language commonly directs that surplus be paid to the "mortgagor" or to the "mortgagor, heirs, successors and assigns," and makes no specific mention of junior lienholders and other junior interests. As in the case of statutes that are similarly worded (see Reporters' Note, Comment *b*, supra), courts should treat junior encumbrancers as the mortgagor's consensual "assigns" or as "assigns" by operation of law, and grant them priority over the mortgagor. See Webster v. Wishon, 675 F.Supp. 552 (W.D.Mo.1986) ("Junior encumbrancers will take precedence over the mortgagor, as regards the right to have their demands paid out of surplus, because the execution of a junior mortgage amounts to an assignment of the mortgagor's equity of redemption to the junior mortgagee and of the assignor's right in equity to the surplus in case of a sale under the prior encumbrance"). Other decisions have simply refused without analysis to prefer the mortgagor over a junior lienor where mortgage language directed that surplus be paid to the "mortgagor." See In re Roberts, 91 B.R. 57 (E.D.Mo.1988); Boedeker v. Jordan, 79 B.R. 843 (E.D.Mo.1986).

Moreover, as Illustration 7 exemplifies, even if the terms of the senior mortgage grant exclusive surplus rights to the holder of the equity of redemption and specifically deny such rights to other foreclosed junior interests, that language will be ineffective. This result is supported by logic and sound policy. To be sure, such language on its face purports to reserve for the mortgagor the right to any senior foreclosure surplus and to deny access to it by foreclosed junior mortgagees and other junior interests. However, having reserved the right to that senior surplus, mortgagor clearly remains free to assign that right thereafter. Thus, any subsequent creation by the mortgagor of a junior mortgage or other consensual junior interest in the real estate surely carries with it an assignment by mortgagor to those junior parties of the right to any senior surplus. Only specific language in the *junior* mortgage reserving for mortgagor the right to senior surplus will accomplish mortgagor's intended purpose.

Moreover, the foregoing senior mortgage language should be equally ineffective against judgment and other nonconsensual junior lienors. Judgment lien legislation in virtually every jurisdiction provides that a general creditor who reduces its claim to judgment and takes the appropriate post-judgment procedural steps sbould be favored with a lien on the debtor's real estate. Moreover, because foreclosure surplus represents a substitute "res" or what remains of the debtor's real estate, it clearly is "real estate" for purposes of judgment lien legislation. To enforce language in a senior mortgage that purports to prevent a judgment lien from attaching to that surplus would be to sanction the use of contract language to impede, if not destroy, the effectiveness of judgment lien legislation. Surely such an attempt to deprive the intended beneficiary of that legislation of its benefits violates public policy and is therefore ineffective.

§ 7.5 Mortgaging After-Acquired Real Estate

(a) An "after-acquired property provision" is any language in a mortgage that purports to be effective against any other parcel of real estate that mortgagor subsequently acquires.

(b) An after-acquired property provision is effective between mortgagor and mortgagee. As to third persons who take an interest in any parcel of real estate subsequently acquired by the mortgagor, the provision is treated as unrecorded until a notice is recorded that

(1) specifically identifies the subsequently acquired real estate,

(2) refers to the mortgage containing the provision, and

(3) is in a form that provides record notice under local law.

However, the lien created by such a provision is junior to any purchase money mortgage, as defined in § 7.2, on mortgagor's after-acquired real estate.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 7.2, Purchase Money Mortgage Priority; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; § 7.4, Effect of Priority on the Disposition of Foreclosure Surplus; § 7.7, Subordination.

Comment:

a. Scope of section. In a limited sense, every mortgage on real estate is also a mortgage on after-acquired property. To the extent that a mortgagor makes improvements on a mortgaged tract of land, they are subjected to the mortgage on that tract. However, this is the result of the doctrine of accession or the law of fixtures, rather than the law governing after-acquired property provisions. In the sense used in this section, an after-acquired property mortgage provision purports to give the mortgagee not only a lien on the mortgagor's specifically described real estate, but also on other *parcels or tracts of land* that the mortgagor subsequently acquires.

This section also does not deal with a provision in a mortgage on a specific parcel of real estate that purports to mortgage any other interest in the *same* real estate that mortgagor subsequently acquires. Thus, for example, it does not deal with a mortgage that not only encumbers mortgagor's presently owned leasehold interest in Blackacre but, in addition, contains language that purports to mortgage any interest in the fee estate or reversion that mortgagor may subsequently acquire. Because such provisions cover after-acquired interests in the same real estate described in the original mortgage, they do not present the complex chain of title and related recording act problems that are inherent in mortgage language that purports to cover separate parcels thereafter acquired by mortgagor.

b. Effectiveness of after-acquired real estate provision between mortgagor and mortgagee. An after-acquired property provision is effective between the mortgagor and mortgagee. This is the case even though the subsequently acquired real estate is located in a different county or state than the real estate originally mortgaged. See Illustration 1. This result is justified on a "specific performance" theory; the provision is treated as a promise to mortgage after-acquired real estate that will be specifically enforced when the mortgagor acquires title to it.

Illustration:

1. Mortgagor borrows $20,000 from Mortgagee and gives Mortgagee a promissory note for that amount secured by a mortgage on Blackacre, land located in Able County in State X. The mortgage contains the following provision: "The lien of this mortgage is effective against any real estate, wherever situated, hereafter acquired by Mortgagor so long as the obligation secured hereby remains unsatisfied." The mortgage is promptly recorded. A year later, Mortgagor acquires title to Whiteacre, real estate located either in State Y or in Baker county in State X. Assuming the mortgage obligation remains unsatisfied, the mortgage attaches to Whiteacre.

c. Effect of treating mortgage containing after-acquired property provision as unrecorded as against those acquiring interests in mortgagor's after-acquired real estate. Under Subsection (b), an after-acquired property provision in a mortgage is treated as unrecorded as against a person taking an interest in the after-acquired parcel of real estate after the mortgagor acquires title to it, even though the mortgage containing the provision is in fact recorded. Thus, although the lien of the mortgage containing the provision attaches to the subsequently acquired real estate, it may be junior to the interests of subsequent takers. Whether this subordination to later takers occurs will depend on the qualifications of such takers under the recording act of the particular jurisdiction. For example, under recording acts of the notice type, the mortgagee's lien on after-acquired property will be subordinate to the interest of any person who pays value for the real estate and lacks notice of the after-acquired property provision. This will be the case whether the subsequent taker acquires a lien, lease, easement, or any other interest in the after-acquired real estate. See Illustrations 2–5. On the other hand, the mortgagee's after-acquired property lien will be senior to any interest in an after-acquired parcel of a donee from the mortgagor. See Illustration 6.

The foregoing approach is grounded in the recording acts and is consistent with traditional title examination practice. As a general rule, recorded documents are treated as unrecorded if a person acquiring an interest in the land could not have discovered them by a reasonably diligent search of the records. This is sometimes explained by saying that a person examining title should not be responsible for a document that is not in the "chain of title" of the real estate being examined. After-acquired property clauses are especially troublesome in this context. While it is true that the mortgage containing the after-acquired property provision is almost always recorded, it will contain a legal description only of the original mortgaged real estate. Hence, one acquiring an interest in *other* real estate—namely, the after-acquired parcel—ordinarily cannot find the mortgage with a reasonably diligent search. To be sure, a title examiner could use a county's grantor-grantee index to discover every mortgage the proposed borrower may have previously executed with respect to any real estate in that particular county. Each such mortgage then could be examined to determine if it contained an after-acquired property provision. However, such a search would be unduly burdensome, and it would be unreasonable to impose such an obligation on title examiners. Indeed, even if such an obligation were imposed, it would do no good if the after-acquired parcel were located in a different county than the county in which the mortgage was recorded.

Illustrations:

2. Mortgagor borrows $20,000 from Mortgagee–1 and gives Mortgagee–1 a promissory note for that amount secured by a mortgage on Blackacre, land located in Able County in State X, which has a notice or notice-race type of recording act. The mortgage contains the following provision: "The lien of this mortgage is effective against any real estate, wherever situated, hereafter acquired by mortgagor so long as the obligation secured hereby remains unsatisfied." The mortgage is promptly recorded. Several months later Mortgagor takes delivery of a deed by which Mortgagor acquires title to Whiteacre, land located in the same county and state as Blackacre. The deed is promptly recorded. Two months thereafter, mortgagor borrows $10,000 from Mortgagee–2 and gives Mortgagee–2 a promissory note for that amount secured by a mortgage on Whiteacre. Mortgagee–2 takes its mortgage having no actual knowledge of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee–2 promptly records its mortgage. Mortgagee–1 has a valid lien on Whiteacre, but it is junior to Mortgagee–2's mortgage.

3. The facts are the same as Illustration 2, except that Mortgagee–2 takes its mortgage on Whiteacre with actual knowledge of the existence of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee–1 has a valid lien on Whiteacre and it is senior to Mortgagee–2's mortgage.

4. The facts are the same as Illustration 2, except that instead of giving a mortgage on Whiteacre to Mortgagee–2, Mortgagor, for a valuable consideration, delivers to Tenant a 10–year lease on Whiteacre. Tenant takes the lease having no actual knowledge of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee–1 has a valid lien on Whiteacre, but it is junior to Tenant's lease.

5. The facts are the same as Illustration 4, except that Tenant takes the lease on Whiteacre with actual knowledge of the existence of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee–1 has a valid lien on Whiteacre and it is senior to Tenant's lease.

6. The facts are the same as Illustration 2, except that instead of giving a mortgage on Whiteacre to Mortgagee–2, Mortgagor grants to E a roadway easement over Whiteacre. E has no actual knowledge of the after-acquired property provision contained in the mortgage on Blackacre, but pays no value for the easement. Mortgagee–1 has a valid lien on Whiteacre and it is senior to E's easement.

d. Effect of recording of notice by after-acquired property mortgagee. A recorded mortgage containing an after-acquired property provision is treated as unrecorded as against those who later take interests in the after-acquired real estate. See Comment *c*, supra. Nevertheless, once the mortgagor acquires such real estate, the mortgagee may obviate that problem by recording a notice which specifically describes the parcel of after-acquired real estate, refers to the mortgage, and is in a form that provides record notice under local law. When such a notice is recorded, the after-acquired property provision becomes part of the chain of title of the after-acquired parcel, and interests in that real estate that arise thereafter will be junior to the lien of the after-acquired property provision. See Illustrations 7–8.

The mortgagee may also satisfy the notice requirement of Subsection (b) by ensuring that language specifically referring to the mortgage containing the after-acquired property provision is included in the recorded deed by which the mortgagor acquires additional real estate. See Illustration 9.

Illustrations:

7. The facts are the same as Illustration 2, except that after Mortgagor acquires title to Whiteacre, but before Mortgagor gives Mortgagee–2 the promissory note and mortgage on Whiteacre, Mortgagee–1 records a notice that specifically describes Whiteacre, refers to the mortgage containing the after-acquired property provision, and is in a form that provides record notice under local law. Mortgagee–1 has a valid lien on Whiteacre and it is senior to Mortgagee–2's mortgage.

8. The facts are the same as Illustration 4 except that after Mortgagor acquires title to Whiteacre, but before mortgagor gives Tenant the lease on Whiteacre, Mortgagee–1 records a notice that specifically describes Whiteacre, refers to the mortgage containing the after-acquired property provision, and is in a form that provides record notice under local law. Mortgagee has a valid lien on Whiteacre and it is senior to Tenant's lease.

9. The facts are the same as Illustration 2, except that the deed by which Mortgagor obtains title to Whiteacre contains language referring to the mortgage containing the after-acquired property provision. Mortgagee–1 has a valid lien on Whiteacre and it is senior to Mortgagee–2's mortgage.

e. Purchase money mortgage priority over lien arising under after-acquired property provision. Under § 7.2(b) a purchase money mortgage "has priority over any mortgage, lien, or other claim" attaching to the real estate that arose against the purchaser-mortgagor prior to the latter's acquisition of title. See § 7.2(b), supra. Because an after-acquired property provision operates as a "mortgage, lien, or other claim" arising through a mortgagor-purchaser before the latter's acquisition of title, a purchase money mortgage, whether given to a vendor or a third party, will be senior to the lien created by mortgagor's previously executed after-acquired property provision. Moreover, the foregoing result is not altered by the fact that the purchase money mortgagee takes its mortgage with actual knowledge of the after-acquired property provision. See Illustrations 10–11. Nor will the recording by the after-acquired property mortgagee of the notice authorized in § 7.5(c) jeopardize the priority of the purchase money mortgagee. See Illustration 12.

This result is supported by the same policy concerns that underlie the general rule granting priority to vendor and third party purchase money mortgages over earlier interests arising through the purchaser-mortgagor. The application of the rule in the after-acquired property context clearly supports the socially desirable goal of expanding the availability of purchase money financing. See § 7.2, Comment *b*. Similarly, general fairness arguments are equally strong in this setting. Because the after-acquired property provision is executed before the mortgagor acquires the real estate to which the provision subsequently attaches, it will, in most instances, be difficult to assert that the after-acquired property mortgagee relied on that real estate in extending credit to mortgagor. But for the willingness of the vendor-mortgagee to part with the real estate, it would have been completely unavailable to the after-acquired property mortgagee for the satisfaction of its claim. The position of the third party purchase money mortgagee is equally strong. Without its advance of money to the mortgagor, the latter would not have acquired title to the real estate and the lien created by the after-acquired property provision would not have attached to it. Preferring the purchase money mortgagee in both instances avoids conferring a windfall on the after-acquired property mortgagee.

Illustrations:

10. Mortgagor borrows $20,000 from Mortgagee and gives Mortgagee a promissory note for that amount secured by a mortgage on Blackacre. The mortgage contains the following provision: "The lien of this mortgage is effective against any real estate, wherever situated, hereafter acquired by mortgagor so long as the obligation secured hereunder remains unsatisfied." The mortgage is promptly recorded. Several months later Mort-

gagor acquires title to Whiteacre, land located in the same county and state as Blackacre, from V. Mortgagor pays V part of the purchase price in cash and the remainder by giving V a promissory note secured by a mortgage on Whiteacre. At the time of V's conveyance to Mortgagor, V has actual knowledge of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee has a valid lien on Whiteacre, but it is junior to V's mortgage.

11. The facts are the same as Illustration 10, except the remainder of the purchase price for Whiteacre is financed by giving a mortgage on Whiteacre to Bank, rather than to V. At the time of taking its mortgage on Whiteacre, Bank has actual knowledge of the after-acquired property provision contained in the mortgage on Blackacre. Mortgagee has a valid lien on Whiteacre, but it is junior to Bank's mortgage.

12. The facts are the same as Illustration 10, except that a few days before Mortgagor takes the conveyance of Whiteacre, Mortgagee learns that Mortgagor will acquire Whiteacre and records a notice which specifically describes Whiteacre, refers to the mortgage containing the after-acquired property provision, and is in a form that provides record notice under local law. Mortgagee has a valid lien on Whiteacre, but it is junior to V's mortgage.

REPORTERS' NOTE

Scope of section, Comment a. See G. Glenn, Mortgages §§ 409–432 (1943); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 9.3 (3d ed. 1993); Arnold, After-Acquired Property as Mortgage Security in Maryland, 19 Md. L. Rev. 294 (1959); Cohen & Gerber, The After-Acquired Property Clause, 87 U. Pa. L. Rev. 635 (1939); Cunningham & Tischler, Equitable Real Estate Mortgages, 17 Rutgers L. Rev. 679, 715–723 (1963); Ethridge, The After-Acquired Property Doctrine and Its Application in Mississippi, 17 Miss. L. J. 153 (1945); Francis, Mortgages of After-Acquired Property in Kentucky, 35 Ky. L. J. 320 (1947); Note, Mortgages—After-Acquired Property Clause in Mortgage Is Valid, 28 Rocky Mtn. L. Rev. 432 (1956); Note, After-Acquired Property and the Title Search, 24 Fordham L. Rev. 412 (1955).

One commentary describes the relationship of the accession concept to the law of mortgages on after-acquired real estate as follows:

> In considering the impact of after-acquired property clauses on real estate, it is important to distinguish between the mortgagor's placing of improvements on Blackacre, the land described in the mortgage, and the subsequent acquisition by the mortgagor of Whiteacre. While an after-acquired property clause is necessary to reach Whiteacre it is not, because of the accession con-

cept, with respect to the subsequent improvements on Blackacre.

1 G. Nelson & D. Whitman, Real Estate Finance Law 811 (3d ed. 1993). Professor Glenn analyzes the relationship in a similar fashion:

> Now when a thing is thus owned by the mortgagor and is then affixed to the land, the benefit passes to the mortgagee as part of his security. As was said in a leading case, "No one ever doubted that a mortgage of land bound a house subsequently built upon it, nor that it bound anything originally personal which became afterward part of the land." (quoting from Hoyle v. Plattsburgh M.R., 54 N.Y. 314 (1873)). Thus it cannot be denied that if the mortgagor brings upon the premises a thing which by its own nature becomes part of the land by virtue of the law of real property, the mortgagee may enjoy the resulting benefit without the need of an after-acquired property clause.

2 G. Glenn, Mortgages 1450 (1943). See Horizon Bank v. Sigrist, 579 N.Y.S.2d 279 (N.Y.App.Div.1992) ("It is axiomatic that a mortgagee of real property is entitled to have his lien respected, not only concerning all that was realty when the mortgage was executed, but also concerning all accession to the realty"); In re Rebel Mfg. and Mktg. Corp., 54 B.R. 674 (Bankr.S.C.1985) (real estate mortgage deemed to cover mobile home that was subsequently affixed to the mortgaged real estate and that under state law was deemed a fixture).

Effectiveness of after-acquired real estate provision between mortgagor and mortgagee, Comment b. The history and status of after-acquired property provisions is complex and often contradictory. As Cunningham and Tischler point out,

> In ... some ... states, the after-acquired property clause is effective to create an equitable lien upon both real and personal property subsequently acquired by the mortgagor regardless of the character of the business in which the mortgagor is engaged, provided the new property bears a functional relation to the property originally mortgaged. In other states the after-acquired property clause is effective to create an equitable lien upon both realty and personalty if the mortgagor is a railroad or other public utility company, but is effective only with respect to realty if not within that class.

Cunningham & Tischler, Equitable Real Estate Mortgages, 17 Rutgers L. Rev. 679, 718 (1963). In addition, there is authority that "to put the after-acquired property clause into effect, the mortgagee must show that the subsequently acquired property bears practical relation to the property which was presently conveyed under the mortgage." 3 G. Glenn, Mortgages 1649 (1943). Nevertheless, there are cases (albeit a small number) that take the position that such provisions are effective between the parties as to after-acquired real estate, if not personalty, without regard to "practical relation" considerations. See J. H. Dowling, Inc. v. First Fed. Sav. and Loan Ass'n, 502 So.2d 1306 (Fla.Dist.Ct.App.1987) (after-acquired property clause covered adjoining real estate not described in the mortgage but subsequently acquired by mortgagor and its lien was superior to that of a judgment creditor of the mortgagor who had actual knowledge of the after-acquired property mortgage); American Nat'l Bank v. International Harvester Credit Corp., 269 So.2d 726 (Fla.Dist.Ct.App.1972) (dictum); Rose v. Lurton Co., 149 So. 557 (Fla.1933); Hickson Lumber Co. v. Gay Lumber Co., 63 S.E. 1045 (N.C. 1909); Franklin v. Community Fed. Sav. & Loan Ass'n, 629 F.2d 514 (8th Cir.1980) (after-acquired property clauses extend only to "other real estate or fixtures and attachments to the mortgaged real estate.").

The position of this section is largely consistent with the Uniform Land Security Interest Act (U.L.S.I.A.), promulgated by the National Conference of Commissioners on Uniform State Laws in 1985. U.L.S.I.A. expressly recognizes the validity of an after-acquired property provision between mortgagor and mortgagee except in certain situations where the mortgagor is giving real estate security for residential real estate that he or she will or does occupy. U.L.S.I.A. § 205(a). In the latter situation, "no security attaches to after-acquired land ... unless the land is contiguous to the original collateral or is described in the security agreement and is contemplated as additional security." U.L.S.I.A. § 205, Comment 2. Moreover, U.L.S.I.A. does not require that the subsequently acquired real estate bear a "practical relation" to the real estate specifically described in the mortgage.

The Uniform Commercial Code recognizes the validity of after-acquired property provisions in chattel security agreements. See U.C.C. § 9-204(1) (1995). However, such provisions are ineffective as to goods "used or bought for use primarily for personal, family or household purposes" unless the mortgagor acquires them within 10 days after the mortgagee gives value. See U.C.C. §§ 9-204(2) (1995), 9-109(1) (1995).

Effect of treating mortgage containing after-acquired property provision as unrecorded as against those acquiring interests in mortgagor's after-acquired real estate, Comment c. There is isolated case authority that a mortgage containing an after-acquired property provision, once recorded, is "valid and enforceable against subsequent purchasers, because the registration is effectual notice as against the world." Hickson Lumber Co. v. Gay Lumber Co., 63 S.E. 1045 (N.C.1909). However, it is extremely difficult to conclude that the mortgage containing the after-acquired property provision is in the chain of title to the after-acquired real estate or that it will be disclosed by a reasonable title examination of the latter real estate. The *Hickson* "notice as against the world" approach surely is incorrect. Professor Glenn so concluded:

> Here two cases can arise: the new land may be located in the same county where the mortgaged land lies, or it may be in a county where the mortgage was never recorded. In each case, let us put the question, does the record of the mortgage afford statutory notice of the after-acquired property clause, to anyone who purchases the new land from the mortgagor?
>
> (A) There is an immediate answer where the new land lies in a county where the mortgage was never recorded. That answer is No, because the record in each county relates only to land within the county, and thus a title search could never turn up the original mortgage. Nor will it do the mortgagee any good to record his mortgage in any county or state where he imagines the mortgagor will later pick up some land. Such a re-

cording will be ineffective because, as the mortgage does not presently pass land in this county or State, there is nothing to record in legal contemplation. For it seems clear that a deed or mortgage cannot be recorded in gross, in the hope that land will later come into the mortgagor's hands and will then be transferred under the mortgage. The instrument can be recorded, indeed, but it will never afford statutory notice as to property later acquired.

(B) Let us take the case of subsequent land which lies within the same county where a mortgage has been duly recorded as covering the land presently conveyed. Here the mortgage is of record all right, but the difficulty is that it will not show up in the chain of title that relates to the new property. To say, then, that the purchaser of this new property is bound by the after-acquired property clause in the mortgage is to assert that the purchaser must examine every mortgage of record that the proposed borrower may have executed at any time previously.

Some courts in effect impose that requirement, but the reasons advanced are not satisfactory. It does not settle the question to say that the mortgage, once recorded, is "valid and enforceable against subsequent purchasers, because the registration is effectual notice as against the world." It is better to say that the purchaser is not bound by statutory notice, because that notice affects only the new land which the purchaser is examining, and he is not required to search the records for mortgages of other property, merely because they may happen to have been made by the same would be grantor.

3 G. Glenn, Mortgages 1657–1659 (1943). For a similar analysis, see 1 G. Nelson & D. Whitman, Real Estate Finance Law 812–813 (3d ed. 1993).

The foregoing situation is largely analogous to the "after-acquired title" or "estoppel by deed" chain of title problem, which is described as follows:

> Imagine that B purports to deed ... land to X before B has any title, and X immediately records the deed. Later B acquires the title from A. The doctrine of estoppel by deed is usually held to pass title to X instantly on these facts, at least if the B–X deed contained warranties or represented that title was being conveyed. But if B later purports to convey to C, the question is raised whether C's title searcher can be expected to find the B–X deed. This is not impossible, but to do so the searcher must examine the grantor index under B's name not only during the time B owned the land, but for a lengthy and burdensome prior period as well, in order to account for the possibility that B made an adverse conveyance before acquiring title. Most of the recent cases have excused the searcher from this obligation.

R. Cunningham, W. Stoebuck & D. Whitman, The Law of Property 852 (2d ed. 1993). For cases supporting the foregoing analysis, see Southeastern Sav. & Loan Ass'n v. Rentenbach Constructors, Inc., 114 B.R. 441 (E.D.N.C.1989), aff'd, 907 F.2d 1139 (4th Cir. 1990) (early-recorded deed is treated as unrecorded); Far West Savings & Loan Ass'n v. McLaughlin, 246 Cal.Rptr. 872 (Cal.Ct.App.1988) (same); Schuman v. Roger Baker & Assoc., 319 S.E.2d 308 (N.C.Ct.App. 1984) (same); Security Pacific Fin. Corp. v. Taylor, 474 A.2d 1096 (N.J. Super. Ct. 1984) (same). If under the foregoing principle an early recorded deed that specifically describes the real estate does not afford constructive notice to subsequent takers, surely an after-acquired property mortgage on Blackacre that does not contain a legal description of Whiteacre will not provide such notice to subsequent persons who take liens and other interests in Whiteacre.

Some states partially avoid the foregoing problem by enacting special recording statutes that apply only to certain narrowly defined classes of mortgagors such as public utilities or similar business entities. Under such legislation, the recording in a specific county of a mortgage containing an after-acquired property provision will be effective against those who take a lien or other interest in any real estate in that county that mortgagor thereafter acquires. See, e.g., S.C. Code Ann. § 29-3-80 (applicable only to mortgagors that are gas or electrical utilities or electric cooperatives). This priority for the after-acquired property mortgagee applies even though the after-acquired property provision contains only a general description that refers simply to "all real property or real property interests * * * acquired hereafter * * *." S.C. Code Ann. § 29-3-90(A).

Effect of recording of notice by after-acquired property mortgagee, Comment d. Although the recordation of the original mortgage containing an after-acquired property provision will not provide constructive notice te those who take subsequent interests from mortgagor in after-acquired real estate, a recorded notice that (1) refers to the earlier mortgage, (2) specifically describes the after-acquired real estate, and (3) is in a form that provides record notice under local law, will afford such notice. As one recent California decision stated, albeit in the early-recorded deed context,

> The second grantee who purchases for value and records first will prevail by virtue of the terms of the recording statute.... He has no constructive notice of the deed to the first grantee, for the record of such deed, made before the grantor had title, *is not in the chain of title.* For the first grantee to prevail he would have to have recorded his deed *again* (1) *after* record title had come to his grantor and (2) *before* the second grantee had given value. [Emphasis added.]

Far West Sav. & Loan Ass'n v. McLaughlin, 246 Cal.Rptr. 872, 876 (Cal.Ct.App.1988) (emphasis in original). Applying the foregoing reasoning to the after-acquired mortgage setting, once the mortgagor acquires title to the after-acquired real estate, a second recording, this time specifically describing that real estate, will provide effective notice to those who later take interests in it.

Of course, as Comment *d* also illustrates, the recording of the separate notice by the mortgagee is unnecessary if the deed by which the mortgagor receives the additional real estate specifically refers to the mortgage containing the after-acquired property provision. Support for this latter concept and Illustration 9 is found in S.C. Code Ann. § 29-3-90(C), although the latter statute is applicable only to mortgagors who are gas or electrical utilities or electric cooperatives.

Purchase money mortgage priority over lien arising under after-acquired property provision, Comment e. There is significant authority that a purchase money mortgage is superior to a lien arising under an after-acquired property provision. See Faulkner County Bank v. Vail, 293 S.W. 40 (Ark.1927); Associates Discount Corp. v. Gomes, 338 So.2d 552 (Fla.Dist.Ct. App.1976) (dictum); Pinellas County v. Clearwater Federal Sav. & Loan Ass'n, 214 So.2d 525 (Fla.Dist.Ct.App. 1968) (dictum); Fleet Mortgage Corp. v. Stevenson, 575 A.2d 63 (N.J. Super. 1990) (dictum); Chase Nat'l Bank v. Sweezy, 281 N.Y.S. 487 (1931), aff'd, 261 N.Y. 710, 185 N.E. 803 (1933); United States v. New Orleans & Ohio R.R., 79 U.S. (12 Wall.) 362 (1870); 1 G. Nelson & D. Whitman, Real Estate Finance Law 802 (3d ed. 1993); Comment, Mortgages—After-Acquired Property Clause in Mortgage is Valid, 28 Rocky Mtn. L. Rev. 432, 433 (1956). Contra, Hickson Lumber Co. v. Gay Lumber Co., 63 S.E. 1048 (N.C.1909). Moreover, this priority should not be defeated by the fact that purchase money mortgagee takes its mortgage with actual knowledge of the after-acquired property provision. Cf. Brock v. First South Sav. Ass'n in Receivership, 10 Cal. Rptr.2d 700 (Cal.Ct.App.1992) (actual knowledge of vendor's lien does not defeat purchase money mortgagee's priority over it).

§ 7.6 Subrogation

(a) One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.

(b) By way of illustration, subrogation is appropriate to prevent unjust enrichment if the person seeking subrogation performs the obligation:

(1) in order to protect his or her interest;

(2) under a legal duty to do so;

(3) on account of misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition; or

(4) upon a request from the obligor or the obligor's successor to do so, if the person performing was promised repayment and reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will not materially prejudice the holders of intervening interests in the real estate.

Cross-References:

Section 2.2, Expenditures for Protection of the Security; § 5.1, Transfers with Assumption of Liability; § 5.2, Transfers Without Assumption of Liability; § 5.3, Discharge of Transferor from Personal Liability; § 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests; § 8.6, Marshaling: Order of Foreclosure on Multiple Parcels; Restatement Third, Suretyship and Guaranty § 28.

Comment:

a. Introductory note. Subrogation is an equitable remedy designed to avoid a person's receiving an unearned windfall at the expense of another. It may arise when one pays or performs in full an obligation owed by another and secured by a mortgage. The effect of subrogation is to assign the mortgage and the obligation to the person performing (termed the "payor" in this Comment) by operation of law, rather than discharging them. The payor thus becomes the subrogee. After performing the obligation, the subrogee is entitled to receive upon request a formal written assignment of these rights. Such an assignment may be placed in the public records and may be helpful in ensuring that others recognize the subrogee's rights. See § 6.4(f).

Subrogation may also occur by voluntary assignment or agreement between the mortgagee and the payor. This is commonly termed "conventional subrogation." However, subrogation imposed as an equitable remedy, often but perhaps inaptly called "legal subrogation," is the subject matter of this section.

The principle of subrogation is applicable to both secured and unsecured obligations. Subrogation to an unsecured obligation may be appropriate where the subrogee has discharged that obligation under circumstances in which it would be unjust to deny the subrogee the right to recover on the obligation against the debtor or obligor. However, the concern of this section is with obligations secured by mortgages. Ordinarily one who is entitled to subrogation is permitted to enforce both the mortgage and the secured obligation. Of course, subrogation does not make anyone liable on the obligation who was not liable before; thus the subrogee may be able to enforce the mortgage against numerous persons, such as holders of junior liens, who have no liability on the obligation.

Subrogation to a mortgage is usually of importance only when a subordinate lien or other junior interest exists on the real estate. If no such interest existed, the subrogee could simply sue on the obligation, obtain a judgment lien against the real estate, and execute on it. However, if an interest exists that is subordinate to the mortgage in favor of some other person, such a judgment lien would be inferior to it in priority and might have little or no value. In this setting the subrogee wants more than a lien; he or she wants a lien with the priority of the original mortgage, and this is precisely what subrogation gives. The holders of intervening interests can hardly complain about this result, for they are no worse off than before the senior obligation was discharged. If there were no subrogation, such junior interests would be promoted in priority, giving them an unwarranted and unjust windfall.

Where subrogation to a mortgage is sought, the entire obligation secured by the mortgage must be discharged. Partial subrogation to a mortgage is not permitted. The reason is that partial subrogation would have the effect of dividing the security between the original obligee and the subrogee, imposing unexpected burdens and potential complexities of division of the security and marshaling upon the original mortgagee. However, if the payor can negotiate a full settlement of the obligation for less than its face value, subrogation will be recognized.

While a subordinate mortgagee who makes partial payments on a prior mortgage (for example, to cure a default in payment of an installment by the mortgagor) may not have subrogation, such a mortgagee may add the payment to the balance owing on the subordinate mortgage, and may recover it in foreclosure or in an action on the debt or for reimbursement of the payment, as appropriate. See § 2.2. The payor may also have an independent claim for restitution to prevent unjust enrichment.

Subrogation is a broad concept, and the situations described in Subsection (b) of this section do not necessarily exhaust it. They should be regarded as illustrative, as should the following comments. Additional situations may arise, beyond those discussed here, in which one who performs a mortgage is entitled to subrogation in order to avoid unjust enrichment.

b. Performance to protect an interest. A person's interest in real estate may be jeopardized by the threat of foreclosure of a prior mortgage. Performing that mortgage obligation may be the only or most feasible means of protecting the interest. Hence one who engages in such performance is subrogated to the mortgage and to the debt discharged. See Illustrations 1 and 2.

Illustrations:

1. Blackacre is owned by Mortgagor, subject to two mortgages held respectively by Mortgagee–1 and Mortgagee–2. Mortgagor defaults on the obligation secured by the first mortgage and Mortgagee–1 threatens foreclosure. Mortgagee–2, learning of these facts, pays Mortgagee–1's debt in full. Mortgagee–2 is

subrogated to the mortgage and to the debt it secures, and may enforce them against Mortgagor and Blackacre.

2. Blackacre is owned by Mortgagor, subject to a mortgage held by Mortgagee and to a subordinate lease held by Lessee. Mortgagor defaults in payment on the obligation secured by the mortgage, and Mortgagee threatens foreclosure. Lessee, learning of these facts, pays Mortgagee's debt in full. Lessee is subrogated to the mortgage and te the debt it secures, and may enforce them against Mortgagor and Blackacre.

Subrogation is unavailable to a person performing the mortgage obligation to the extent that he or she was primarily responsible for it. The point of subrogation is to prevent unjust enrichment of others, not to compensate one who has paid a debt that in fairness he or she should have paid. Thus, although the subrogee must discharge the entire obligation in order to have the right of subrogation, subrogation will be granted for only the part of the obligation for which the subrogee was not primarily responsible. See Illustrations 3 through 5. As Illustration 3 suggests, one may be primarily responsible for the obligation without necessarily having personal liability on it.

Illustrations:

3. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee, but neither A nor B is personally liable on the mortgage debt. A and B are equal tenants in common, and under applicable law are equally responsible with respect to one another to pay the debt, so that either who pays is entitled to contribution from the other for one-half of the payment. Hence each is primarily responsible for one-half of the mortgage debt. A refuses to pay any part of the debt, and Mortgagee threatens foreclosure. B, learning of these facts, pays Mortgagee's debt in full. B is subrogated to the mortgage to the extent one-half of the debt it secures, and may enforce the mortgage against A's interest in Blackacre in order to recover that amount.

4. The facts are the same as in Illustration 3, except that A and B were formerly married, and the court decree dissolving the marriage ordered B to pay the entire debt secured by the mortgage. Since on these facts B was primarily responsible for payment of the entire debt and A for none of it, B may not have subrogation.

5. Blackacre and Whiteacre are owned by Mortgagor, subject to a blanket mortgage on both parcels held by Mortgagee. Mortgagor sells Blackacre to Grantee, who takes subject to the

blanket mortgage but assumes only one-half of the debt; it is the parties' understanding that Mortgagor will pay the other half of the debt in due course. However, Mortgagor fails to do so. Mortgagee threatens foreclosure, and Grantee pays the entire debt in order to protect Blackacre from foreclosure. Grantee is subrogated to the mortgage and to the portion of the debt for which Mortgagor was responsible, and may enforce them against Mortgagor and Whiteacre.

In each of the foregoing Illustrations, the person seeking subrogation held an interest in the mortgaged real estate that was subordinate to the mortgage. In such cases, the performance of the obligation is properly referred to as a redemption from the mortgage; see § 6.4, Comment *g*. However, subrogation is not limited to cases of redemption; under this section, the subrogee must have performed in order to protect an "interest," but that interest need not be a legally recognized interest in real property. It may be, for example, a business or financial interest that would be impaired by foreclosure of the mortgage, an interest in reputation, or a moral obligation. See Illustrations 6 through 9.

Prior case law has often indicated that one who pays as a "volunteer" is not entitled to subrogation. However, the meaning of the term "volunteer" is highly variable and uncertain, and has engendered considerable confusion. This Restatement does not adopt the "volunteer" rule, but instead requires simply that the subrogee pay to protect some interest.

Illustrations:

6. Mortgagor owns Blackacre and obtains a construction loan mortgage from Mortgagee to build an office building. Mortgagor purchases a payment bond from B, a bonding company, under which B becomes liable for payment for any labor or materials supplied to the project for which Mortgagor fails to pay. Mortgagor defaults in payment on the construction loan and Mortgagee threatens foreclosure. B reasonably fears that in the event of foreclosure of the mortgage, B will be subject to numerous claims on the bond by contractors and materials suppliers. To avoid this result, B discharges the mortgage. B is subrogated to the mortgage and the debt it secures, and may enforce them against Mortgagor and Blackacre.

7. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee–1. Mortgagor desires to refinance by obtaining a new first mortgage loan from Mortgagee–2, and Mortgagee–2 requests

a title insurance binder from TI, a title insurance company. TI issues a binder showing the existence of the first mortgage held by Mortgagee–1, and indicates that it will not issue a title policy showing a first lien in Mortgagee–2 unless the prior mortgage is discharged. The settlement of the refinancing transaction is conducted by A, who is an "approved" attorney of TI, although not acting as TI's agent in conducting the settlement. A records the new mortgage in favor of Mortgagee–2, but fraudulently absconds with the funds which A should have paid to discharge Mortgagee–1. Assume that under applicable law, as between Mortgagor and Mortgagee–2 this loss would fall on Mortgagor. TI, in order to protect its business reputation in the mortgage lending community, discharges Mortgagee–1's mortgage, although TI has no legal duty to do so. TI is subrogated to the first mortgage and the debt it secures, and may enforce them against Mortgagor and Blackacre.

8. Mortgagor obtains a loan from Mortgagee, and secures repayment of the loan with a mortgage on Blackacre. Mortgagor is assisted in obtaining the loan by the assurances of F, Mortgagor's father, who advises Mortgagee that his son is a good risk and will repay the loan. J sues Mortgagor and obtains a judgment lien on Blackacre that is subordinate to the mortgage. Subsequently Mortgagor defaults in payment of the mortgage loan, and F, acting under a sense of moral obligation, pays the loan in full. F is entitled to subrogation to the rights of Mortgagee as against Mortgagor and J.

9. Mortgagor resides on Blackacre but has no funds. Blackacre is subject to a mortgage in favor of Mortgagee, payments on which are in default. Mortgagor's children, A and B, acting out of affection for their mother, pay the mortgage debt in full to protect Mortgagor's residence from foreclosure. Upon Mortgagor's death her title to Blackacre passes by intestate succession to her husband H, who made no contribution to the payment of the mortgage debt. A and B are subrogated to the rights of Mortgagee, and can enforce the mortgage against H.

While the concept of "interest" is broadly defined, it does not cover every conceivable payor. A true "intermeddler" who has no legitimate need or reason to pay the mortgage debt is not entitled to subrogation.

In some cases the subrogee discharges a debt secured by a mortgage, but wishes to have subrogation only to the debt and not the mortgage. The subrogee is privileged to disregard the real estate security and seek subrogation only to the debt. Here, as above, the "interest" the subrogee pays to protect may be a legally recognized interest in the real estate, or may be some other benefit. See Illustrations 10 and 11.

Illustrations:

10. Mortgagor obtains a loan from Mortgagee and secures repayment of the loan with a mortgage on Blackacre. Later Mortgagor agrees to sell Blackacre to Grantee, with Grantee's purchase to be financed by a new purchase money mortgage loan having first priority. Attorney A is employed by Grantee to conduct the settlement. A records a release of the mortgage from Mortgagee and records the deed to Grantee. However, instead of transmitting to Mortgagee the funds required to discharge the old mortgage, A gives the entire proceeds of the sale to Mortgagor, who promises to discharge Mortgagee. Mortgagor fails to do so. A pays Mortgagee with A's own funds in order to protect A's reputation and to forestall an action for malpractice by Grantee. A is subrogated to Mortgagee's claim against Mortgagor on the debt, even though A does not wish to, and probably could not, assert subrogation to the mortgage.

11. Mortgagor owns Blackacre subject to a recorded mortgage held by Mortgagee-1. Mortgagor borrows money from Mortgagee-2 and gives Mortgagee-2 a mortgage on Blackacre, which Mortgagor falsely represents as having first priority. Mortgagee-2 makes no title examination. Subsequently Mortgagee-2 wishes to assign the second mortgage to another investor, and in preparing to do so discovers the existence of the first mortgage. Mortgagee-2 pays Mortgagee-1's debt in full in order to give the second mortgage first priority, thereby making it more readily marketable in the secondary mortgage market. Mortgagee-2 is subrogated to the debt that was discharged, and can assert it against Mortgagor, even though Mortgagee-2 does not wish to assert subrogation to the mortgage.

c. Performance made under legal duty. In many situations a mortgage obligation is discharged by one having a legal duty to do so. Common examples include insurers, sureties, and guarantors. Such persons are ordinarily given a right of subrogation. See Illustrations 12–15. This is consistent with the treatment of sureties and guarantors under Restatement Third, Suretyship and Guaranty § 28.

Illustrations:

12. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Pursuant to the terms of the mortgage, Mortgagor purchases fire insurance from Insurer; the policy names both Mortgagor and Mortgagee as loss payees. Mortgagor, by means of arson, causes a fire that destroys the improvements on Blackacre. Under the terms of the insurance policy, Insurer is bound to indemnify Mortgagee for the loss notwithstanding that it resulted from Mortgagor's arson. However, the policy withdraws Mortgagor's insurance coverage as a consequence of the arson. To satisfy its duty under the policy, Insurer pays Mortgagee the entire balance owing on the mortgage debt. Insurer is subrogated to the mortgage and to the debt it secures, and may enforce them against Mortgagor.

13. Mortgagor, owner of Blackacre, borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. At Mortgagee's insistence, Mortgagor convinces a friend, Guarantor, to give Mortgagee a written guaranty of Mortgagor's note. Subsequently Mortgagor defaults in payment of the note, and Guarantor pays it in full. Guarantor is subrogated to the note and mortgage, and may enforce them against Mortgagor.

14. The facts are the same as in Illustration 13, except that Guarantor also pledges a municipal bond owned by Guarantor to Mortgagee as security for the guaranty. Upon Mortgagor's default, Mortgagee sells the bond to pay Mortgagor's debt. Guarantor is subrogated to the note and mortgage, and may enforce them against Mortgagor.

15. Mortgagor, owner of Blackacre, borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. At Mortgagee's insistence, Mortgagor procures a "standby" letter of credit from Bank in favor of Mortgagee to enhance Mortgagor's credit. The letter of credit obligates Bank to pay on the condition that Mortgagor defaults in payment of the note. and obligates Mortgagor to reimburse Bank if it is required to pay. Subsequently Mortgagor defaults and Bank, acting under the letter of credit, pays the secured note in full. Bank is subrogated to the note and mortgage, and may enforce them against Mortgagor, notwithstanding that the letter of credit may be technically regarded as a primary obligation of Bank.

As noted above, one cannot claim subrogation upon payment of an obligation to the extent that he or she is primarily responsible for it. There is no unjust enrichment in paying one's own debts. For example, a grantee of land who assumes a mortgage on it, and subsequently pays the mortgage, is not entitled to subrogation. See § 8.5, Comment *c*, and § 8.5, Illustration 19. However, in many situations subrogation is appropriate even though the subrogee is personally liable on the obligation being paid, if that liability is partial or secondary. One example is the "accommodation party," who executes an instrument for the purpose of becoming liable on it without any corresponding direct benefit; see Uniform Commercial Code § 3–419 (1995). See Illustration 16. Another is the mortgagor who sells the real estate subject to, or with an assumption of, the mortgage debt, with the purchaser paying cash equal to the difference between the agreed purchase price and the balance owing on the mortgage debt. Such a mortgagor, while still personally liable to the mortgagee by virtue of having executed the original note or other evidence of debt, becomes, as between the mortgagor and the grantee, secondarily liable as a surety when the transfer occurs; see § 5.1, Comment *i*; § 5.2, Comment *c*. The mortgagor may pay the debt and be subrogated to the mortgage (whether the transfer was with an assumption or was merely "subject to" the mortgage) as well as the debt (if the transferee assumed the debt). See § 5.1(d); § 5.2(e); Illustrations 17–18.

On the other hand, in the relatively rare case in which the purchaser of land pays the full price in cash but takes subject to a preexisting mortgage with the understanding (or express promise) that the grantor will pay the mortgage debt, the roles of the grantor and grantee are reversed. Here the grantor is primarily liable for payment, and the grantee is, to the extent of the value of the land, a surety. If the grantor fails to pay the mortgage debt when due, the grantee may pay it and be subrogated to the debt and mortgage as against any junior interests. See § 5.2(c); Illustration 19.

Illustrations:

16. To raise capital to start a business, Mortgagor wishes to borrow money from Mortgagee on the security of Blackacre, which Mortgagor owns. To induce Mortgagee to make the loan, Mortgagor persuades his sister, S, to execute the promissory note together with Mortgagor, although S is not involved in Mortgagor's business and derives no benefit from the loan. Subsequently Mortgagor defaults on the note and, at Mortgagee's demand, S pays it in full. S is subrogated to the note and mortgage, and may enforce them against Mortgagor.

17. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee, securing Mortgagor's promissory note. Mortgagor sells Blackacre to Grantee, who promises to assume the mortgage debt and pays Mortgagor cash equal to the difference between the mortgage debt and the agreed purchase price of Blackacre. Subsequently Grantee defaults on the note and, at Mortgagee's demand, Mortgagor pays it in full. Mortgagor is subrogated to the note and mortgage, and may enforce them against Grantee.

18. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Mortgagor sells Blackacre to Grantee, who takes subject to the mortgage, but does not assume the mortgage debt. Grantee pays Mortgagor cash equal to the difference between the mortgage debt and the agreed purchase price of Blackacre, and expects to make the remainder of the payments on the mortgage debt as they fall due. Subsequently Grantee defaults on the note and, at Mortgagee's demand, Mortgagor pays it in full. Mortgagor is subrogated to the mortgage, and may enforce it against Grantee.

19. Mortgagor owns Blackacre subject to two mortgages, held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor is personally liable on the debts secured by the two mortgages. Mortgagor sells Blackacre to Grantee, who takes subject to the mortgages, but pays the full purchase price in cash with the understanding that Mortgagor will pay the mortgage debts. Mortgagor defaults in payment to Mortgagee-1, and Grantee pays that mortgage debt in full. Grantee is subrogated to the first mortgage, and may enforce it against Mortgagee-2. Grantee is also subrogated to the debt secured by the first mortgage as against Mortgagor.

In Illustration 17 the mortgagor is subrogated to both the note and mortgage as against the grantee, while in Illustration 18 the mortgagor is subrogated only to the mortgage. The difference in result follows from the fact that the grantee did not assume the promissory note in Illustration 18, and hence is not personally liable on it.

d. Performance induced by fraud or the like. In some cases one may be induced to perform and discharge a mortgage obligation by misrepresentation, mistake, duress, undue influence, deceit, or other similar imposition. The deception may be practiced on the payor by the mortgagor or by some other person. If the circumstances are such that subrogation to a prior mortgage will relieve the payor, and if no prejudice to any innocent person will result, the payor may have subrogation.

Illustrations:

20. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. F, who has no interest in Blackacre, purports to sell it to Grantee subject to the mortgage, and gives Grantee a forged deed. Grantee, believing that she has title to Blackacre, pays the mortgage debt in full. Grantee is subrogated to Mortgagee's rights and may enforce the mortgage and the debt against Mortgagor.

21. Mortgagor holds Blackacre subject to two mortgages, held respectively by Mortgagee-1 and Mortgagee-2. Mortgagor sells Blackacre to Grantee, falsely stating to Grantee that Blackacre is subject only to the first mortgage and promising that Mortgagor will pay and satisfy that mortgage obligation with the proceeds of the sale. Grantee, believing this statement, makes no title examination and is unaware of the existence of the second mortgage. Grantee completes the purchase. Mortgagor uses the proceeds of the sale to satisfy the first mortgage but does not satisfy the second. Grantee is entitled to be subrogated to the rights of Mortgagee-1 as against Mortgagee-2 and may enforce the first mortgage against Mortgagee-2.

22. Mortgagor holds Blackacre subject to a mortgage in favor of Mortgagee, securing Mortgagor's promissory note to Mortgagee. Mortgagee borrows funds from Bank, and as collateral for repayment assigns the note and mortgage to Bank. Subsequently, when Mortgagee repays the borrowed funds, Bank erroneously and negligently releases the mortgage instead of reassigning it to Mortgagee. Mortgagee, upon discovering that Bank has released the mortgage, demands that Bank compensate Mortgagee for the loss of its security. Bank responds by paying Mortgagee the balance owed on the mortgage note. Bank is subrogated to Mortgagee's rights under the note and mortgage, and may enforce them against Mortgagor and Blackacre.

Illustration 21 states that the grantee lacks knowledge of the intervening lien. However, knowledge is not necessarily fatal to the grantee's claim of subrogation, if equity would nonetheless dictate the recognition of subrogation. See the discussion in Comment *e*, infra. Moreover, the grantee's right to subrogation is not lost even if the second mortgage was recorded and the grantee might be held to have had constructive notice of it under the applicable recording act. Although the grantee may have examined the title carelessly or may have made no title examination at all, if the cash price paid by the grantee included the second mortgage balance, subrogation to, rather than extinction of, the first mortgage will result in order to prevent unjust enrichment of the second mortgagee.

e. Performance at the request of the debtor. A mortgage debtor may ask another person to discharge the debt. In some circumstances, the payor who does so is warranted in receiving, by subrogation, the benefit and priority of the mortgage paid. The most common context for this sort of subrogation is the "refinancing" of a mortgage loan; that is, the payment of a loan with the proceeds of another loan.

Obviously subrogation cannot be involved unless the second loan is made by a different lender than the holder of the first mortgage; one cannot be subrogated to one's own previous mortgage. Where a mortgage loan is refinanced by the same lender, a mortgage securing the new loan may be given the priority of the original mortgage under the principles of replacement and modification of mortgages; see § 7.3. The result is analogous to subrogation, and under this Restatement the requirements are essentially similar to those for subrogation.

When a mortgage loan is paid by one who makes a new loan for that purpose, the payor will have the benefit of subrogation to the mortgage that was discharged only if the payor was promised repayment of the funds advanced and reasonably expected to receive a mortgage, with the priority of the discharged mortgage, on the real estate to secure that repayment. See Illustrations 23 and 24. Thus, a payor who makes a mere gift, or who makes a loan that is, by its terms, unsecured or secured with a lien of inferior priority, cannot claim subrogation, since that would provide the payor with an unwarranted windfall. See Illustration 25. On the other hand, if the debtor promises to provide security in the real estate to the payor, but fails to do so, the payor is entitled te subrogation.

Perhaps the case occurring most frequently is that in which the payor is actually given a mortgage on the real estate, but in the absence of subrogation it would be subordinate to some intervening interest, such as a junior lien. Here subrogation is entirely appropriate, and by virtue of it the payor has the priority of the original mortgage that was discharged. This priority is often of critical importance, since it will place the payor's security in a position superior to intervening liens and other interests in the real estate. The holders of such intervening interests can hardly complain of this result, for it does not harm them; their position is not materially prejudiced, but is simply unchanged.

Many judicial opinions dealing with a mortgagee who pays a preexisting mortgage focus on whether the payor had notice of the intervening interest at the time of the payment. Most of the cases disqualify the payor who has actual knowledge of the intervening interest, although they do not consider constructive notice from the public records to impair the payor's right of subrogation. Under this Restatement, however, subrogation can be granted even if the payor had actual knowledge of the intervening interest; the payor's notice, actual or constructive, is not necessarily relevant. The question in such cases is whether the payor reasonably expected to get security with a priority equal to the mortgage being paid. Ordinarily lenders who provide refinancing desire and expect precisely that, even if they are aware of an intervening lien. See Illustration 26. A refinancing mortgagee should be found to lack such an expectation only where there is affirmative proof that the mortgagee intended to subordinate its mortgage to the intervening interest. See Illustration 27.

Subsection (b) speaks of the subrogee discharging the obligation secured by the mortgage. This should not be taken to require a direct payment from the subrogee to the prior mortgagee. In a refinancing, the new lender may pay the prior lender directly, may pay a title company or other closing agent with instructions to pay the prior lender, or may disburse funds directly to the mortgagor with an understanding or agreement that the mortgagor will pay the prior mortgage. The mechanics of the transaction are not controlling, and subrogation may be appropriate when any of these forms of payment has been employed.

Subrogation will be recognized only if it will not materially prejudice the holders of intervening interests. The most obvious illustration is that of a payor who lends the mortgagor more money than is necessary to discharge the preexisting mortgage. The payor is subrogated only to the extent that the funds disbursed are actually applied toward payment of the prior lien. There is no right of subrogation with respect to any excess funds. See Illustration 28.

Similarly, if the payor demands a higher interest rate than prevailed under the original mortgage loan, the positions of intervening interest holders may be jeopardized, since the increased interest may result in the mortgage's having a higher balance at the time it is later foreclosed. Subrogation should be granted only to the extent of the debt balance that would have existed if the interest rate had been unchanged. See Illustration 29. This reasoning is inapplicable if the original mortgage provided for variable or adjustable interest, and the interest on the refinancing loan falls within the parameters thus established.

On the other hand, a mere extension of time resulting from refinancing is generally not regarded as seriously prejudicial to holders of intervening interests, and is often advantageous to them. See the discussion in § 7.3, Comments *b* and *c*.

Illustrations:

23. Mortgagor owns Blackacre subject to two mortgages held by Mortgagee-1 and Mortgagee-2 in order of priority. Both mortgages are recorded. Mortgagor approaches Mortgagee-3, a bank engaged in mortgage lending, and obtains a loan for the purpose of discharging Mortgagee-1's mortgage. Mortgagee-3 is not aware of the existence of Mortgagee-2's interest, does not perform a title examination, and expects that its mortgage will have first priority. Mortgagee-3 makes the loan and disburses the proceeds to pay and discharge in full Mortgagee-1's mortgage. Mortgagee-3 is entitled to be subrogated to Mortgagee-1's mortgage.

24. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee-1. A and B are tenants in common, and under applicable law are equally responsible with respect to one another to pay the debt secured by the mortgage, so that either who pays is entitled to contribution from the other for one-half of the payment. A refuses to pay any part of the debt, and Mortgagee-1 institutes foreclosure proceedings. B, learning of these facts, approaches Mortgagee-2 and obtains a loan the proceeds of which are used to fully discharge Mortgagee-1's mortgage. B gives Mortgagee-2 a mortgage on B's interest in Blackacre, but A refuses to execute a mortgage on A's interest. Mortgagee-2 is subrogated to Mortgagee-1's rights, and may enforce the first mortgage against A's interest in Blackacre.

25. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee. Mortgagor asks his mother, M, to pay off the mortgage debt, and orally promises her that he will reimburse her for the outlay. However, Mortgagor does not represent that M will receive any security for this promise. M discharges the mortgage, but Mortgagor does not reimburse M. M is not entitled to subrogation to the debt and mortgage, as she had no reasonable expectation of security with a priority equal to that of the mortgage she discharged.

26. The facts are the same as Illustration 23, except that Mortgagee-3 has actual knowledge of the intervening mortgage held by Mortgagee-2. Notwithstanding this knowledge, Mortgagee-3 is entitled to be subrogated to Mortgagee-1's mortgage.

27. The facts are the same as Illustration 26, except that the mortgage taken by Mortgagee-3 states that it is a "second mortgage." These words establish that Mortgagee-3 did not expect to acquire the priority of the mortgage that was discharged,

and Mortgagee-3 is not entitled to be subrogated to Mortgagee-1's mortgage.

28. Blackacre is owned by A and B, subject to a mortgage held by Mortgagee-1 securing a debt of $100,000. A and B are tenants in common. A approaches Mortgagee-2 and induces it to make a loan of $150,000, of which $100,000 is used to pay off the first mortgage in full. The remaining $50,000 is used by A for other purposes. B is not a party to this transaction, but A forges B's name on the note and mortgage to Mortgagee-2. Mortgagee-2 is subrogated to the first mortgage to the extent of $100,000, and can enforce it against B's interest in Blackacre. Mortgagee-2 is not entitled to subrogation with respect to the remaining $50,000.

29. The facts are the same as Illustration 23, except that the interest rate under Mortgagee-1's mortgage was 8 percent, and Mortgagor and Mortgagee-3 agree to an interest rate of 12 percent. Mortgagee-2's mortgage is senior to Mortgagee-3's mortgage to the extent that the increase in the interest rate enlarges the balance owing on the obligation secured by Mortgagee-3's mortgage.

Cases commonly arise in which subrogation is proper under more than one subsection of this section. For example, a lender may be induced by fraud or forgery (Subsection (b)(3)) to make a loan to pay off a prior mortgage (Subsection (b)(4)). See Illustration 28, supra. No particular difficulty should arise in granting subrogation in such cases.

f. Subrogation not granted where injustice would result. Since the purpose of subrogation is to prevent unjust enrichment, it will not be granted where it would produce injustice. In virtually all cases in which injustice is found, it flows from a delay by the payor in recording his or her new mortgage, in demanding and recording a written assignment, or in otherwise publicly asserting subrogation to the mortgage paid. The delay may lead the holder of an intervening interest to take detrimental action in the belief that that interest now has priority.

For example, if the payor who discharges a prior mortgage does not immediately record his or her own mortgage, the public records may for some period of time appear to indicate that the real estate is unencumbered. One who in good faith acquires an interest in the real estate during this period will be severely prejudiced if the payor is permitted to gain priority over that interest by subrogation. In such cases subrogation is denied. See Illustration 30.

Even if the payor's mortgage is recorded immediately, prejudice to the holder of a junior interest can arise if the payor delays in making a demand for subrogation to that holder or seeking subrogation in the courts. For example, a junior mortgage or other subordinate interest in the real estate may be sold to a good-faith purchaser after the first mortgage is discharged. The purchaser of the junior mortgage may believe, from the appearance of the public records, that he or she is acquiring a first lien on the property. Even if the payor who discharged the first mortgage immediately recorded his or her own mortgage, it may not be apparent to the purchaser of the intervening interest that the priority of the old first mortgage will be preserved by subrogation. Such purchasers should be protected against subrogation unless they had actual knowledge that the payor's advances were used to pay the first mortgage. See Illustration 31. The payor could, of course, forestall this problem by an immediate assertion of subordination and the filing of an appropriate action to establish priority. The filing of such an action (and in some jurisdictions, the recordation of an appropriate notice of lis pendens) would give constructive notice of the subrogation claim to anyone contemplating a purchase of the junior interest.

Illustrations:

30. Mortgagor owns Blackacre subject to a mortgage held by Mortgagee–1. Mortgagor obtains a loan from Mortgagee–2 for the purpose of discharging Mortgagee–1's mortgage. Mortgagee–2 makes the loan and disburses the proceeds to pay and discharge Mortgagee–1's mortgage. A satisfaction of Mortgagee–1's mortgage is recorded in the public records. However, Mortgagee–2's mortgage is not recorded until several days later. During the period between recordation of the satisfaction and the new mortgage, Mechanic, a contractor hired by Mortgagor, commences work under a contract to build a house on Blackacre. Mortgagor fails to pay Mechanic, who records a notice of mechanics lien on Blackacre. Under applicable law, such liens take their priority from the date work on the contract commenced. A court is warranted in finding that a grant of subrogation to Mortgagee–2 would be unjust to Mechanic, and upon such a finding may deny Mortgagee–2's subrogation claim.

31. Mortgagor owns Blackacre subject to two mortgages held respectively by Mortgagee–1 and Mortgagee–2. Mortgagor obtains a loan from Mortgagee–3 for the purpose of discharging Mortgagee–1's mortgage. Mortgagee–3 makes the loan and disburses the proceeds to pay and discharge Mortgagee–1's mortgage. A satisfaction of Mortgagee–1's mortgage is recorded in the

public records, and Mortgagee-3's mortgage is recorded immediately. Thereafter, Mortgagee-2 offers to sell the second mortgage to Investor, and represents it as heing a first lien on the real estate. Investor examines the public records, confirms that the mortgage previously held by Mortgagee-1 has been discharged, and purchases the second mortgage from Mortgagee-2. At the time of this purchase Mortgagee-3 has made no claim of subrogation, and Investor is unaware that the funds advanced by Mortgagee-3 were used to pay Mortgagee-1. A court is warranted in finding that, since Mortgagee-2's mortgage appeared to have first priority of record on the date Investor purchased the second mortgage, injustice would result if Mortgagee-3 were subrogated to Mortgagee-1's mortgage as against Investor. Upon such a finding, the court may deny Mortgagee-2's subrogation claim.

REPORTERS' NOTE

For general treatments of subrogation, see G. Nelson & D. Whitman, Real Estate Finance Law, Practitioner Series, §§ 10.1–10.8 (3d ed. 1994); Marasinghe, An Historical Introduction to the Doctrine of Subrogation: The Early History of the Doctrine, 10 Val. U. L. Rev. part 1 at 45, part 2 at 275 (1975–76); Comment, 31 Mich. L. Rev. 826 (1932).

Introductory note, Comment a. Cases holding that a partial payment will not entitle the payor to subrogation include Mutual Life Ins. Co. of N.Y. v. Grissett, 500 F.Supp. 159 (M.D.Ala.1980) (Alabama law); In re Cavalier Homes, 102 B.R. 878 (Bankr.M.D.Ga.1989); Western Coach Corp. v. Rexrode, 130 Ariz. 93, 634 P.2d 20 (Ariz.Ct.App.1981); Capitol Nat'l Bank v. Holmes, 95 P. 314 (Colo.1908); Consolidated Naval Stores Co. v. Wilson, 90 So. 461 (Fla. 1921); Jessee v. First Nat'l Bank, 267 S.E.2d 803 (Ga.Ct.App.1980); United States Fidelity & Guar. Co. v. Maryland Casualty Co., 352 P.2d 70 (Kan. 1960). On the other hand, if the payee accepts partial payment as a complete discharge of the mortgage, subrogation will ensue; see Dietrich Industries, Inc. v. United States, 988 F.2d 568 (5th Cir.1993). Likewise, a partial or pro tanto subrogation is possible if the entire debt is paid, partly by the subrogee and partly from other sources; see Ray v. Donohew, 352 S.E.2d 729 (W.Va.1986).

Cases finding a duty on the part of the mortgagee to give a written assignment to the subrogee include Motes v. Roberson, 32 So. 225 (Ala. 1902); Global Realty Corp. v. Charles Kannel Corp., 170 N.Y.S.2d 16 (N.Y.Sup.Ct.1958) (payment by junior tenant); Payne v. Foster, 135 N.Y.S.2d 819 (N.Y.App.Div.1954) (payment by holder of remainder); Simonson v. Lauck, 93 N.Y.S. 965 (N.Y.App.Div.1905) (payment by a third party at the request of a tenant in common of the real estate); Averill v. Taylor, 8 N.Y. 44 (1853).

Performance to protect an interest, Comment b. Illustration 1 is based on Matter of Forester, 529 F.2d 310 (9th Cir.1976). To the same effect, but with the subrogee paying a prior property tax lien, is Smart v. Tower

Land & Inv. Co., 597 S.W.2d 333 (Tex.1980). See also C.T.W. Co. v. Rivergrove Apartments, Inc., 582 So.2d 18 (Fla.Dist.Ct.App.1991) (payment made by corporation formed by junior mortgagees); Rock River Lumber v. Universal Mortgage Corp. of Wis., 262 N.W.2d 114 (Wis. 1978); Gaub v. Simpson, 866 P.2d 765 (Wyo. 1993) (payment of prior federal tax lien). Contra, see Frago v. Sage, 737 S.W.2d 482 (Mo.Ct.App.1987), in which the court declined to grant subrogation on the seemingly incorrect reasoning that the junior mortgagee, who foreclosed his own mortgage, took title, and then paid off the senior mortgage, was a mere "volunteer."

Illustration 2 is based on Brown v. Bellamy, 566 N.Y.S.2d 703 (N.Y.App. Div.1991); G.B. Seely's Son, Inc. v. Fulton-Edison, Inc., 382 N.Y.S.2d 516 (N.Y.App.Div.1976); and Dominion Fin. Corp. v. 275 Washington St. Corp., 316 N.Y.S.2d 803 (N.Y.Sup.Ct. 1970). See Annot., Lessee's Right of Subrogation in Respect of Lien Superior to His Lease, 1 A.L.R.2d 286.

Illustrations 3 and 4 are based on Snider v. Basinger, 132 Cal.Rptr. 637 (Cal.Ct.App.1976); Meckler v. Weiss, 80 So.2d 608 (Fla.1955); Evans' Adm'r v. Evans, 199 S.W.2d 734 (Ky.1947); Richards v. Suckle, 871 S.W.2d 239 (Tex. Ct. App. 1994); and Eloff v. Riesch, 111 N.W.2d 578 (Wis.1961). Illustration 4 is further supported by Walters v. Walters, 466 P.2d 174 (Wash.Ct.App.1970). See Annot., Contribution, Subrogation, and Similar Rights, As Between Cotenants, Where One Pays the Other's Share of Sum Owing on Mortgage or Other Lien, 48 A.L.R.2d 1305. See also In re Stendardo, 991 F.2d 1089 (3d Cir. 1993) (mortgagee who foreclosed and subsequently paid delinquent property taxes was not entitled to subrogation to property tax lien, since after foreclosure payment of those taxes was mortgagee's responsibility).

Illustration 5 is based on Cox v. Wooten, 610 S.W.2d 278 (Ark.App. 1981). A similar result was reached in the opposite situation, in which the purchaser agreed to pay a portion of the debt but failed to do so, and it was paid by the vendor, in Cozzetto v. Wisman, 819 P.2d 575 (Idaho Ct.App. 1991).

A somewhat unusual illustration of a payment made to protect an interest is found in State ex rel. Moulton v. Holland, 367 S.W.2d 791 (Tenn.Ct. App.1962). A city government condemned land on which the owner had placed a mortgage. However, the city's title examination was defective, so it was unaware of the mortgage and failed to name the mortgagee as a party to the eminent domain action. At the conclusion of the action the entire condemnation award was paid to the mortgagors. The city subsequently discovered the mortgage and paid the mortgagee the balance owing on the mortgage debt. It then brought an action to recover that sum from the mortgagors. The court held that the mortgagee could have established a constructive trust or equitable lien on the proceeds of the condemnation, and hence that the city, having paid the mortgagee, was subrogated to those rights as against the mortgagors.

The volunteer rule is discussed and disparaged in G. Nelson & D. Whitman, Real Estate Finance Law § 10.4 (3d ed. 1993); Note, Subrogation and the Volunteer Rule, 24 Va. L. Rev. 771 (1938); Note, 48 Yale L.J. 683 (1939).

Illustration 6 is based on the facts of Heller Fin. v. Insurance Co. of N.

America., 573 N.E.2d 8 (Mass.1991), but in that case the bonding company took an express assignment of the mortgage and hence had no need to rely on the doctrine of subrogation. See also Cagle, Inc. v. Sammons, 254 N.W.2d 398 (Neb.1977), where the party seeking subrogation was a general contractor which sought subrogation *against* a bonding company that had written a payment bond in favor of a subcontractor's suppliers. The general contractor paid the suppliers upon the subcontractor's default, and was held subrogated to the suppliers' claims on the bond.

Illustration 7 is based on the facts of Lawyers Title Insurance Corp. v. Edmar Constr. Co., 294 A.2d 865 (D.C.1972). However, that case rejected the title company's subrogation argument, concluding that it was a volunteer.

Illustration 9 is based on Springham v. Kordek, 462 A.2d 567 (Md.Ct. App.1983). See also In re Mach, 25 N.W.2d 881 (S.D.1947), noted in 32 Mich. L. Rev. 183 (1948) (son who provided support to invalid father was entitled to an equitable lien on father's land and subrogation to father's rights as against noncontributing brother).

See also Hoppe v. Phoenix Homes, Inc., 318 N.W.2d 878 (Neb.1982), in which Phoenix owed money to Hoppe on an unsecured loan. Phoenix owned real estate encumbered by a mortgage, and proposed to convey it to Hoppe in satisfaction of the debt owed to Hoppe, free of encumbrances, if Hoppe would first pay the mortgage debt. Hoppe did so, and Phoenix then deeded the land to Hoppe, but it was subject to two judgment liens, subordinate to the mortgage, of which Hoppe had been unaware. The court held that Hoppe was subrogated to the first mortgage he had paid, and could foreclose it against the judgment liens. Hoppe's position was justified on the basis that he paid the mortgage debt in order to protect his interest in the payment of the debt owed to him by Phoenix.

For a case of "intermeddling," see Norton v. Haggett, 85 A.2d 571 (Vt. 1952), in which the plaintiff paid the defendant's mortgage debt in the apparent belief that by subrogation he would become the owner of it. The two parties had recently had several arguments, the plaintiff apparently intended to harm the defendant, and seems to have wished to become the holder of the defendant's mortgage and note in order to harass the defendant. The mortgagee's president testified that he assumed the payment was a gift and that he would not have voluntarily assigned the note and mortgage to the plaintiff. The court found that the plaintiff had no interest to protect in making the payment and denied subrogation. The result is consistent with this Restatement.

Illustration 10 is based on Cureton v. Frierson, 850 S.W.2d 38 (Ark.Ct. App.1993).

Illustration 11 is based on Dolan v. Borregard, 466 So.2d 11 (Fla.Dist.Ct. App.1985).

Performance made under legal duty, Comment c. Illustration 12 is based on the facts of McPheeters v. Community Fed. Sav. & Loan Ass'n, 736 S.W.2d 62 (Mo. Ct. App. 1987). However, in that case as in most similar cases the fire insurer took a written assignment, and no subrogation argument was necessary. See also Credit Bureau Corp. v. Beckstead, 385 P.2d 864 (Wash.1963), in which a title insurance company issued a title policy incident to a sale of real estate which was encumbered by a judgment and a mortgage junior to the judgment. The title company missed the judgment in its title search, and, upon discovering the error, it paid the judgment in full. The holder of the junior mortgage then claimed to hold a first lien on the property. The court held that the title company was subrogated to the judgment it had paid, and could therefore foreclose it against the junior mortgage.

Illustration 13 is based on Aultman v. United Bank, 378 S.E.2d 302 (Ga. 1989). See also Golden Eagle Ins. Co. v. First Nationwide Fin. Corp., 31 Cal.Rptr.2d 815 (Cal.Ct.App.1994) (surety on payment bond entitled to subrogation to mechanics' liens which it discharged); Security Nat'l Trust v. Moore, 639 So.2d 373 (La.Ct.App. 1994) (accommodation endorser entitled to subrogation upon payment of mortgage debt); Atlas Fin. Corp. v. Trocchi, 19 N.E.2d 722 (Mass.1939).

Illustration 14 is based on Ray v. Donohew, 352 S.E.2d 729 (W.Va. 1986), except that in that case the mortgagee foreclosed the mortgage and then took the bond for the deficiency; hence there was no mortgage to which the guarantor could be subrogated. She was held subrogated to the note.

The "standby letter of credit" issue in Illustration 15 has been controversial in the courts. Cases allowing subrogation include In re Valley Vue Joint Venture, 123 B.R. 199 (Bankr. E.D.Va.1991); In re Air One, Inc., 80 B.R. 145 (Bankr.E.D.Mo.1987); In re National Service Lines, Inc., 80 B.R. 144 (Bankr.E.D.Mo.1987); In re Sensor Systems, Inc., 79 B.R. 623 (Bankr.E.D.Pa.1987); In re Minnesota Kicks, Inc., 48 B.R. 93 (Bankr. D.Minn.1985); In re Glade Springs, Inc., 47 B.R. 780 (Bankr.E.D.Tenn. 1985). This position is endorsed by U.C.C. § 5–117 (1995), which treats the issuer as secondarily liable for purposes of the subrogation doctrine.

Cases denying subrogation, usually on the ground that the issuer of a letter of credit is primarily liable for payment, include Tudor Development Group, Inc. v. United States Fidelity and Guaranty, 968 F.2d 357 (3d Cir. 1992); In re Carley Capital Group, 119 B.R. 646 (W.D.Wis.1990); In re Agrownautics, Inc., 125 B.R. 350 (Bankr.D.Conn.1991); Berliner Handels-Und Frankfurter Bank v. East Texas Steel Facilities, Inc., 117 B.R. 235 (Bankr.N.D.Tex.1990); In re St. Clair Supply Co., Inc., 100 B.R. 263 (Bankr.W.D.Pa.1989); Bank of America v. Kaiser Steel Corp., 89 B.R. 150 (Bankr.D.Colo.1988); In re Munzenrieder Corp., 58 B.R. 228 (Bankr.M.D.Fla.1986); Merchants Bank v. Economic Enterprises, Inc., 44 B.R. 230 (Bankr.D.Conn.1984). See pre-1995 U.C.C. § 5–103, Official Comment 3 ("The issuer is not a guarantor of the performance of these underlying transactions"); Avidon, Subrogation in the Letter of Credit Context, 56 Brook. L. Rev. 129, 136 (1990). Even under this view, the bank may have subrogation if the parties have agreed in advance to that effect. See Wichita Eagle and Beacon Publ. Co. v. Pacific Nat'l Bank, 493 F.2d 1285 (9th Cir.1974).

For the proposition that an assuming grantee who pays the mortgage is primarily liable to do so, and hence may not have subrogation, see Pee Dee State Bank v. Prosser, 367 S.E.2d 708 (S.C.App.1988). The South Carolina Supreme Court subsequently refused to apply this rationale to a case in which the grantee took only a tenancy in common interest in the property, with the understanding that the grantor would pay a pro rata share of the mortgage corresponding to the ownership interest the grantor retained. The grantor was held to have an equitable primary obligation with respect to that portion of the debt, and the grantee who paid the entire debt was given subrogation in that amount. See United Carolina Bank v. Caroprop Ltd., 446 S.E.2d 415 (S.C.1994). No subrogation should be awarded to a grantee who merely takes subject to the mortgage, if the parties' understanding is that the grantee will in fact make the payments on the mortgage debt as they fall due. Such a grantee is regarded as primarily liable to the extent of the value of the land. See § 5.2, Comment c. Cf. Capabianco v. Bork, 256 A.2d 76 (N.J. Super. Ct. 1969), which recognizes (incorrectly, under the view of this Restatement) subrogation in favor of a nonassuming grantee.

Illustration 16 is based on Evans' Adm'r v. Evans, 199 S.W.2d 734 (Ky. 1947) (wife executed note as surety or accommodation party for husband). See also Reimann v. Hybertsen, 550 P.2d 436, modified, 553 P.2d 1064 (Or.1976); Hoopes v. Hoopes, 861 P.2d 88 (Idaho Ct.App.1993) (accommodation party who pays note has right of subrogation against personal property security given by principal obligor). If the mortgage secures an instrument governed by Article 3 of the Uniform Commercial Code, U.C.C. § 3–419(e) (1995) gives the accommodation party a right of reimbursement against the accommodated party and a right to enforce the instrument itself, but that section does not specifically provide for subrogation to the mortgage security.

Illustration 17 is based on Malone v. United States, 326 F.Supp. 106 (N.D.Miss.1971), affirmed, 455 F.2d 502 (5th Cir.1972); Toler v. Baldwin County Sav. & Loan Ass'n, 239 So.2d 751 (Ala.1970); Finance Co. of Am. v. Heller, 234 A.2d 611 (Md.1967); Konoff v. Lantini, 306 A.2d 176 (R.I. 1973); Sanders v. Lackey, 439 S.W.2d 610 (Tenn.Ct.App.1968); French v. May, 484 S.W.2d 420 (Tex. Ct. Civ. App. 1972); First Vt. Bank v. Kalomiris, 418 A.2d 43 (Vt. 1980). See also Cozzetto v. Wisman, 819 P.2d 575 (Idaho Ct.App.1991).

Illustration 18 is based on Johnson v. Zink, 51 N.Y. 333, 336–37 (1873). See Wright v. Estate of Valley, 827 P.2d 579 (Colo.Ct.App.1992); Howard v. Burns, 116 N.E. 703 (Ill.1917); Woodbury v. Swan, 58 N.H. 380 (1878); University State Bank v. Steeves, 147 P. 645 (Wash.1915), noted 2 A.L.R. 237. In United Carolina Bank v. Caroprop Ltd., 446 S.E.2d 415 (S.C.1994), the grantee took only a partial interest in the mortgaged real estate as a tenant in common. The grantee failed to make any mortgage payments despite the parties' understanding that it would do so. The grantor, who was the original mortgagor, then discharged the mortgage and claimed subrogation to the extent of the portion of the debt that the grantee should have paid. The court held that the grantor was only secondarily liable as to that portion of the debt, and gave the grantor subrogation against the grantee.

Illustration 19 is based on Joyce v. Dauntz, 45 N.E. 900 (Ohio 1896). See also Hooper v. Henry, 17 N.W. 476 (Minn.1883). Modern transactions of this sort are not common; the grantee ordinarily expects to pay the mortgage and pays a cash price reduced by the mortgage balance to reflect that expectation.

Performance induced by fraud or the like, Comment d. See generally Restatement of Restitution § 171. Illustration 20 is similar to Brookfield v. Rock Island Improvement Co., 169 S.W.2d 662 (Ark.1943), except that case involved the payment of a property tax lien rather than a prior mortgage. See also Kuske v. Staley, 28 P.2d 728 (Kan.1934), in which a mortgagee whose mortgage was forged but who had paid off a prior mortgage was given the benefit of subrogation to that mortgage.

Illustration 21 is based on Dixon v. Morgan, 285 S.W. 558 (Tenn. 1926). See also In re Hubbard, 89 B.R. 920 (Bankr.N.D.Ala.1988), involving similar facts except that the grantee sent a check to the grantor for the amount necessary to discharge the first mortgage; Union Trust Co. v. Lessovitz, 199 N.E. 614 (Ohio.Ct.App.1931), in which a mortgagee was fraudulently induced to pay off a prior mortgage on the assurance that it would then have a first mortgage. See Farm Credit Bank of Texas v. Ogden, 886 S.W.2d 305 (Tex. Ct. App. 1994), in which a new lender was granted subrogation to an old mortgage which it discharged; the title company had been instructed to obtain a subordination from the holder of an intervening lien, but due to a mistake it failed to do so. See also U.S. v. Avila, 88 F.3d 229 (3d Cir.1996), holding that a purchaser of land who paid off a senior mortgage under the mistaken belief that a junior federal tax lien on the land was no longer enforceable would be subrogated to the senior mortgagee's rights.

Illustration 22 is based on First Nat'l Bank v. Huff, 441 So.2d 1317 (Miss.1983). In that case, however, the land had been sold to a bona fide purchaser after the mortgage was released; hence the court held that it would be unjust to give the bank a lien on the land.

Performance at the request of the debtor, Comment e. An occasional case recognizes subrogation of a mortgagee to its *own* prior lien. See, e.g., Davis v. Johnson, 246 S.E.2d 297 (Ga.1978). However, the better view, followed by this Restatement, is that such cases should be handled as replacement mortgages rather than under the principle of subrogation. See § 7.3.

The following cases support the position of this Restatement that subrogation is available to the payor despite actual knowledge of the intervening interest: Wilkins v. Gibson, 38 S.E. 374 (Ga.1901); Klotz v. Klotz, 440 N.W.2d 406 (Iowa.Ct.App.1989); Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. Ct. App. 1994) (subrogation granted where payor had actual knowledge of intervening lien, and instructed title company to obtain a subordination from its holder, but title company failed to do so); Med Center Bank v. Fleetwood, 854 S.W.2d 278 (Tex. Ct. App. 1993) (subrogation granted even though payor was fully aware of intervening lien and trial court found that payor had no expectation of getting security in the tract in question); Chicago Title Ins. Co. v. Lawrence Inv., Inc., 782 S.W.2d 332 (Tex. Ct. App. 1989) (payor apparently had actual knowledge); Providence Inst. for Savings v. Sims, 441 S.W.2d 516, 520 (Tex.1969). See also Trus Joist Corp. v. National Union Fire Ins. Co., 462 A.2d 603 (N.J. Super. App. Div. 1983), in which the payor was fully apprised of the intervening judgment lien by the title insurer, and caused $18,000 of its loan to be placed in escrow to cover the lien. The court set aside the payor's mortgage on the ground that it was a result of a fraudulent conveyance (a risk of which the payor was fully aware when it made the loan), but nonetheless granted the payor subrogation to the extent that its loan had been used to discharge mortgages having priority over the judgment lien.

The Georgia cases subsequent to Wilkins v. Gibson, supra, are inconsistent, and it is difficult to determine whether Wilkins v. Gibson is still Georgia law. See Benenson v. Evans, 134 S.E. 441 (Ga.1926) (rejecting subrogation where the payor had actual notice); McCollum v. Lark, 200 S.E. 276 (Ga.1938) (leaving unclear whether actual notice would defeat subrogation); Bank of Canton v. Nelson, 160 S.E. 232 (Ga.1931) (holding that constructive notice from recordation would defeat subrogation, but with Hines, J., dissenting); Davis v. Johnson, 246 S.E.2d 297 (Ga.1978) (suggesting that actual knowledge tends to indicate an intent by the payor not to have the priority of the lien being paid).

The majority of cases refuse subrogation if the payor had actual knowledge of the intervening interest, but allow subrogation if the payor's only notice was constructive from the recordation of the intervening interest. See United States v. Baran, 996 F.2d 25 (2d Cir.1993) (N.Y. law); Han v. United States, 944 F.2d 526 (9th Cir. 1991) (California law); United States v. Hughes, 499 F.2d 322 (8th Cir. 1974) (Arkansas law; unclear whether court would have disallowed subrogation based on constructive notice alone); Mutual Life Ins. Co. of N.Y. v. Grissett, 500 F.Supp. 159 (M.D.Ala. 1980); Burgoon v. Lavezzo, 92 F.2d 726, 730 (D.C. Ct. App. 1937), noted in 113 A.L.R. 944; In re Hubbard, 89 B.R. 920 (Bankr.N.D.Ala.1988); Herberman v. Bergstrom, 816 P.2d 244 (Ariz.Ct.App.1991) (priority over intervening homestead declaration denied, where paying lender had actual knowledge of homestead claim); Commonwealth Bldg. & Loan Ass'n v. Martin, 49 S.W.2d 1046 (Ark.1932); Smith v. State Sav. & Loan Ass'n, 223 Cal.Rptr. 298 (Cal.Ct.App.1985); Metropolitan Life Ins. Co. v. First Security Bank, 491 P.2d 1261 (Idaho 1971) (subrogation denied, where payor had actual knowledge of intervening mechanics' liens but believed the lienors had agreed to hold the payor's title insurer harmless against the liens; the agreement, however, had been obtained by the mortgagor by fraud and was unenforceable against the lienors); Smith v. Dinsmore, 4 N.E. 648 (Ill.1887); Goodyear v. Goodyear, 33 N.W. 142 (Iowa 1887); Louisiana Nat'l Bank v. Belello, 577 So.2d 1099 (La.App.1991); United Carolina Bank v. Beesley, 663 A.2d 574 (Me.1995); Kitchell v. Mudgett, 37 Mich. 81 (1877); Prestridge v. Lazar, 95 So. 837, 838 (Miss. 1923); Anison v. Rice, 282 S.W.2d 497 (Mo.1955); Metrobank for Sav. v. National Community Bank, 620 A.2d 433 (N.J. Super. App. Div. 1993); Capabianco v. Bork, 256 A.2d 76 (N.J. Super. Ct. 1969) (subrogation granted despite payor's actual knowledge of intervening judgment lien, where former owner had submitted a false affidavit averring that the lien was not against him); King v. Pelkofski, 229 N.E.2d 435 (N.Y. 1967) (intervening interest was not a second mortgage, but a recorded trust agreement encumbering the real estate); Home Title Guaranty Co. v. Carey, 144 N.Y.S.2d 116 (N.Y.Sup.Ct. 1955); Rusher v. Bunker, 782 P.2d 170 (Or.App.1989); Pee Dee State

Bank v. Prosser, 367 S.E.2d 708 (S.C.App.1988); Lamoille County Sav. Bank v. Belden, 98 A. 1002 (Vt.1916); Restatement, Second, Restitution § 31, Comment *f* and Illustration 10 (Tentative Draft No. 2, 1984); Annot., 70 A.L.R. 1396, 1414 (1931).

A minority view denies subrogation even if the payor's only knowledge of the intervening interest was constructive notice from the recordation of that interest. See In re Gordon, 164 B.R. 706 (Bankr.S.D.Fla.1994) (Florida law); Independence One Mortg. Corp. v. Katsaros, 681 A.2d 1005 (Conn. Ct. App. 1996); Hieber v. Florida Nat'l Bank, 522 So.2d 878 (Fla. Dist.Ct.App.1988); Bank of Canton v. Nelson, 160 S.E. 232 (Ga.1931); Belcher v. Belcher, 87 P.2d 762 (Or. 1939), noted 24 Minn. L. Rev. 121 (1939). The continuing vitality of Belcher v. Belcher is called into question by Rusher v. Bunker, 782 P.2d 170 (Or.Ct.App.1989), refusing to bar subrogation where the payor had only constructive notice of the intervening lien.

Several cases deny subrogation because the payor had constructive notice of an intervening mechanic's lien from the knowledge that construction of improvements had recently been completed. See Collateral Inv. Co. v. Pilgrim, 421 So.2d 1274 (Ala. Ct. Civ. App. 1982); Carl H. Peterson Co. v. Zero Estates, 261 N.W.2d 346 (Minn. 1977); Cheswick v. Weaver, 280 S.W.2d 942 (Tex. Ct. Civ. App. 1955); Richards v. Security Pacific Nat'l Bank, 849 P.2d 606 (Utah Ct. App. 1993).

The payor is entitled to subrogation only if he or she expected to receive security in the entire real estate encumbered by the mortgage being paid. In Jefferson Standard Life Ins. Co. v. Brunson, 145 So. 156 (Ala. 1932), the first mortgage encumbered the entire tract, and the second mortgage only a portion of it. The payor discharged the first mortgage, but took a mortgage on only the portion of the tract which the second mortgage covered. The court refused to grant the payor subrogation to the first mortgage, pointing out that the limited coverage of the mortgage the payor received negated any intent that it should be treated as the equitable assignee of the first mortgage. Similar facts arose in Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. Ct. App. 1994). The payor retired a mortgage on a large tract of land, but took a new mortgage that excluded 191 acres of that land. The court held that the payor obviously had no expectation of security as to the 191 acres, and refused to grant subrogation with respect to it.

There is limited authority for subrogation even if the payor was not promised and did not expect to receive any security in the real estate. See Turney v. Roberts, 501 S.W.2d 601 (Ark.1973). That view is not followed in this Restatement.

The fact that the payor did not pay the prior mortgagee directly, but rather disbursed funds to the mortgagor with the understanding that the mortgagor would use them to pay the prior mortgage, will not preclude subrogation; see Dodge City of Spartanburg, Inc. v. Jones, 454 S.E.2d 918 (S.C.Ct.App.1995) (Howard, J., concurring).

Illustration 23 is based on Davis v. Johnson, 246 S.E.2d 297, 300 (Ga. 1978). See also Camden County Welfare Board v. FDIC, 62 A.2d 416 (N.J.Super.Ch.1948); Equity Sav. & Loan Ass'n v. Chicago Title Ins. Co., 463 A.2d 398 (N.J. Super. 1983), in which the mortgagor actively concealed the existence of the second mortgage from the third mortgagee. Under this Restatement, no such concealment is essential to the payor's right of subrogation. See also King v. Pelkofski, 229 N.E.2d 435 (N.Y. 1967), in which the intervening interest was not a second mortgage, but was a recorded trust agreement encumbering the real estate.

Illustration 24 is based on Anison v. Rice, 282 S.W.2d 497 (Mo.1955).

Illustration 25 is based on the facts of Talley v. Blackmon, 609 S.W.2d 113 (Ark.App.1980). However, that case was not argued on the basis of subrogation but as an equitable mortgage case. The court denied the equitable mortgage on the ground that the mother was not promised any security.

Illustration 26 is based on Klotz v. Klotz, 440 N.W.2d 406 (Iowa.Ct.App. 1989).

Illustration 28 is based on New York Fed. Sav. & Loan Ass'n v. Griggs, 204 N.Y.S.2d 647 (N.Y.Sup. Ct.1960). In that case the court held that the second mortgage was also enforceable against A's interest in the real estate to the extent of the full amount disbursed. See also Levenson v. G.E. Capital Mortgage Services, Inc., 643 A.2d 505 (Md. Ct. App. 1994); Federal Land Bank v. Henderson, Black & Merrill Co., 42 So.2d 829 (Ala.1949).

Cases implicating more than one subsection of this section are common. See, e.g., Equity Sav. & Loan Ass'n v. Chicago Title Ins. Co., 463 A.2d 398 (N.J. Super. 1983) (second mortgage obtained by fraud, with its proceeds used to pay off prior mortgage).

Subrogation not granted where injustice would result, Comment f. Illustration 30 is based on Rock River Lumber Corp. v. Universal Mortgage Corp., 262 N.W.2d 114 (Wis.1978) and Peterman-Donnelly Eng'rs & Contractors Corp. v. First Nat. Bank of Ariz., 408 P.2d 841 (Ariz.Ct.App. 1965). See also Richards v. Griffith, 28 P. 484 (Cal.1891) (intervening judgment lien foreclosed after prior mortgage had been satisfied and payor's mortgage had not yet been recorded). See Annot., 70 A.L.R. at 1413.

Illustration 31 is based on Richards v. Suckle, 871 S.W.2d 239 (Tex. Ct. App. 1994). In that case the court found that assignee of the second mortgage was aware of the subrogation claim, was not a bona fide purchaser, and hence had no defense to subrogation. The result of Illustration 31 is easier to reach if the assignment of the second mortgage occurs before the third mortgage is recorded; see Coonrod v. Kelly, 119 F. 841 (3d Cir. 1902).

The payor's delay in asserting a right of subrogation may prejudice the owners of intervening interests, and may cause a court to reject the claim of subrogation. In Heegaard v. Kopka, 212 N.W. 440 (N.D. 1927), the intervening interest was a second mortgage. The payor took a third mortgage, the proceeds of which were used to discharge the first mortgage debt. The holder of the intervening second mortgage then proceeded to foreclose it and bid in the full amount of the debt, in the belief that he now had a first mortgage. If subrogation were granted to the payor, the value of the real estate after deducting the amount of the original first mortgage would apparently have been less than the second mortgage debt. The court refused to grant subrogation to the payor, holding that his delay in seeking subrogation had prejudiced the holder of the second mortgage. See Railroadmen's Bldg. & Sav. Ass'n v. Rifner, 163 N.E. 236 (Ind.Ct.App. 1928) (payor delayed nearly four years in asserting subrogation, while intervening contract purchaser continued to make payments on contract; court held purchaser was prejudiced by the delay and denied subrogation). See also Neff v. Elder, 105 S.W. 260 (Ark.1907); Provident Cooperative Bank v. James Talcott, Inc., 260 N.E.2d 903 (Mass.1970); Landis v. State, 66 P.2d 519 (Okla.1937).

However, a delay in assertion of the right of subrogation does not necessarily prejudice anyone. In Levenson v. G.E. Capital Mortgage Services, Inc., 643 A.2d 505 (Md. Ct. App. 1994), the holder of a deed of trust lent funds to the borrower, a portion of which were used to pay off a prior mortgage loan. The holder subsequently foreclosed its deed of trust, and was informed a few days prior to the foreclosure sale of the existence of certain intervening judgment liens. The court held that it had no right of subrogation against those liens because it had not asserted that right in any judicial proceeding prior to foreclosing. However, it is unclear why this action should have been necessary, since granting subrogation would not have prejudiced the judgment lienholders and no rights of third party purchasers were involved. If the absence of a clear claim of subrogation were thought to have tainted the foreclosure sale, the court could have ordered a reforeclosure.

§ 7.7 Subordination

A mortgage, by a declaration of its mortgagee, may be made subordinate in priority to another interest in the mortgaged real estate, whether existing or to be created in the future, if the interest to which the mortgage is being subordinated is described with reasonable specificity in the declaration. A subordination that would materially prejudice the mortgagor or the person whose interest is advanced in priority is ineffective without the consent of the person prejudiced.

Cross-References:

Section 7.3, Replacement and Modification of Senior Mortgages: Effect on Intervening Interests.

Comment:

a. Introductory note. A mortgage subordination has the effect of reducing the mortgage's priority below that of some other interest or group of interests in the real estate to which the mortgage would otherwise be superior. While such a step is in itself usually disadvantageous to the subordinating mortgagee, it can be highly useful, for it may permit the consummation of a transaction that would otherwise be impractical. See Illustration 1.

Illustration:

1. Mortgagor owns Blackacre, a rental apartment project, subject to a mortgage held by Mortgagee-1. The mortgage secures a debt requiring monthly payments, but Mortgagor's payments are in default. The project has many vacancies and is in poor repair. Mortgagee-2 offers to make a new mortgage loan to provide funds to renovate the project, but only if the new mortgage can attain first priority. Mortgagee-1 concludes that this course of action offers a prospect of increasing the project's occupancy and bringing Mortgagee-1's loan current. Mortgagee-1 voluntarily executes a subordination in favor of a new mortgage loan by Mortgagee-2. The subordination specifies the amount, interest rate, and repayment terms of that loan and provides that its proceeds must be used for renovation of the project. This subordination is enforceable according to its terms, and gives Mortgagee-2's mortgage first priority.

This section deals only with subordination of mortgages. Other interests in land may also be subordinated. For example, a tenant may subordinate the leasehold interest to a subsequent mortgage given by the landlord over which the tenant would otherwise have priority. The holder of a servitude (an easement or covenant) may join in the execution of a mortgage on the real estate, thereby subjecting the servitude to the mortgage. These transactions are outside the scope of this section, although the principles discussed here are generally applicable to them.

One frequently sees references to "subordination agreements." It is true that a subordination can be incorporated in a contract, and that one can contract to give a subordination in the future. However, in its essence a subordination is not a contract but a declaration by a mortgagee that it is relinquishing the priority of mortgage to some other interest. The consent or involvement of the mortgagor or of the holder of the interest being promoted is necessary only if that person would be prejudiced by the promotion, a relatively rare occurrence. See Comment *d*.

If a mortgagee gives a subordination gratuitously, and not out of contractual duty, the mortgagee may attempt to withdraw it and return to its previous priority. This is permitted unless, prior to receiving notification of the withdrawal, a person whose interest is advanced by the subordination materially changes position in justifiable reliance on it, brings suit on it, or manifests assent to it at the request of anyone else who holds an interest in the real estate. See by analogy § 5.1(c)(5).

A subordination may be accomplished in several ways. If both the mortgage and the interest which is to gain priority by the subordination are already in existence, the subordinating mortgagee may execute (and record, if desired) a simple statement identifying that interest and declaring the mortgage to be subordinate to it. This conduct invites reliance on the part of the holder of the interest gaining priority by virtue of the subordination. While recording is not a requisite to the enforceability of the subordination as among persons with notice of it, it is a wise precaution from the viewpoint of the holder of the interest being advanced in priority. Without recording, the risk exists that a bona fide purchaser who lacks notice of the subordination will deal with the mortgagee in the belief that the mortgage continues to have priority, and that the recording act will permit such a person to treat the subordination as a nullity.

If the mortgage to be subordinated and the interest to gain priority over it are being created as part of the same transaction, a subordination can be achieved by the addition of a term to the mortgage itself, identifying or describing the other interest and reciting that it has priority over the mortgage. Alternatively, the parties may purport to establish priority between the mortgage and the other interest by the order of recording the two documents. While it seems widely assumed that order of recording will establish priority, a literal application of the recording acts would call this assumption into question. Most recording acts protect only subsequent purchasers without notice, and in the usual case involving the creation of two mortgages in the same transaction, each party is fully aware of the other's existence and the rights the other is acquiring. Hence neither is "without notice." Nonetheless, where the evidence shows that the parties employed a particular order of recording as a means of establishing priority, it is entirely appropriate for a court to treat the recording order as evidence of the parties' intent and adopt the priority thus indicated. On the other hand, it is inappropriate for a court to follow the order of recording if the parties' contract or other evidence shows that it contradicts the parties' intentions as to priority, or tbat the recording order was inadvertent, was contrary to the parties' instructions, or was regarded by them as insignificant.

A subordination is often the product of a contract, and as such is subject to the same sort of vitiating elements as other contracts, such as fraud, mistake, duress, and the like. While a subordination itself requires no consideration, a contract to subordinate in the future may be unenforceable unless supported by consideration.

b. Subordination to interests not yet in existence. Subordination is more complex when the mortgagee desires to yield priority to some interest that is to be created in the future. It is clear that such a subordination is possible. If an agreement, a clause in the mortgage, or a separate statement describes with reasonable specificity the interest that is to gain priority and declares that the mortgage will become subordinate to it, the subordination will be specifically enforced. For example, the holder of a purchase money mortgage may subordinate to a new mortgage loan to be made in the future to finance construction of improvements on the real estate.

However, in such cases the requirement of description with reasonable specificity assumes greater importance. When one subordinates to an interest already in existence, it is generally easy to identify it unmistakably by a reference to such information as its date, its parties, or the recording information for the document that created it. But when the interest that is to gain priority does not yet exist, it must necessarily be described in more general terms. If the generality is too great, it can seriously disadvantage the subordinating mortgagee. A premise of this section is that mortgage holders should not be placed in the position of subordinating to interests with inadequately specified characteristics, since it may be fundamentally unconscionable to do so. While the interest to be created in the future obviously cannot be depicted in precise detail, it must be described with reasonable specificity; if this is not done, the courts will not enforce the subordination.

What is reasonably specific depends on the circumstances. Where the interest to gain priority is another mortgage securing a debt, reasonable specificity requires at a minimum an identification of the new lender or the type of lender, an upper limit on the initial amount of that debt, and an upper limit on its interest rate. If the parties contemplate that the proceeds of the later mortgage will be used to improve the real estate, and that those improvements are part of the bargained-for security on which the subordinating mortgagee is relying, then reasonable specificity requires a statement requiring use of the subsequent loan proceeds for that purpose and a reasonable description of the improvements. See Illustrations 2 and 3.

Illustrations:

2. Mortgagee sells Blackacre to Mortgagor and takes, as part of the price, a purchase money mortgage. Mortgagor proposes to construct a condominium project on Blackacre and requires a construction loan for that purpose. Mortgagee subordinates the purchase money mortgage "to a construction loan to be made in the future," but the mortgage provides no further description of the loan. The subordination is not enforceable.

3. The facts are the same as Illustration 2, except that Mortgagee subordinates "to a construction loan to be obtained

from a bank or savings association in X County. Such loan shall not exceed $1 million, its term shall not exceed two years, and its interest rate shall not exceed the prime rate plus two percent. No amortization of principal during the term of the loan need be required. All funds disbursed under such loan shall be used for labor and materials to construct a condominium project in substantial conformity with the plans and specifications approved by Mortgagee and attached hereto." The subordination is enforceable if the subsequent loan satisfies the stated conditions.

In Illustration 3 the subordination incorporates the plans and specifications for the improvements to be constructed on the real estate. While this level of specificity may be wise from the viewpoint of the subordinating mortgagee, it is not essential to enforcement of the subordination. A much more general description of the improvements (e.g., "a 50-unit residential condominium project") is acceptable. With respect to the financial terms of the loan to which the mortgagee is subordinating, Illustration 3 represents the minimum acceptable level of specificity: amount, interest rate (including the basis for any future adjustments to interest), term, and amortization payments (if any) must be stated or limited.

A person who requests a mortgagee to subordinate to an interest to be created in the future may attempt to avoid the requirement of reasonable specificity by inserting in the subordination, or in some related contract, a provision purporting to waive the mortgagee's right to reasonable specificity. The fundamental reason for the requirement is to prevent unfairness to the subordinating mortgagee in the enforcement of the subordination. A waiver provision may shed some light on whether enforcement would be unconscionable, particularly if the mortgagee is highly sophisticated and experienced, but it is not conclusive. Enforcement of an unduly vague subordination may well be considered unjust notwithstanding a waiver provision. See Restatement, Second, Contracts § 208, Unconscionable Contract or Term; § 362, Effect of Uncertainty of Terms.

c. Conditional subordination. Subordinations may be and frequently are made conditional. For example, in Illustration 3 above, the provisions respecting amount, term, interest rate, type of lending institution, and use of funds are all conditions. To the extent that the conditions are not satisfied, and that the failure to satisfy them is materially prejudicial to the subordinating mortgagee, the subordination is ineffective. By analogy, see § 7.3(b), dealing with modification of mortgages. In many cases in which the conditions are unsatisfied, justice can be done by imposing a *pro tanto* loss of priority to reflect the loss suffered by the subordinating mortgagee as a result of deviation from the conditions. See Illustrations 4–7.

Illustrations:

4. The facts are the same as Illustration 3. However, the subsequent loan is made at an interest rate equal to the prime rate plus three percent. That loan has priority over Mortgagee's mortgage, but only to the extent of the loan balance that would have existed if its interest rate had been the prime rate plus two percent. To the extent of the remainder of the loan balance, it is subordinate to Mortgagee's mortgage.

5. The facts are the same as Illustration 3. However, the subsequent loan is made for $1.5 million. That loan has priority over Mortgagee's mortgage, but only to the extent of $1 million plus interest thereon. To the extent of the remainder of the loan balance, it is subordinate to Mortgagee's mortgage.

6. The facts are the same as Illustration 3, except the construction lender administers the loan without using reasonable care, allowing Mortgagor to divert some proceeds of the loan to nonconstruction purposes. To the extent of these diverted funds, the construction mortgage is subordinate to Mortgagee's mortgage.

7. The facts are the same as Illustration 3, except that the entire loan proceeds are disbursed and used to purchase business inventory rather than for construction of improvements. The entire mortgage is subordinate to Mortgagee's mortgage.

When a mortgagee subordinates to an interest that is already in existence, the terms of that interest become, in effect, conditions of the subordination. Hence, if the terms of that interest are later materially modified in a manner that materially prejudices the position of the subordinating mortgagee, the conditions are no longer satisfied and the subordination will no longer be effective. In general, a *pro tanto* loss of priority is the appropriate remedy. See § 7.3, dealing with the substantially identical situation of modification of mortgages. See Illustration 8.

Illustration:

8. Mortgagee sells Blackacre to Mortgagor and takes, as part of the price, a purchase money mortgage. Mortgagor intends to construct a condominium project on Blackacre and arranges a construction loan for that purpose. The construction loan and the purchase money mortgage are given at the same settlement. The

purchase money mortgage contains a term subordinating it to the construction mortgage, which it specifically identifies by date and mortgagee. Subsequently the construction lender and Mortgagor modify the construction loan's terms by increasing the amount and eliminating the requirement that funds advanced under it must be used for construction on Blackacre. These modifications are materially prejudicial to Mortgagee. The subordination is no longer effective to the extent that the modifications result in loss to Mortgagee, and Mortgagee's purchase money mortgage has priority over the construction mortgage to that extent.

In Illustration 8, Mortgagee may suffer loss because the construction loan has an increased balance as a result of the modification, because the real estate has fallen in value because of a modified and extended loan term, because funds disbursed under the construction loan are diverted to non-construction purposes, or for all of these reasons.

d. Consent to subordination required. In most cases subordination is beneficial to the holder of the interest being promoted in priority. Such parties often negotiate vigorously to obtain a subordination. However, in some cases the advancement of priority may actually be disadvantageous. See Illustration 9. In such a case, the subordination is not effective without the consent of the party being advanced.

Illustration:

9. Blackacre is owned by Mortgagor, subject to a mortgage held by Mortgagee and a lease, junior to the mortgage, held by Tenant. The rental under the lease is burdensome and the lease terms are disadvantageous to Tenant. Mortgagor defaults in payment on the debt secured by the mortgage, and Mortgagee institutes foreclosure proceedings. Under applicable law, Tenant has the right to become a party to those proceedings and, because of its junior status, to have Tenant's lease terminated upon completion of the foreclosure. Tenant desires this result, but Mortgagee does not. In an attempt to prevent this result and preserve the lease, Mortgagee informs Tenant that Mortgagee is subordinating its lien to Tenant's lease. Tenant refuses to consent to this action. The subordination is ineffective.

Similarly, mortgagors are generally indifferent to subordination. The mortgagor's real estate is subject to the same mortgages as before; only their order of priority has changed. If, however, the change of priorities can be shown to result in material prejudice to the mortgagor, it is effective only with the mortgagor's consent.

REPORTERS' NOTE

Introductory note, Comment a. See generally 2 G. Nelson & D. Whitman, Real Estate Finance Law § 12.9 (3d ed. 1993); Lambe, Enforceability of Subordination Agreements, 9 Real Prop. Prob. & Tr. J. 631 (1984); Korngold, Construction Loan Advances and the Subordinated Purchase Money Mortgagee: An Appraisal, A Suggested Approach, and the ULTA Perspective, 50 Fordham L. Rev. 313 (1981); Note, The Subordination of Purchase-Money Security, 52 Cal. L. Rev. 157 (1964); Miller, Starr and Regalia, Subordination Agreements in California, 13 U.C.L.A. L. Rev. 1298 (1966).

In the absence of prejudice, a subordination requires the consent of neither the mortgagor (see Graydon v. Colonial Bank—Gulf Coast Region, 597 So.2d 1345 (Ala.1992)) nor the holder of the interest gaining priority (see In re Lantana Motel, 124 B.R. 252 (Bankr.S.D.Ohio 1990); Southern Floridabanc Fed. Sav. & Loan Ass'n v. Buscemi, 529 So.2d 303 (Fla.Dist. Ct.App.1988); Johnson v. Florida Bank, 13 So.2d 799 (Fla.1943)).

A subordination may be achieved either by agreement, or by a "waiver or release" by the holder of the subordinating mortgage; see Oakes v. Michigan Oil Co., 476 So.2d 618 (Ala. 1985).

The Statute of Frauds is usually held applicable to subordinations; see Troj v. Chesebro, 296 A.2d 685 (Conn. Sup. Ct. 1972); Metrobank for Savings v. National Community Bank, 620 A.2d 433 (N.J. Super. Ct. 1993). Contra, see North Georgia Sav. & Loan Ass'n v. Corbeil, 339 S.E.2d 779 (Ga.Ct.App.1986). Nonetheless, oral subordination agreements are often enforced on a variety of theories; see Poyzer v. Amenia Seed and Grain Co., 409 N.W.2d 107 (N.D.1987) (part performance); In re Mihalko, 87 B.R. 357 (Bankr.E.D.Pa.1988) (enforced on basis of instructions to settlement clerk); Community Title Co. v. R.T. Crow, 728 S.W.2d 652 (Mo.Ct.App. 1987) (same). Cf. In re Red Cedar Construction Co., 63 B.R. 228 (Bankr. W.D.Mich.1986) (letter constituted insufficient evidence of intent to subordinate liens on inventory and accounts receivable).

Illustration 1 is based on Peninsula Fed. Sav. & Loan Ass'n v. DKH Properties, Ltd., 616 So.2d 1070 (Fla. Dist.Ct.App.1993). See also MCB Ltd. v. McGowan, 359 S.E.2d 50 (N.C.Ct. App.1987), which involved similar facts, but in which the court refused to enforce the subordination because the description of the loan to be promoted in priority was too vague.

Courts frequently assume that order of recording will determine priority among mortgages. However, if the parties have notice of one another this is strictly correct only in a state with a "race" recording statute; see Carolina Builders Corp. v. Howard-Veasey Homes, Inc., 324 S.E.2d 626 (N.C.Ct.App.1985). The fallacy that order of recording automatically subordinates the later-recorded mortgage is recognized in FDIC v. Republicbank, 883 F.2d 427 (5th Cir.1989); Colonial Villas, Inc. v. Title Ins. Co. of Minnesota, 703 P.2d 534 (Ariz.Ct. App.1985); and Friarsgate, Inc. v.

First Fed. Sav. & Loan Ass'n, 454 S.E.2d 901 (S.C.Ct.App.1995). Even courts that assume recording order controls also recognize that a contrary agreement or expression of intent will override recording order as a determinant of priority. See FDIC v. Republicbank, 883 F.2d 427 (5th Cir.1989) (parties' agreement controls); Monterey Devel. Corp. v. Lawyer's Title Ins. Corp., 4 F.3d 605 (8th Cir.1993) (parties' judicial stipulation for judgment controls over order of recording); In re Mihalko, 87 B.R. 357 (Bankr.E.D.Pa.1988); BankWest v. U.S., 102 B.R. 738 (D.S.D.1989) (parties' intent controls); In re Berkley Multi-Units, Inc., 102 B.R. 852 (Bankr.M.D.Fla.1989), further opinion, 104 B.R. 455 (Bankr.M.D.Fla. 1989) (statement in group of mortgages that they were of "equal dignity," and in another mortgage that it was a "third mortgage," effectively established priority, irrespective of recording order); Community Title Co. v. Crow, 728 S.W.2d 652 (Mo.Ct. App.1987) (parties' intent controls).

A subordination procured by fraud is subject to rescission; see Weisman v. Kaspar, 661 A.2d 530 (1995); Perkins v. Coombs, 769 P.2d 269 (Utah Ct.App.1988); Ashmore v. Herbie Morewitz, Inc., 475 S.E.2d 271 (Va. 1996). A contract to subordinate is unenforceable in the absence of consideration; see Bigelow v. Nottingham, 833 P.2d 764 (Colo.Ct.App.1991), reversed on other grounds, 855 P.2d 1368 (Colo.1993); Cameron v. Churchill Mortgage Corp., 290 S.E.2d 474 (Ga.1982); Dugan v. First National Bank, 606 P.2d 1009 (Kan.1980). However, consideration is generally easy to find; see In re Cliff's Ridge Skiing Corp., 123 B.R. 753 (Bankr. W.D.Mich.1991) (lender who was benefited by subordination agreement supplied consideration by making the new loan); Miller v. Wines, 554 N.E.2d 784 (Ill. App. Ct. 1990) (advance of funds to seller by lender who was benefited by subordination was sufficient consideration for subordination agreement).

Subordination to interests not yet in existence, Comment b. Illustrations 2 and 3 are based on Handy v. Gordon, 422 P.2d 329 (Cal. 1967), noted in 26 A.L.R.3d 84, and Stockwell v. Lindeman, 40 Cal.Rptr. 555 (Cal.Ct. App.1964). See also Lahaina–Maui Corp. v. Tau Tet Hew, 362 F.2d 419 (9th Cir.1966) (Hawaii law); Stenehjem v. Kyn Jin Cho, 631 P.2d 482 (Alaska 1981); Roskamp Manley Associates, Inc. v. Davin Dev. and Inv. Corp., 229 Cal.Rptr. 186 (Cal. Ct. App. 1986); Troj v. Chesebro, 296 A.2d 685 (Conn. Sup. Ct. 1972); Malani v. Clapp, 542 P.2d 1265 (Hawaii 1975); Hux v. Raben, 219 N.E.2d 770 (Ill. App. Ct. 1966), affirmed, 230 N.E.2d 831 (Ill.1967); Grooms v. Williams, 175 A.2d 575 (Md.1961); American Federal Sav. & Loan Ass'n v. Orenstein, 265 N.W.2d 111 (Mich. Ct.App.1978); MCB Ltd. v. McGowan, 359 S.E.2d 50 (N.C.Ct.App.1987), noted in 23 Wake For. L. Rev. 575 (1988) (agreement to subordinate to a new first mortgage "in such amount as may reasonably be requested" was too vague to enforce).

Contrary cases, enforcing subordinations with vague or missing descriptions of the interest to be promoted, include Rice v. Salem Dev. Corp., 1993 WL 242029 (Conn. Sup. Ct. 1993) (enforcing an "automatic" subordination to a future mortgage identified only by a maximum amount per lot); Southern Floridabanc Fed. Sav. & Loan Ass'n v. Buscemi, 529 So.2d 303 (Fla.Dist.Ct.App.1988) (enforcing a subordination agreement which described the loan to gain priority only by amount and lender); Provident Fed. Sav. & Loan Ass'n v. Idaho Land Developers, Inc., 757 P.2d 716 (Idaho Ct.App.1988); Dorothy Edwards Realtors, Inc. v. McAdams, 525 N.E.2d 1248 (Ind.Ct.App. 1988) (subordination in installment sale contract); Hyatt v. Maryland Fed. Sav. & Loan Ass'n, 402 A.2d 118 (Md. Ct. App. 1979); Campbell Inns v. Banholzer, Turnure & Co., 527 A.2d 1142 (Vt.1987); White & Bollard, Inc. v. Goodenow, 361 P.2d 571 (Wash. 1961). See Conn. Gen. Stat. Ann. § 49–31c, rejecting the view of this section and approving subordinations that do not contain any of the terms of future mortgages being subordinated to. See generally Annot., Requisite Definiteness of Provision in Contract for Sale or Lease of Land, that Vendor or Landlord Will Subordinate His Interest to Permit Other Party to Obtain Financing, 26 A.L.R.3d 855 (1969).

Conditional subordination, Comment c. Illustrations 4, 5, and 7 are based on Jones v. Sacramento Sav. & Loan Ass'n, 56 Cal.Rptr. 741 (Cal.Ct. App.1967) (subordination on the condition that permanent loan commitments were to be obtained before construction loans were made). See also Creditco Financial Services, Inc. v. Calvert, 638 So.2d 821 (Ala.1994) (condition subordinating to "a construction loan" was not satisfied where subsequent mortgage did not secure a loan, but instead secured payment to a contractor for work or materials supplied to the property); Guarantee Bank v. Magness Constr. Co., 462 A.2d 405 (Del.1983) (agreement to subordinate to a loan to be made to a corporation does not subordinate to a loan made to a related individual); U.S. v. South Atlantic Prod. Credit Ass'n, 606 So.2d 691 (Fla.Dist.Ct.App.1992) (subordination to a first mortgage "in an amount not to exceed $85,060"); Credithrift, Inc. v. Knowles, 556 So.2d 775 (Fla.Dist. Ct.App.1990) (subordination only on condition that mortgagor attempted to substitute collateral); Life Sav. & Loan Ass'n v. Bryant, 467 N.E.2d 277 (Ill. App. Ct. 1984) (subordination to a first mortgage not exceeding a stated amount and interest rate, and only for 45 days); National Bank of Waterloo v. Moeller, 434 N.W.2d 887 (Iowa 1989) (subordination only on condition that mortgagee be provided additional collateral by mortgagor); Riggs Nat'l Bank v. Wines, 474 A.2d 1360 (Md. Ct. App. 1984) (subordination to a mortgage "from a recognized lending institution, the proceeds of which are to be applied to the erection of improvements"); Johnson-Shea Assoc. v. Union Valley Corp., 649 A.2d 1293 (N.J. Super. App. Div. 1994) (condition subordinating to a "development mortgage" was not satisfied, where subsequent mortgage secured preexisting, formerly unsecured, debts of the developer); Sawyer Sav. Bank v. Kent, 600 N.Y.S.2d 807 (N.Y.App.Div.1993) (subordination found not to be conditioned upon promoted mortgagee's formal dismissal of preexisting suit against mortgagor); Friarsgate, Inc. v. First Fed. Sav. & Loan Ass'n, 454 S.E.2d 901 (S.C.Ct.App.1995) (subordination on condition that total loans on real estate did not exceed 75% of market value of lot and improvements); Bank v. Crumley, 699 S.W.2d 164 (Tenn.Ct. App.1985) (subordination only to a loan used for "working capital"); Campanella v. Ranier Nat'l Bank, 612 P.2d 460 (Wash.Ct.App.1980) (party given priority by subordination for one year must complete foreclosure within the year); Blanton v. FDIC, 706 P.2d 1111 (Wyo.1985) (subordination to loan not exceeding $200,000 to be used for certain purposes). See also Machias Sav. Bank v. Longfellow, 662 A.2d 235 (Me.1995) (subordination held effective, even though mortgage achieving priority did not conform precisely to the conditions of subordination, where subordinating mortgagee's conduct in reviewing the new mortgage manifested assent to it).

Illustration 6 is based on In re Sunset Bay Assoc., 944 F.2d 1503 (9th Cir.1991); Creditco Fin. Serv. v. Calvert, 638 So.2d 821 (Ala.1994); Burkons v. Ticor Title Ins. Co., 813 P.2d 710 (Ariz.1991); Dickens v. First American Title Ins. Co., 784 P.2d 717 (Ariz.Ct.App.1989); Protective Equity Trust No. 83 v. Bybee, 2 Cal.Rptr.2d 864 (Cal.Ct.App.1991); Mercantil Intercontinental, Inc. v. Generalbank, 601 So.2d 293 (Fla.Dist.Ct.App.1992); and Pastor v. Lafayette Bldg. Ass'n, 567 So.2d 793 (La.Ct.App.1990) (decided on the basis that construction lender's careless disbursal of funds was a negligent misrepresentation, but more readily analyzed as a violation by the construction lender of the conditions of the subordination). See generally Annot., Construction Mortgagee–Lender's Duty to Protect Interest of Subordinated Purchase-Money Mortgagee, 13 A.L.R.5th 684 (1993).

In Mayor and Council of Rockville v. Walker, 640 A.2d 751 (Md. Ct. App. 1994), the city, as grantor of land to an urban renewal developer, reserved a right of entry but subordinated that right to any "authorized" mortgage the developer might impose on the land. The agreement required the developer to give the city advance notice of any proposed mortgage, but the developer executed a mortgage without giving such notice. The divided court held that the subordination was nonetheless effective; it found that the developer's promise to give the notice was only a covenant, and not a condition.

Conditions on a subordination may be very strictly enforced. In Business Bank v. Beavers, 442 S.E.2d 644 (Va. 1994), land sellers agreed to take back a purchase money mortgage and promised that they would subordinate it to any "bona fide land acquisition/land development/construction loan(s)." The purchaser arranged a land development loan prior to the closing of the sale, and caused the closing agent to record it before recordation of the sellers' purchase-money mortgage as a means of subordinating the latter. The court held that this method of accomplishing the subordination was not authorized by the subordination agreement, which it read as requiring an act of the sellers to accomplish the subordination. Since there was no suggestion that the land development loan failed to comply with the specification in the subordination agreement, the decision seems to exalt form over substance. Note, however, that the agreement's meager description of the loan to be obtained would not meet this Restatement's requirement of reasonable specificity.

An "automatic" promise to subordinate in the future, even though it is too vague to enforce, may be made enforceable by a subsequent more specific subordination executed by the mortgagee after the new loan has been identified. Likewise, the subsequent subordination may omit protective conditions that appeared in the original agreement, and if it does those protections may be lost; see Roberts v. Harkins, 292 So.2d 603

(Fla.Dist.Ct.App.1974); Security Trust Fed. Sav. & Loan Ass'n v. Gill Sav. Ass'n, 398 S.E.2d 382 (Ga.Ct. App.1990); Aetna Life Ins. Co. v. McElvain, 717 P.2d 1081 (Mont.1986) (subordination valid, although mortgage gaining priority was for much larger amount than subordinating vendors had agreed to, where their broker had knowledge of the larger amount).

When a condition on a subordination is unfulfilled, the question arises whether the subordination should be declared entirely void, or only *pro tanto* to the extent that the lack of satisfaction of the condition harms the lender relying on it. This Restatement adopts the *pro tanto* view, and is supported by Cambridge Acceptance Corp. v. Hockstein, 246 A.2d 138 (N.J. Super. Ct. 1968) ("if, however, the construction mortgagee expressly agrees with the subordinator to see to it that the proceeds of his loan will be applied to construction of the improvement he will be held to his agreement and will lose his priority as to any advance not going into the construction").

An alternative approach, when conditions on a subordination are unfulfilled, is to declare the subordination entirely void but to give the lender which would have benefited from the subordination an equitable lien, prior to the subordinating mortgagee's lien, to the extent necessary to prevent unjust enrichment. See Jones v. Sacramento Sav. & Loan Ass'n, 56 Cal. Rptr. 741 (Cal.Ct.App.1967) (subordination declared void due to failure of conditions, but construction lender granted an equitable lien to recover its investment in houses built on the real estate with its disbursements). This produces approximately the same result as a *pro tanto* reversal of priorities.

Another form of remedy for unsatisfied conditions in a subordination is represented by Electric M & R, Inc. v. Banco Popular de Puerto Rico, 863 F.2d 1055 (1st Cir.1988), in which the subordinating lender imposed two conditions: that the new lender would limit its loan to a fixed dollar amount, and that it would declare the mortgagor in default if it failed to meet its obligations. The court found that the new lender failed to meet both of these conditions. The subordinating lender brought an action for damages, but the court held that it had made no showing that its losses on its loan were caused by the failure of the conditions. This result is compatible with the *pro tanto* reversal of priorities called for by Illustrations 4 through 6.

This Restatement takes no position as to whether a court should imply conditions on subordinations to protect the subordinating mortgagee. A few cases, principally in California, have implied conditions; see Middlebrook–Anderson Co. v. Southwest Sav. & Loan Ass'n, 96 Cal.Rptr. 338 (Cal.Ct.App.1971); Woodworth v. Redwood Empire Sav. & Loan Ass'n., 99 Cal.Rptr. 373 (Cal.Ct.App.1971); Peoples Bank v. L & T Developers, Inc., 434 So.2d 699 (Miss.1983); Cambridge Acceptance Corp. v. Hockstein, 246 A.2d 138 (N.J. Super. Ct. 1968) (implying condition that construction lender will "make and administer the loan in the conventional manner of a construction lender"). Contra, refusing to imply conditions, see Home Sav. Ass'n v. State Bank of Woodstock, 763 F.Supp. 292 (N.D.Ill. 1991) (Illinois law, declining to impose a condition of "cautious loan administration"); In re Nash, 60 B.R. 27

(Bankr. 9th Cir. 1986) (Arizona law); Connecticut Bank and Trust Co. v. Carriage Lane Assoc., 595 A.2d 334 (Conn.1991) (no conditions will be implied where parties have negotiated the matter and failed to include express conditions); Rockhill v. United States, 418 A.2d 197 (Md.1980); Fineo v. Chemical Bank, 603 N.Y.S.2d 555 (N.Y.App.Div.1993) (subordination upheld despite subordinated mortgagee's allegations of bad faith and improper use of the senior loan proceeds); Tuscarora, Inc. v. B. V. A. Credit Corp., 241 S.E.2d 778 (Va. 1978).

Illustration 8 is based on Koloff v. Reston Corp., 1993 WL 106062 (Del. Ch.1993), but in that case the court apparently ordered a total loss of priority. Other cases in which priority was entirely reversed include In re Sunset Bay Assoc., 944 F.2d 1503 (9th Cir.1991); Citizens & Southern Nat'l Bank v. Smith, 284 S.E.2d 770 (S.C.1981); and Gluskin v. Atlantic Sav. & Loan Ass'n, 108 Cal.Rptr. 318 (Cal.Ct.App.1973). Under this Restatement the loss of priority would be only *pro tanto*. Cases supporting a *pro tanto* reversal of priorities include Mercantil Intercontinental, Inc. v. Generalbank, 601 So.2d 293 (Fla. Dist.Ct.App.1992) (dictum); United States Cold Storage v. Great Western Sav. & Loan Ass'n, 212 Cal.Rptr. 232 (Cal.Ct.App.1985); and Miller v. Citizens Sav. & Loan Ass'n, 56 Cal.Rptr. 844 (Cal.Ct.App.1967). See also Partridge v. Hynning, 335 F.2d 994 (D.C.Cir.1964), in which the mortgagee executed a subordination to a new first mortgage. The mortgagor later wished to borrow an additional amount from the new first mortgagee, and the court held that the old mortgagee had no obligation to subordinate to this additional amount. In effect, the result is identical to a *pro tanto* reversal of priority.

The court in *Sunset Bay*, supra, asserted that under California case law, *pro tanto* reversal is granted where *implied* conditions are broken, while total reversal is granted where *express* conditions are broken; id. at note 13. This distinction is of dubious merit and is not followed in this Restatement. Cases such as Illustration 8, which involve a modification of the mortgage which receives priority under the subordination, may be regarded as simple matters of modification of a senior mortgage, governed by the principles of § 7.3. However, since the interest which is given priority by the subordination agreement suffers only a *pro tanto* loss of priority as a consequence of the modification, the result is the same.

Consent to subordination required, Comment d. Although no cases have been found specifically requiring the consent of a mortgagor or other person materially prejudiced by a subordination agreement, there are decisions in which courts have upheld such agreements only after concluding that there was no such prejudice. See, e.g., Graydon v. Colonial Bank—Gulf Coast Region, 597 So.2d 1345 (Ala.1992). For an analogy, see Restatement, Second, Contracts § 317(2)(a), which disallows the assignment of contractual rights in circumstances when the assignment would prejudice the obligor. Alternatively, a court will recognize a prejudicial advancement in priority if the holder of the interest being advanced has already consented to it; see In re 240 North Brand Partners, Ltd., 200 B.R. 653 (9th Cir. BAP 1996) (lease clause consented to tenant's advancement of priority by mortgagee's subordination).

§ 7.8 Foreclosure of Wraparound Mortgages

If a mortgagee has a contractual duty to the mortgagor to perform an obligation secured by another mortgage of higher priority on the same real estate, the mortgagee may seek to recover in foreclosure only the amount by which the balance owing on the obligation secured by the mortgage being foreclosed exceeds the balance owing on the mortgage obligation that the mortgagee has a duty to pay, together with appropriate fees and costs. Any surplus remaining after application of this sum is distributed under the principles of § 7.4.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 7.4, Effect of Priority on the Disposition of Foreclosure Surplus.

Comment:

a. Introduction. This section deals with wraparound mortgages. In a wraparound mortgage transaction, an existing or "underlying" mortgage created at some earlier date encumbers the real estate. The wraparound mortgagee typically makes a loan to the real estate's owner for an additional amount, and receives from the owner a note or other evidence of obligation in an amount equal to the sum of the additional amount advanced and the balance owing on the underlying mortgage debt. This full obligation is secured by a new "wraparound" mortgage with a priority subordinate to that of the underlying mortgage. The wraparound mortgagee covenants to make the payments due on the underlying debt, on the condition that the mortgagor makes the payments due on the wraparound debt. Illustration 1 is an outline of a typical wraparound mortgage transaction governed by this section.

Illustration:

1. Mortgagor owes $300,000 to Mortgagee-1. The debt bears interest at six percent per annum and requires monthly payments of principal and interest of $2,532, which are sufficient to amortize the debt in 15 years. It is secured by a first mortgage on Blackacre, which Mortgagor owns. Mortgagor approaches Mortgagee-2 and seeks to borrow an additional $500,000. Mortgagee-2 agrees to loan that sum to Mortgagor on a wraparound basis. Mortgagor executes a second mortgage on Blackacre to Mortgagee-2, securing a promissory note payable to Mortgagee-2 for $800,000. The note bears interest at eight percent per annum and requires monthly payments of principal and interest of $6,692,

which are sufficient to amortize the $800,000 debt in 20 years. Mortgagee–2 covenants to make the monthly payments due to Mortgagee–1, on the condition that Mortgagor makes the monthly payments due to Mortgagee–2.

Illustration 1 fulfills the preliminary conditions of this section: The wraparound mortgagee (in the Illustration, Mortgagee–2) has a contractual duty to make the payments due to a mortgagee with higher priority (Mortgagee–1). This section applies even though that duty is conditional, in the sense that the mortgagee must pay on the superior lien only if the mortgagee receives the corresponding payment from the mortgagor.

b. Rights and duties in foreclosure. The focus of this section is the foreclosure of the wraparound mortgage. Since the wraparound mortgage is subordinate to the underlying mortgage, a foreclosure of the wraparound mortgage will place title to the real estate in the hands of the foreclosure purchaser subject to the underlying mortgage, unless the latter is discharged. See § 7.1. A well-informed bidder at the foreclosure sale will, of course, take this fact into account in formulating a bid. See Illustration 2.

Illustration:

2. The facts are the same as Illustration 1. Mortgagor defaults in payment to Mortgagee–2, who institutes foreclosure proceedings for the entire $800,000 balance owing on the wraparound mortgage debt. Buyer is interested in acquiring Blackacre at the foreclosure sale. Prior to the foreclosure sale, Buyer inspects Blackacre and concludes that its market value, free of all encumbrances, is $1 million. Buyer inquires of Mortgagee–1 and learns that the balance owing on the first mortgage debt is $300,000. In the absence of any assurance that any proceeds of the foreclosure sale will be applied toward Mortgagee–1's debt, Buyer determines that the maximum bid he or she will enter at the foreclosure sale is the difference between Blackacre's market value ($1 million) and the first mortgage debt ($300,000), or $700,000.

On the facts of Illustration 2, no unfairness to the foreclosure sale buyer occurs. The buyer expects to take the land subject to the first mortgage, and discounts his or her bid accordingly. The buyer recognizes that discounting the bid in this manner is necessary because, if he or she does not ultimately pay the $300,000 debt secured by the first mortgage, the real estate remains subject to foreclosure by

Mortgagee-1. This follows from the fundamental principle that foreclosure of a junior mortgage leaves the real estate subject to all senior mortgages; see § 7.1. Thus, although the second (wraparound) mortgage will be eliminated by the foreclosure, the first (underlying) mortgage will not. The buyer will need to pay the $300,000 first mortgage debt later in order to clear the title to the real estate. For that reason, the highest bid the buyer will enter at the foreclosure sale is the $1 million market value less the $300,000 balance owing on the prior mortgage, or $700,000.

The focus of this section is the proper disposition of the funds received at the wraparound mortgage foreclosure sale. This section provides that the foreclosing mortgagee is permitted to retain those funds only to the extent of what may be termed the "net" balance owing on the wraparound debt—that is, the excess of the wraparound mortgage balance over the underlying mortgage balance (plus the usual costs and attorneys' fees as provided in the mortgage and approved under local law). Any remaining funds must be treated as surplus and applied toward subordinate liens or placed in the mortgagor's hands under the principles of § 7.4. In substance, the wraparound mortgage is treated like any other junior mortgage, except that its balance is considered to be only the "net" balance owed to the wraparound mortgagee. See Illustration 3.

Illustration:

3. The facts are the same as Illustration 1. Mortgagor defaults in payment to Mortgagee-2, who institutes foreclosure proceedings. Mortgagee-2 is permitted to recover from the foreclosure sale proceeds only the difference between the $800,000 balance owing on the wraparound mortgage debt and the $300,000 balance owing on the underlying mortgage debt, or $500,000. Buyer evaluates Blackacre as having an unencumbered market value of $1 million, and purchases at the foreclosure sale with a bid of $700,000 as in Illustration 2. Mortgagee-2 may retain only $500,000 of the foreclosure proceeds and, there being no subordinate liens on the real estate, the remaining $200,000 is paid to Mortgagor as surplus.

This method of distribution of wraparound mortgage foreclosure proceeds is equitable to all parties involved and is consistent with the general principles governing mortgage foreclosures and disposition of foreclosure surplus. If the wraparound mortgagee fails to perform its contractual duty to pay the installments due on the underlying mortgage debt, at a time when the mortgagor has in fact paid the corresponding payments on the wraparound debt, the result will be a higher-than-scheduled balance on the underlying debt. In such a setting, the mortgagor is entitled to recover that additional amount as surplus from the foreclosure sale proceeds, in effect offsetting it against the wraparound mortgagee.

The further operation of this section in cases in which the successful foreclosure bid is less than the "net" wraparound balance is shown in Illustration 4.

Illustration:

4. The facts are the same as Illustration 3, except that Buyer determines that the unencumbered market value of Blackacre is only $700,000. Buyer purchases at the foreclosure sale with a bid of $400,000. This entire sum is applied toward the debt owed to Mortgagee-2. In addition, Mortgagee-2 may claim a deficiency of $100,000 against Mortgagor if Mortgagor is personally liable on the debt and no statute bars collection of a deficiency. Mortgagee-1 continues to hold a mortgage on Blackacre to secure the $300,000 underlying debt.

On the facts of Illustrations 3 and 4 no unjust enrichment occurs. In Illustration 3, since the $200,000 surplus is placed in Mortgagor's hands, Mortgagor will be able to apply it toward any deficiency that may be owed to Mortgagee-1 in the future, assuming that Mortgagor is personally liable on Mortgagee-1's debt and that collection of the deficiency is not barred by statute.

If Mortgagee-1's debt is already in default at the time the surplus from Mortgagee-2's foreclosure is to be paid to Mortgagor, as in Illustration 3, Mortgagee-1 may bring an action on the debt or file an appropriate motion to garnish or sequester the surplus funds. This will ensure that Mortgagor will not dissipate the funds and lack the ability to apply them toward any deficiency that may ensue in a later foreclosure by Mortgagee-1.

The rule of this section is subject to variation by the terms of the wraparound mortgage, or by other agreement among the wraparound and underlying mortgagees and the mortgagor. Such an agreement may provide that surplus from the foreclosure of the wraparound mortgage must be paid to the underlying mortgagee. An agreement of this sort runs counter to the ordinary rules governing disposition of surplus (see § 7.4), but if clearly expressed is enforceable according to its terms.

REPORTERS' NOTE

Introduction, Comment a. On wraparound mortgages generally, see Galowitz, How to Use Wraparound Financing, 5 Real Est. L. J. 107 (Fall 1976); Gunning, The Wrap-Around Mortgage ... Friend or U.F.O.?, 2 Real Est. Rev. 35 (Summer 1972); Gurrin, Selected Problems in Wraparound Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis, 14 U. Mich. J. L. Ref. 401 (1981); Leider, How to Wrap Around a Mortgage, 4 Real Est. Rev. 29 (Winter 1975); Comment, The Wrap-Around Mortgage: A Critical Inquiry, 21 UCLA L. Rev. 1529 (1974); Note, 10 Pac. L.J. 923 (1979); Annot., Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage, 36 A.L.R.4th 144 (1985); 2 G. Nelson & D. Whitman, Real Estate Finance Law § 9.8 (3d ed. 1993).

Rights and duties in foreclosure, Comment b. Illustration 2 is based on Midyett v. Rennat Properties, Inc., 831 P.2d 868 (Ariz.Ct.App.1992). The court described the position of the wraparound mortgage foreclosure purchaser as follows:

> [The purchaser] was bound to examine the title of the land purchased ... and was bound by the doctrine of caveat emptor because that doctrine applies to judicial sales.... When [the purchaser] purchased the property from the sheriff at the execution sale, it had notice that the property was subject to a prior lien and was being sold to satisfy the judgment obtained by [the wraparound mortgagee].... The purchaser at a foreclosure sale of a junior lien takes subject to all senior liens.

Id. at 870.

Illustration 3 is based on Midyett v. Rennat Properties, Inc., 831 P.2d 868 (Ariz.Ct.App.1992), which supports the fundamental rule of this section. In that case the wraparound lender held an installment contract vendor's lien. Upon the mortgagor's default, the wraparound lender foreclosed, and the sale produced a surplus above the difference between the contract balance and the underlying mortgage balance. This surplus was ordered to be paid to the defaulting mortgagor. The foreclosure purchaser then filed a motion to compel the payment of the surplus to the underlying mortgagee instead, and thus to reduce the balance owing on the underlying debt. The court rejected this claim, holding that the trial court "could not have ordered that the surplus be applied to the prior lien. The surplus had to be paid to the judgment debtor on whose behalf the property was sold to satisfy the judgment."

The rule of this section is also supported by Carroll v. Miller, 561 N.Y.S.2d 47 (N.Y.App.Div.1990), holding that the wraparound lender who receives a prepayment has no corresponding duty, in the absence of an express mortgage provision, to prepay the underlying mortgage debt. Cf. Reilly v. Barrera, 620 So.2d 1116 (Fla.Dist.Ct.App.1993), in which the mortgage documents imposed a duty on the wraparound lender who received a prepayment to clear the title of the underlying mortgage.

See also Hampton v. Minton, 785 S.W.2d 854 (Tex. Ct. App. 1990), holding that when the mortgagor defaulted in payment on the wraparound debt, the wraparound mortgagee's obligation to continue making payments on the underlying debt was excused. Many wraparound mortgage documents contain an express provision to this effect. The point is significant in the context of this section; if the wraparound mortgagee has no obligation to discharge the underlying debt, and if it is inequitable for the wraparound mortgagee to retain the surplus, the only plausible alternative is to compel the wraparound mortgagee to pay the surplus to any junior lienholders or to the mortgagor.

Saro Investments v. Ocean Holiday Partnership, 441 S.E.2d 835 (S.C.Ct. App.1994), is also consistent with the position of this section. In that case the mortgagor defaulted on the wraparound note, and the wraparound mortgagee then defaulted on the underlying note. The underlying lender foreclosed on the real estate, but waived all claim to a deficiency judgment against the wraparound lender (who was also the predecessor in title of the mortgagor, and who would have been personally liable for the deficiency). The wraparound mortgagee then sued the mortgagor for the full face balance owing on the wraparound note. The court held that the wraparound mortgagee could recover on the note only the "net" wraparound debt—that is, the difference between its face balance and the balance owing on the underlying debt. The decision had the effect of leaving with the mortgagor the portion of the wraparound debt in excess of its "net" amount.

Two alternative methods of disbursal of wraparound foreclosure proceeds, insofar as they exceed the "net" debt secured by the wraparound mortgage, have been suggested in the case law: that they should be retained by the wraparound mortgagee, or that they should be paid directly to the holder of the underlying mortgage. Both of these methods raise serious problems, as discussed below.

If the wraparound mortgagee is permitted to retain the entire foreclosure proceeds, facts like those of Illustration 2 will result in unjust enrichment to Mortgagee-2. Assume that in Illustration 2 Buyer does indeed bid $700,000. If Mortgagee-2 retains that entire sum, despite the fact that the "net" wraparound debt is only $500,000, Mortgagee-2 will realize an unearned windfall of $200,000.

Moreover, if Mortgagee-2 is permitted to retain the entire $700,000 bid, and if Mortgagee-1 subsequently forecloses and suffers a deficiency as a consequence of Blackacre's value having fallen precipitously, the deficiency claim against Mortgagor may be as large as the entire first mortgage debt, or $300,000. This result would be unjust, since Mortgagor would have received no credit, against the deficiency, for the $200,000 that Buyer paid in excess of Mortgagee-2's net debt.

The injustice of this result may readily be seen by comparing it with an alternate fact pattern in which both Mortgagee-1 and Mortgagee-2 have ordinary (non-wraparound) mortgages. If Mortgagee-2 forecloses and the sale generates proceeds of $700,000, Mortgagee-2 will be permitted to retain only $500,000, the balance owing on the debt. The remaining $200,000 will be returned to Mortgagor as surplus. If Mortgagee-1 later forecloses and obtains a deficiency judgment, Mortgagor will be able to apply the $200,000 toward satisfaction of the deficiency. Mortgagor's maximum additional financial exposure for the deficiency will be only $100,000.

A final form of injustice that would result if Mortgagee-2 were allowed to retain the surplus in excess of the "net" wraparound debt is reflected in the enormous bidding advantage Mortgagee-2 would have over outside bidders. As indicated in Illustration 2, no well-informed outside bidder would offer more than $700,000 at the foreclosure sale of the wraparound mortgage. However, if Mortgagee-2 were permitted to retain the full wrap loan balance, it could safely bid up to $800,000, since all amounts bid between $700,000 and $800,000 would redound to it. The result would be to chill outside bidding, reducing the probability that the successful bid would approximate the market value of the real estate.

In FPCI RE-HAB 01 v. E & G Investments, Ltd., 255 Cal.Rptr. 157 (Cal.Ct.App.1989), the argument was made that permitting the wraparound mortgagee to foreclose for the full face amount of the wraparound debt and to retain the entire bid would give the mortgagee an unfair bidding advantage. The court (inexplicably) rejected that argument. See also Concept Management, Ltd. v. Carpenter, 405 S.E.2d 119 (Ga.Ct.App.1991).

A second alternative approach to disposition of wraparound foreclosure proceeds would permit the foreclosing wraparound lender to recover up to the full face balance of the wraparound debt, but with a corresponding duty to pay to (or hold for the benefit of) the underlying mortgagee the amount received in foreclosure in excess of the "net" wraparound debt—that is, the difference between the wraparound loan balance and the balance on the underlying loan. Several cases appear to support this approach. In Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580 (Tex.1989), the court held that the foreclosing wraparound mortgage had an "implied covenant" to "apply the [surplus] first to the satisfaction of pre-existing debt before making any distribution to the mortgagor." In that case the successful bidder was the wraparound mortgagee, and it had (apparently erroneously) entered a bid which produced a surplus. The court's decision seems to have been motivated by a desire to help the mortgagee avoid the consequences of its error. See St. Claire, Wraparound Mortgage Problems in Nonjudicial Foreclosures, 20 Real Est. L. Rev. 221 (1992); Note, 21 St. Mary's L.J. 1043 (1990); Note, 21 Tex. Tech L. Rev. 873 (1990); Note, 47 Wash. & Lee L. Rev. 1025 (1990). The *Summers* case is rejected by this section.

A second case supporting the same approach is Armsey v. Channel Associates, Inc., 229 Cal.Rptr. 509 (Cal.Ct.App.1986). The court held that, while the procedure for foreclosing a wraparound mortgage might be unclear in some respects, the wraparound mortgagee had the right to seek the entire face balance of the wraparound debt in foreclosure. In that case, the wraparound lender was the successful bidder, with a bid that was approximately equivalent to the difference between the balances on the wraparound debt and the underlying debt. The wraparound mortgagee was permitted to recover in addition the proceeds of a fire insurance policy on the real estate. The court did not determine whether the wraparound lender had any duty to pay the insurance proceeds to the holders of the underlying mortgages. To the same effect, see Matter of Park North Partners, Ltd., 72 B.R. 79 (Bankr.N.D.Ga.1987), order vacated on other grounds, 80 B.R. 551 (N.D.Ga.1987); J. M. Realty Inv. Corp. v. Stern, 296 So.2d 588 (Fla.App.1974). These cases are also rejected by this section because of the procedural difficulties they raise, as discussed below.

It is difficult to find any general legal basis for a rule requiring the distribution of the surplus proceeds from the wraparound foreclosure to the holder of the underlying mortgage. Upon foreclosure, the wraparound mortgage is obviously terminated, and the wraparound lender's previous contractual duty to make payments on the underlying mortgage debt is ended unless a specific term of the mortgage documents expressly requires that the surplus be paid to the underlying mortgagee. Such a provision would run counter to the usual rule providing for payment of surplus to junior interest-holders (see § 7.4), and should be enforced only if clearly expressed.

It is useful to consider the impact of a rule requiring the surplus to be paid to the senior mortgagee on the bids entered at the foreclosure sale. Assume, for example, facts that are the same as Illustration 2, except that Mortgagee-2 announces prior to the foreclosure sale that all sale proceeds in excess of the difference between the balance owing on Mortgagee-2's debt and the balance owing on Mortgagee-1's debt will be paid to Mortgagee-1. Assume further that this disposition of proceeds is required by the mortgage documents and permitted under local law. Buyer will now be willing enter a cash bid up to the property's market value, $1 million, since Buyer knows that the excess of any bid over $800,000 will fully discharge that debt, leaving Buyer with the property free of both liens.

An interesting feature of this sort of foreclosure is the fact that all cash bid amounts between $300,000 and $800,000 are, practically speaking, identical. That is true because bidders at junior mortgage foreclosure sales must anticipate the necessity of paying and discharging all senior liens, after completing the purchase, in order to clear the real estate title of those liens. Hence, well-informed bidders always determine their maximum cash bids by subtracting, from the property's market value, the amount that will be necessary to retire the senior liens. In the present factual context, any cash amount Buyer bids in excess of $300,000 (up to $800,000) will be applied to reduce the balance owing on the first mortgage, thus leaving a lower balance for Buyer to pay later in order to clear the title to the real estate. For example, if Buyer makes a cash bid of $400,000, Buyer will need to pay an additional $400,000 after the sale to clear Mortgagee-1's lien. If Buyer makes a cash bid of $600,000, the amount necessary to clear Mortgagee-1's lien later is only $200,000. Thus, whether Buyer makes a cash bid of $300,000, $800,000, or any amount in between those two figures is irrelevant. In essence, any bid above $300,000 (up to $800,000) amounts to an "early" payment by Buyer on the senior lien—a payment that Buyer would have to make in the long run in any event.

Alternatively, assume that the market value of the real estate in the foregoing illustration is only $700,000. Buyer will enter a cash bid of no more than $200,000, realizing that it will be necessary to pay Mortgagee-1 an additional $500,000 later to clear the senior lien. If the real estate's market value were below $500,000, no bids at all would be made—reflecting the fact that there is no value in the real estate to secure the second lien.

As seen above, a rule requiring the foreclosing wraparound mortgagee to pay surplus to the underlying mortgagee will allow the bidding process to function properly if all bidders understand the principles involved correctly. However, those principles are apt to be unfamiliar to most bidders, and serious confusion might result. As one court noted,

> Affidavits and depositions of skilled lawyers for both parties reflect that the so-called "wrap-around" mortgage is an area of real property law not well understood by property lawyers in North Carolina, and further, that the foreclosure of such a mortgage is fraught with questions and uncertainty.

Quality Inns International Inc. v. Booth, Fish, Simpson, Harrison and Hall, 292 S.E.2d 755, 762 (N.C.Ct. App.1982).

A rule requiring payment of the wraparound foreclosure surplus to the underlying mortgagee would be problematic in certain other respects. It would effectively force the underlying mortgagee into a foreclosure not of its making, something that mortgage law ordinarily does not do to senior mortgagees. This would raise serious problems if the underlying mortgage debt were by its terms nonprepayable or prepayable only with a substantial fee. It would, of course, be possible for a court to order the surplus placed in an escrow or trust account or deposited with the clerk of court for ultimate payment on the underlying obligation as it came due. However, if a fee were required for prepayment of the underlying debt, a conflict might arise between the mortgagor and the wraparound mortgagee as to whether a prepayment should be made or not. Under the rule of this section that issue does not arise.

Further, this section's approach avoids the difficult questions that may arise when a mortgage wraps around more than one prior encumbrance. If the surplus were payable to underlying mortgagees, it would be necessary to determine in what order they were to be paid, and no principled answer to this question has been suggested.

Finally, the rule of this section is consistent with existing case law involving voluntary prepayment of wraparound mortgages outside the foreclosure context. The New York Appellate Division has held that unless the terms of the mortgage require the contrary, the wraparound mortgagee who receives a prepayment is not required to make a corresponding prepayment of the underlying debt. See Carroll v. Miller, 561 N.Y.S.2d 47 (N.Y.App.Div.1990).

CHAPTER 8

FORECLOSURE

Introductory Note: Chapter 8 consists of six sections dealing with frequently litigated and often troublesome issues that arise during the foreclosure process.

Section 8.1 states the fundamental rules governing acceleration of the mortgage obligation. It identifies when and how acceleration becomes effective and specifies the limited situations when the obligation may be "de-accelerated" by tender of arrearages. While acceleration may be defeated by waiver and by a wide variety of mortgagee misconduct, it cannot be defeated by the mortgagor's negligence, mistake, or improvidence and the resulting hardship they may create.

Section 8.2 delineates the mortgagee's remedies after a valid acceleration has taken place. This section adopts the pervasive common-law rule that mortgagee is free either (1) to obtain a judgment on the personal obligation and, to tbe extent that the judgment is not satisfied, foreclose the mortgage on the real estate; or (2) to foreclose against the real estate and, to the extent that the real estate does not satisfy the mortgage obligation, obtain a deficiency judgment for the balance in accordance with § 8.4. This section rejects the "one-action" principle followed by California and a handful of other states that requires the mortgagee to exhaust the mortgaged real estate before proceeding on the underlying personal obligation.

Section 8.3 deals with the perennial and controversial problem of when a foreclosure sale may be invalidated because of price inadequacy. This section reaffirms the time-honored rule that a regularly conducted foreclosure process that otherwise complies with local law will not be set aside unless the price is grossly inadequate.

Section 8.4 incorporates the rule followed by most states that gives the mortgagee the right to a deficiency judgment when the foreclosure process fails fully to satisfy the mortgage obligation. In so doing, it rejects the approach of some states that prohibit deficiency judgments aftor power of sale foreclosure or after any foreclosure of a purchase money mortgage. On the other hand, it also adopts the "fair market value" limitation on deficiency judgments mandated by statute or judicial decision in over 30 states. Under this approach, the fair market value of the real estate, rather than the foreclosure sale price, is used to calculate the deficiency. This enables the mortgagee to be made whole where the real estato is insufficient to satisfy the mortgage obligation, but also protects against the mortgagee unfairly profiting by purchasing the real estate at a sub-market price, obtaining a deficiency judgment, and later reselling the real estate at a profit.

Section 8.5 specifies that the merger doctrine is inapplicable to the law of real estate mortgages and the obligations they secure. In a formal sense, this section marks a sharp break with the past. This centuries-old doctrine, which was not initially intended to apply to mortgage law, has created innumerable conceptual and practical problems in land finance transactions. Importantly, eliminating merger analysis from mortgage law changes virtually no substantive result. This is largely because courts often find a way to honor the merger doctrine only in the breach. The comments to this section demonstrate that in virtually every mortgage law context, the application of non-merger principles produces the same result, but with a conceptually clearer and more satisfying analysis, than would follow from the use of merger. Ultimately, freeing mortgagees of merger should not only simplify the law of land finance and make it more efficient, but should significantly reduce frivolous litigation.

Section 8.6 deals with marshaling, the doctrine that requires foreclosure of a senior mortgage on multiple parcels in an order that is least likely to damage the claims of holders of subordinate interests in the parcels. It adopts both the "two funds" rule, under which parcels without junior encumbrances must be foreclosed before parcels having junior encumbrances, and the "inverse order of alienation" rule, under which parcels with more recent junior encumbrances are foreclosed before parcels with older junior encumbrances. These rules are widely accepted.

§ 8.1 Accrual of the Right to Foreclose—Acceleration

(a) An acceleration provision is a term in a mortgage, or in the obligation it secures, that empowers the mortgagee upon default by tbe mortgagor to declare the full

mortgage obligation immediately due and payable. An acceleration becomes effective on the date specified in a written notice by the mortgagee to the mortgagor delivered after default.

(b) Prior to the date an acceleration becomes effective, the mortgagor may cure the default and reinstate the mortgage obligation by paying or tendering to the mortgagee the amount that is then owing on the mortgage obligation or performing any other duty the mortgagor is obligated to perform under the terms of the mortgage documents.

(c) After an acceleration has taken place and subject to Subsection (d), a mortgagor may prevent foreclosure only by paying or tendering to the mortgagee the full accelerated mortgage obligation.

(d) A mortgagor may defeat acceleration and reinstate the mortgage obligation by paying or tendering to the mortgagee the amount due and owing at the time of tender in the absence of acceleration and by performing any other duty in default the mortgagor is obligated to perform in the absence of acceleration if:

(1) such an action is authorized by statute or the terms of the mortgage documents; or

(2) the mortgagee has waived its right to accelerate; or

(3) the mortgagee has engaged in fraud, bad faith, or other conduct making acceleration unconscionable.

Cross-References:

Section 6.4, Redemption from Mortgage by Performance or Tender; § 7.1, Effect of Mortgage Priority on Foreclosure; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage.

Comment:

a. Introduction. Virtually all mortgages today contain acceleration clauses. In the event of mortgagor default, such a clause gives the mortgagee the right to declare the entire mortgage obligation due and payable. The general validity of these provisions is universally accepted. An acceleration provision is effective to make the entire mortgage obligation due and payable so long as it is contained in either the mortgage or the obligation it secures. Equally important, acceleration is not only permitted for failure to pay the mortgage debt promptly, but also for defaults in mortgage covenants to pay taxes, to maintain insurance, to keep buildings intact, to maintain an adequate financial condition, to avoid the commission of waste, and the like.

The mortgagee's acceleration based on the mortgagor's commission of common-law waste is permissible only when the waste impairs the mortgagee's security under § 4.6(b)(1). On the other hand, where the mortgagee's acceleration stems from the mortgagor's violation of specific covenants, impairment of security need not be shown. Thus, for example, if the mortgage requires the mortgagor to care for an improvement in a certain manner, to insure the premises, or to pay real estate taxes, defaults on these covenants are the proper basis for acceleration even though they also constitute waste under § 4.6(a)(4) and do not impair security. See § 4.6, Comment *g*.

Mortgage documents commonly contain "cross-default" provisions that authorize a mortgagee to accelerate the mortgage obligation if any other mortgage on the real estate goes into default. Such provisions are enforceable under this section.

This section deals only with acceleration provisions that give the mortgagee the *option* to accelerate in the event of mortgagor default. While this "option" type provision is almost universally used, on rare occasion mortgage documents may contain language that makes acceleration automatic on mortgagor default or on the basis of a specific event, such as the mortgagor's filing a bankruptcy petition or entering into a general assignment for the benefit of creditors. While such automatic acceleration provisions may be effective, a mortgagee is well-advised to avoid their use because they circumscribe the mortgagee's discretion in dealing with mortgagor default and may have a variety of unintended consequences for both parties.

The absence of an acceleration provision can have profoundly negative consequences for mortgagees. In this setting, the mortgagee must either foreclose for each installment as it comes due or wait until the amortization period expires to foreclose for the full accrued obligation. Both alternatives are cumbersome and impractical in most cases. However, in some rare instances acceleration may be undesirable because the full mortgage obligation cannot yet be ascertained or because it represents an on-going business relationship that the mortgagee does not wish to disturb.

This section does not deal with either "due-on-sale" or "due-on-encumbrance" provisions. These are specialized types of acceleration clauses that enable the mortgagee to make the full principal amount of the mortgage obligation due and payable if the mortgagor transfers or encumbers an interest in the real estate without the mortgagee's consent. Congress preempted the law governing these provisions when it enacted § 341 of the Garn-St. Germain Depository Institutions Act of 1982, codified at 12 U.S.C.A. § 1701j-3. Under that Act, both types of "due-on" provisions, with minor exceptions, are enforceable.

This section also does not deal with demand instruments or other obligations whose nature permits call at any time or without reason. Nor does it deal with language in obligations that empowers the holder to accelerate "at will" or "when he deems himself insecure." See U.C.C. § 1-208 (1995).

b. When acceleration becomes effective. An acceleration becomes effective on the date specified in a written notice delivered by mortgagee to mortgagor after the latter's default. The notice may provide that the acceleration is effective immediately or at some future specified date. See Illustrations 1-3. The acceleration is effective without further notice of any kind. Language in the mortgage documents or other agreement under which mortgagor waives the written notice required by Subsection (a) is ineffective. However, language in the mortgage documents that requires additional notice to that required by Subsection (a) is enforceable.

The delivery referred to in Subsection (a) may be accomplished by personal service, the United States Mail, or any other means reasonably calculated to afford the mortgagor actual notice. These other means include, for example, electronic facsimile, computer networks, electronic mail, and courier and commercial delivery services.

Illustrations:

1. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. Thereafter Mortgagor defaults by failing to pay an installment of principal and interest. Mortgagee then delivers a notice to Mortgagor that states that the mortgage obligation has been accelerated effective immediately. The acceleration is effective upon delivery of the notice.

2. The facts are the same as Illustration 1, except that the notice states that the mortgage obligation will be accelerated 10 days after the date of the notice. Ten days after that date the acceleration is effective, provided that Mortgagor does not cure the default prior to that time.

3. The facts are the same as Illustration 1, except that Mortgagor defaults by failing to pay the real estate taxes on Blackacre when they become due. The acceleration is effective upon delivery of the notice.

c. Tender or payment of arrearages prior to acceleration. If the mortgagor fails to pay the mortgage obligation promptly, the mortgagor may cure the default and reinstate the mortgage by tender or payment of arrearages prior to the effective date of the acceleration. For purposes of this section it is assumed that tender is unconditional and is kept good. See § 6.4, Comment *d.* In addition, for purposes of this section "arrearages" include not only past due installments of principal and interest and any accrued interest thereon, but also, to the extent allowed by local law, late charges, attorneys' and trustee's fees, and publication and court costs. See Illustration 4. Similarly, if the mortgagor defaults by failing to pay real estate taxes, assessments, obtain insurance coverage, or to perform any other obligation imposed by the mortgage documents, the mortgagor may cure that default and reinstate the mortgage by performing that obligation prior to acceleration. See Illustrations 5 and 6.

Illustrations:

4. Mortgagor delivers to mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. Mortgagor thereafter defaults by failing to pay several installments of principal and interest. Prior to an acceleration by Mortgagee, Mortgagor tenders payment of the arrearages. The default is cured and acceleration based on that default is impermissible.

5. The facts are the same as Illustration 4, except that Mortgagor defaults by failing to pay real estate taxes on Blackacre, as required by the mortgage documents. Prior to an acceleration by Mortgagee, Mortgagor pays the real estate taxes and any penalty imposed for late payment. The default is cured and acceleration based on that default is impermissible.

6. The facts are the same as Illustration 4, except that Mortgagor defaults by failing to maintain casualty insurance on the improvement on Blackacre, as required by the mortgage documents. Prior to an acceleration by Mortgagee, Mortgagor obtains the requisite insurance coverage and pays the premium for it. The default is cured and acceleration based on that default is impermissible.

d. Tender or payment after acceleration. Subject to the limitations on acceleration described in Comment *e*, once a mortgage obligation is validly accelerated, only payment or tender of the accelerated amount will be sufficient to avoid foreclosure. Even where the mortgagee accepts mortgagor's tender of arrearages, the only effect is to reduce the amount of the accelerated obligation; the acceleration itself is unaffected. See Illustration 7. The same principle applies to non-debt-related defaults in the performance of mortgage covenants, such as the failure to pay taxes, to maintain casualty insurance, or to keep the premises in reasonable repair. In the latter settings, simply curing the default that triggered the acceleration will not reinstate the mortgage. See Illustrations 8 and 9. Similarly, where a mortgage obligation is accelerated pursuant to a "cross-default" provision (see Comment *a*), the mortgagor may avoid foreclosure of that mortgage only by tendering the accelerated amount. This is the case even though the default in the other mortgage has been cured to the satisfaction of its mortgagee.

Illustrations:

7. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. Mortgagor then defaults by failing to pay several installments of principal and interest. Mortgagee thereafter validly accelerates the mortgage obligation. Mortgagor then tenders payment of the arrearages and Mortgagee accepts the tender. The mortgage obligation is reduced by the amount of the payment, but the acceleration remains effective.

8. The facts are the same as Illustration 7, except that instead of defaulting in paying principal and interest on the mortgage obligation, Mortgagor defaults by failing to pay when due the real estate taxes on Blackacre, as required by the mortgage. Mortgagee thereafter validly accelerates the mortgage obligation. Mortgagor then pays the delinquent real estate taxes. The acceleration remains effective.

9. The facts are the same as Illustration 7, except that instead of defaulting in paying principal and interest on the mortgage obligation, Mortgagor defaults by failing to maintain casualty insurance on the improvements on Blackacre as required by the mortgage. Mortgagee thereafter validly accelerates the mortgage obligation. Mortgagor then obtains and pays for adequate insurance coverage. The acceleration remains effective.

e. Limitations on acceleration. Once acceleration has occurred, the mortgagor's only normal recourse is to redeem by paying the accelerated obligation prior to foreclosure. See § 6.4. However, the potential harshness of acceleration on the mortgagor may be ameliorated in a variety of ways. Increasingly, provisions in commonly used residential mortgage forms place substantial limitations on acceleration. For example, the Federal National Mortgage Association—Federal Home Loan Mortgage Corporation (FNMA-FHLMC) mortgage—deed of trust form, which is widely used for home loan transactions, affords the mortgagor the right to defeat acceleration by tendering arrearages or curing any nonmonetary default until five days prior to the foreclosure sale (in a power of sale foreclosure) or the foreclosure decree (in a judicial foreclosure). "Arrearages" statutes in many states permit the mortgagor to "de-accelerate" by curing the default that existed prior to acceleration. Moreover, broad rights to "de-accelerate" by curing arrearages are available to mortgagors who file pre-foreclosure petitions under Chapter 11, 12, or 13 of the Bankruptcy Code.

In addition, under Subsection (d)(2), a court may relieve a mortgagor from the consequences of acceleration and permit reinstatement of the mortgage by payment of arrearages where it determines that the mortgagee waived its right to accelerate. However, because mortgagee forbearance should not be discouraged, a waiver will not be easily established. Thus, a mere failure to accelerate after one or two payment defaults will not operate as a waiver of the mortgagee's right to accelerate because of later defaults. See Illustration 10. Moreover, even where a mortgagee accepts a late payment without accelerating after notifying mortgagor that it will foreclose in the event of future defaults, that will be insufficient to establish waiver of the right to accelerate for a subsequent default. See Illustration 11. On the other hand, waiver is appropriately found where there has been a *consistent* prior pattern of acceptance of late payments by the mortgagee. See Illustration 12. Even where the mortgagee has engaged in a course of conduct that would otherwise constitute waiver of the right to accelerate, the mortgagee may reestablish that right by notifying the mortgagor that late payment will no longer be tolerated and that acceleration and foreclosure will occur in the event of future defaults. See Illustration 13.

Illustrations:

10. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage contains an acceleration provision. Mortgagor pays monthly installments of principal and interest 15 days late in both June and July, 1995. Mortgagee accepts both late payments and does not accelerate. Mortgagor then fails to pay the August, 1995 installment when it becomes due. Mortgagee then accelerates the mortgage obligation. Mortgagor tenders the August, 1995 installment. Mortgagee refuses the tender. The acceleration is effective.

11. The facts are the same as Illustration 10, except that after accepting the late payment for July, 1995, Mortgagee notifies Mortgagor that acceleration and foreclosure will occur in the event of future defaults. When the December, 1995 payment is 15 days late, Mortgagee accepts the payment and does not accelerate. Mortgagor fails to pay the March, 1996 installment when it becomes due. Mortgagee then accelerates the mortgage obligation. Mortgagor tenders the March, 1996 installment. Mortgagee refuses the tender. The acceleration is effective.

12. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage contains an acceleration provision. During 1995, Mortgagor pays 7 out of 12 installments of principal and interest an average of 15 days late. Mortgagee accepts these payments and raises no objection to Mortgagor concerning the tardiness in payment. Mortgagor fails to pay the January, 1996 installment when it is due. Mortgagee then accelerates the mortgage obligation. Mortgagor tenders the January, 1996 installment. The acceleration is ineffective and the default is cured.

13. The facts are the same as Illustration 12, except that on December 1, 1995, Mortgagee notifies mortgagor that, effective with the January, 1996 payment, there will no longer be forbearance and that acceleration and foreclosure will occur in the event of future defaults. The acceleration is effective.

Mortgagees sometimes seek to avoid the waiver defense to acceleration by including an "anti-waiver" provision in the mortgage documents. While such a provision may, in close cases, tip the balance against a finding of waiver (see Illustration 14), it usually will not be dispositive on the waiver issue. For example, its effect will be negated where the pattern of accepting late payments is sufficiently continuous and prolonged to justify the conclusion that the mortgagee has abandoned or waived the protection of the provision. See Illustration 15.

Illustrations:

14. The facts are the same as Illustration 12, except that the mortgage documents contain the following provision: "Even if, at a time when I am in default, the Mortgagee does not require me to pay immediately in full, Mortgagee will still have the right to do so if I am in default at a later time." The acceleration is effective.

15. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents

contain an acceleration provision. They also contain an anti-waiver provision identical to that in Illustration 14. The documents call for payment of monthly installments of principal and interest on the first day of each month. During the first 18 months after the loan is made, Mortgagor makes each monthly payment on the 14th or 15th day of the month. In the 19th month, Mortgagor fails to pay that month's installment when it is due. Mortgagee then accelerates the mortgage obligation. Mortgagor then tenders the past due installment. Mortgagee refuses the tender. The acceleration is ineffective and the default is cured.

Even though the mortgagee does not engage in a prior pattern of forbearance, a single transaction may sometimes be an appropriate basis for defeating acceleration. For example, a mortgagee may grant a short oral extension to the mortgagor for the latter to cure a default, and may then attempt to accelerate in spite of the extension. See Illustration 16. Similarly, a mortgagee may attempt to accelerate notwithstanding a prior oral assurance to the mortgagor in default that acceleration and foreclosure will be delayed while the mortgagor makes a good-faith effort to sell the property. To the extent that the mortgagor detrimentally relies, and absent withdrawal of the extension by the mortgagee by reasonable notice, there is a defense to acceleration. See Illustration 17. In both situations estoppel, fraud, or bad faith provide appropriato theories for defeating acceleration.

Illustrations:

16. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. An installment of principal and interest is due on Monday, June 15. After Mortgagor informs Mortgagee that funds for payment of that installment will not be available until June 17, Mortgagee orally assures Mortgagor that "so long as you get the money to my office by 5 PM this Friday, there will not be a problem." Mortgagor arrives at Mortgagee's office on 3 PM Friday to make the payment, but the office is closed. On the following Monday morning, Mortgagee accelerates the obligation. That afternoon Mortgagor tenders the late payment to Mortgagee, but the latter declines the tender. The acceleration is ineffective and the default is cured.

17. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. Mortgagor fails to pay several monthly installments of principal and interest and mortgagee threatens acceleration and foreclosure. Mortgagor meets with the

mortgagee, explains that because he has lost his job he is unable to make the mortgage payments, and requests a delay in acceleration and foreclosure to enable him to sell the real estate. Mortgagee replies: "Go ahead and try to sell. I'll wait for a couple of months to see if you are successful before I do anything." A few days thereafter, Mortgagor lists Blackacre for sale with a real estate broker. The property is marketed aggressively for several weeks. Mortgagee, without giving mortgagor reasonable notice withdrawing the extension, then notifies mortgagor in writing that the mortgage obligation has been accelerated. The acceleration is ineffective.

While mortgagee misconduct of the type described in Subsection (d) is an appropriate basis for relief from acceleration, mortgagor's negligence, mistake, or improvidence are not. This is the case even where the default is caused by circumstances beyond mortgagor's control and where acceleration will cause extreme hardship. See Illustrations 18 and 19. Under this Restatement, a mortgagee who is guilty of no misconduct is *ex ante* permitted to rely on its contract acceleration right without being subject to the vagaries of mortgagor's financial and personal situation, a matter over which mortgagee usually has little control. This approach avoids difficult and time-consuming judicial inquiries into such matters as the degree of mortgagor's negligence, the relative hardship that acceleration imposes, and other subjective concerns.

Illustrations:

18. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. On October 3, 1995, two days prior to the due date of an annual installment of principal and interest, Mortgagor contacts Mortgagee and requests that he be permitted to pay half the payment that is due on October 5. Mortgagee responds on October 4 that the full amount of the payment must be made when due. Mortgagor then borrows the additional money and puts a check for the full amount in the mail on October 4. When Mortgagee does not receive the check on October 5, Mortgagee accelerates the mortgage obligation. On October 7, Mortgagee receives the check and returns it to the Mortgagor. The acceleration is effective.

19. Mortgagor delivers to Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage documents contain an acceleration provision. On July 1, 1995, a quarterly installment of principal and interest is due. There is a three-week

grace period for each installment. Prior to leaving on a business trip to Europe on June 10, 1995, Mortgagor requests her bookkeeper to make out a check for the July 1 payment. Through an error in arithmetic, the bookkeeper computes the interest as $4,219, which is $401 short of the correct amount. Mortgagor signs the check. After Mortgagor departs, the bookkeeper discovers the mistake, informs Mortgagee of the error, and forwards the incorrect check to Mortgagee with a promise that the balance will be paid when Mortgagor returns from her trip on July 5. When Mortgagor returns, the bookkeeper forgets to inform her about the error. One day after the grace period expires on July 21, 1995, Mortgagee accelerates the full mortgage obligation. When Mortgagor receives notice of the acceleration, she immediately tenders the full amount of the installment. Mortgagee refuses the tender. The acceleration is effective.

REPORTERS' NOTE

Introduction, Comment a. See generally G. Nelson & D. Whitman, Real Estate Finance Law §§ 7.6–7.7 (3d ed. 1994); Rosenthal, The Role of Courts of Equity in Preventing Acceleration Predicated Upon a Mortgagor's Inadvertent Default, 22 Syracuse L. Rev. 897 (1971). Every jurisdiction recognizes the general validity of mortgage acceleration clauses. See, e.g., Ciavarelli v. Zimmerman, 593 P.2d 697 (Ariz.Ct.App. 1979); David v. Sun Federal Savings & Loan Association, 461 So.2d 93 (Fla.1984); Carle's Motorcycle Shop, Inc. v. Johnson, 301 A.2d 335 (N.H. 1973); Long Island Savings Bank v. Denkensohn, 635 N.Y.S.2d 683 (N.Y.App.Div.1995); Trustco Bank New York v. Drake, 599 N.Y.S.2d 763 (N.Y.App.Div.1993); Phipps v. First Federal Savings & Loan Ass'n, 438 N.W.2d 814 (S.D.1989); Greenberg v. Service Business Forms Industries, Inc., 882 F.2d 1538 (10th Cir.1989) (Oklahoma law).

This section rejects the view that an acceleration provision contained only in the mortgage is ineffective to trigger acceleration of the obligation. See, e.g., 2140 Lincoln Park West v. American National Bank and Trust Company of Chicago, 410 N.E.2d 990 (Ill. App. Ct. 1980).

For consideration of the remedies available to a mortgagee where there is no acceleration provision, see G. Nelson & D. Whitman, Real Estate Finance Law § 7.8 (3d ed. 1994).

Numerous cases support the proposition that acceleration is permissible for defaults other than the failure to make prompt payment of principal and interest. As to failure to pay real estato taxes, see, e.g., Lunn Woods v. Lowery, 577 So.2d 705 (Fla.Dist.Ct. App.1991); Parrott v. Wallace, 900 P.2d 214 (Idaho.Ct.App.1995); Saunders v. Stradley, 333 A.2d 604 (Md. Ct.App.1975); Chapman v. Nation, 388 S.E.2d 744 (Ga.Ct.App.1989); Jenkins v. Thyer, 760 S.W.2d 932 (Mo.Ct. App.1988); Eisen v. Kostakos, 282 A.2d 421 (N.J. Super. Ct. 1971); Barclay's Bank of New York v. Smitty's Ranch, Inc., 504 N.Y.S.2d 295 (N.Y.App.Div.1986); Phillips v. Allums, 882 S.W.2d 71 (Tex. Ct. App. 1994); Chapa v. Herbster, 653 S.W.2d 594 (Tex. Ct. App. 1983). As to failure to maintain insurance, see, e.g., Pezzimenti v. L.R. Cirou, 466 So.2d 274 (Fla.Dist.Ct.App.1985); Benton v. Patel, 362 S.E.2d 217 (Ga.1987). Cf. Strong v. Merchants Mutual Insurance Co., 309 N.E.2d 510 (Mass.App. Ct.1974), modified, 322 N.E.2d 765 (Mass.1975). As to violating a covenant against destruction of improvements, see Laber v. Minassian, 511 N.Y.S.2d 516 (N.Y.Sup.Ct.1987) (acceleration and foreclosure permissible for violation of a covenant not to demolish buildings without mortgagee's consent even though value of remaining real estate substantially exceeded the mortgage obligation). As to violating a covenant that additional funds would not be required to complete the improvements and to maintain an adequate financial condition, see European American Bank v. Village Square Associates Limited Partnership, 623 N.Y.S.2d 296 (N.Y.App.Div. 1995).

A few cases, however, hold that impairment of security is needed to justify acceleration based on the failure by the mortgagor to pay taxes or to maintain casualty insurance on the mortgaged real estate. See Vonk v. Dunn, 775 P.2d 1088 (Ariz.1989) (real estate taxes); Mid-State Trust II v. Jackson, 854 S.W.2d 734 (Ark.Ct.App. 1993) (insurance); Freeman v. Lind, 226 Cal.Rptr. 515 (Cal.Ct.App.1986) (insurance). This section and § 4.6, Comment *g* reject this position.

When acceleration becomes effective, Comment b. Courts use a wide variety of rules to determine when an acceleration becomes effective. Many courts simply require that the mortgagee "perform some affirmative, overt act evidencing his intention to take advantage of the acceleration provision." Spires v. Lawless, 493 S.W.2d 65, 73 (Mo.Ct.App.1973). See United States Savings Bank of Newark, New Jersey v. Continental Arms, Inc., 338 A.2d 579 (Del.Super.Ct.1975); Pici v. First Union National Bank of Florida, 621 So.2d 732 (Fla.Dist.Ct.App.1993); Central Home Trust Co. v. Lippincott, 392 So.2d 931 (Fla.Dist.Ct.App.1980); First Federal Sav. & Loan Ass'n v. Stone, 467 N.E.2d 1226 (Ind.Ct.App.1984); Butter v. Melrose Savings Bank, 435 N.E.2d 1057 (Mass.App.Ct.1982); Jenkins v. Thyer, 760 S.W.2d 932 (Mo.Ct.App.1988); Jeferne, Inc. v. Capanegro, 452 N.Y.S.2d 236 (N.Y.App. Div.1982). For some courts, the "affirmative action" requirement is satisfied by a letter to the mortgagor stating that acceleration has occurred. See, e.g., Butter v. Melrose Savings Bank, 435 N.E.2d 1057 (Mass.App.Ct.1982). Moreover, the commencement of a judicial foreclosure proceeding often constitutes sufficient evidence of an election to acceleration. See, e.g., United States Savings Bank of Newark, New Jersey v. Continental Arms, Inc., 338 A.2d 579 (Del.Super.Ct.1975); Pizer v. Herzig, 105 N.Y.S. 38 (N.Y.App.Div. 1907); Swearingen v. Lahner, 61 N.W. 431 (Iowa 1894); Jacobson v. McClanahan, 264 P.2d 253 (Wash. 1953). Where power of sale foreclosure is used, some courts have held that evidence of an election to accelerate is provided by a letter to the mortgagor threatening foreclosure unless arrearages are promptly paid, coupled with an oral expression to the mortgagor of an intention to foreclose. See Lowry v. Northwestern Sav. & Loan Ass'n, 542 S.W.2d 546 (Mo.Ct.App. 1976). Texas courts require both notice of an intent to accelerate and, in addition, separate notice of the acceleration itself. "Notice of intent to accelerate is necessary in order to provide the debtor an opportunity to cure his default prior to the harsh consequences of acceleration and foreclosure. Proper notice that the debt has been accelerated ... cuts off the debtor's right to cure his default and gives notice that the entire debt is due and payable." Ogden v. Gibraltar Sav. Ass'n, 640 S.W.2d 232, 234 (Tex.1982). See also Shumway v. Horizon Credit Corp., 801 S.W.2d 890 (Tex.1991) (note provision allowing mortgagee to accelerate "without prior notice or demand" was effective to waive mortgagor's right to presentment and notice of acceleration, but not to notice of intent to accelerate); McLemore v. Pacific Southwest Bank, FSB, 872 S.W.2d 286 (Tex. Ct. App. 1994) (separate waiver of notice of intent to accelerate and notice of acceleration required). In taking yet another approach, Oregon focuses on whether time is of the essence in determining the nature and extent of notice required:

> When time is of the essence, the failure to make a payment at the time required by the agreement would permit the mortgagee ... without notice, to accelerate the balance due and to foreclose the mortgage. When time is not of the essence, either by express agreement or by the nature of the contract, failure to make payment on time, although it would give the mortgagee ... a cause of action for payment, does not, without more, permit foreclosure. The mortgagee must give notice of its intention to foreclose if payment is not made on a certain date.

Smith by Coe v. Piluso, 719 P.2d 33, 34–35 (Or.Ct.App.1986).

This section represents an attempt to identify and define the affirmative "overt" act that evidences an intent to accelerate. Thus, under this section, once default occurs, a mortgagee has two options with respect to acceleration. First, acceleration may be effective immediately upon delivery of a written notice to mortgagor if that notice so provides. Alternatively, if the written notice specifies some post-delivery acceleration date, then acceleration will be effective on that date. Of course, to the extent that the language of the mortgage documents requires additional notice to the mortgagor as a precondition to acceleration, such language will be enforceable.

Tender or payment of arrearages prior to acceleration, Comment c. Prior to acceleration, either tender or payment of arrearages by mortgagor will reinstate the mortgage and defeat foreclosure. See, e.g.. Bisno v. Sax, 346 P.2d 814 (Cal.Ct.App.1959); Pici v. First Union National Bank of Florida, 621 So.2d 732 (Fla.Dist.Ct. App.1993); Redmond v. Merrill Lynch Relocation Management, Inc., 294 S.E.2d 575 (Ga.Ct.App.1982); First Federal Sav. & Loan Ass'n v. Stone, 467 N.E.2d 1226 (Ind.Ct.App.1984); Dunfee v. Waite, 439 N.E.2d 664 (Ind.Ct.App.1982); Sindlinger v. Paul, 404 N.W.2d 212 (Mich.1987); Kent v. Pipia, 462 N.W.2d 800 (Mich.Ct.App. 1990); Jeferne, Inc. v. Capanegro, 452 N.Y.S.2d 236 (N.Y.App.Div.1982); Rosselot v. Heimbrock, 561 N.E.2d 555 (Ohio.Ct.App.1988); Overholt v. Merchants & Planters Bank, 637 S.W.2d 463 (Tenn.Ct.App.1982); Hiller v. Prosper Tex, Inc., 437 S.W.2d 412 (Tex. Ct. Civ. App. 1969); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 473 at n.7 (3d ed. 1993).

Tender or payment after acceleration, Comment d. Once a valid acceleration takes place, only tender or payment of the full accelerated obligation will be sufficient to defeat foreclosure. See, e.g., City Savings Bank of Bridgeport v. Dessoff, 491 A.2d 424 (Conn. Ct. App. 1985); Bank of Honolulu v. Anderson, 654 P.2d 1370 (Haw.Ct.App.1982); La Plant v. Beechley, 165 N.W. 1019 (Iowa 1918); Jenkins v. Thyer, 760 S.W.2d 932 (Mo.Ct.App.1988); Dime Savings Bank of New York v. Glavey, 625 N.Y.S.2d 181 (N.Y.App.Div.1995); Centerbank v. D'Assaro, 600 N.Y.S.2d 1015 (N.Y. Sup. 1993); Dime Savings Bank of New York v. Dooley, 444 N.Y.S.2d 148 (N.Y.App.Div.1981); Bell Federal Sav. & Loan Ass'n of Bellevue v. Laura Lanes, Inc., 435 A.2d 1285 (Pa. Super. Ct. 1981); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 7.6 at n.8 (3d ed. 1993). Post-acceleration acceptance of arrearages will serve only to reduce the amount of the mortgage obligation and will not defeat the acceleration. See, e.g., Ryder v. Bank of Hickory Hills, 165 Ill.Dec. 650, 585 N.E.2d 46 (Ill. 1991). Of course, unless the mortgagee makes its intent clear, post-acceleration acceptance of arrearages may under some circumstances constitute a waiver of its right to accelerate. See Comment *e* and accompanying Reporters' Note; Centerbank v. D'Assaro, 600 N.Y.S.2d 1015 (N.Y. Sup. 1993).

Once acceleration has occurred because of a non-debt-related default, this section follows the prevailing view that it cannot be defeated by simply curing that default by, for example, paying the past-due real estate taxes or by reinstating the casualty insurance; only tendering the full accelerated obligation will suffice. See, e.g., Jeffery v. Seven Seventeen Corp., 461 A.2d 1009 (Del.1983); Parrott v. Wallace, 900 P.2d 214 (Idaho.Ct.App.1995); Benton v. Patel, 362 S.E.2d 217 (Ga.1987) (mortgagor's submission of insurance binder a day after receiving notice of acceleration does not defeat acceleration); Saunders v. Stradley, 333 A.2d 604 (Md. Ct.App.1975); Jenkins v. Thyer, 760 S.W.2d 932 (Mo.Ct.App.1988). There are several decisions, which this section rejects, that payment of delinquent real estate taxes prior to the commencement of a foreclosure proceeding defeats acceleration and foreclosure. See Clark v. Equitable Life Assur. Soc., 281 A.2d 488 (Del.1971); Balducci v. Eberly, 500 A.2d 1042 (Md.1985); Eisen v. Kostakos, 282 A.2d 421 (N.J. Super. Ct. 1971); Nichols v. Evans, 401 N.Y.S.2d 426 (N.Y.Sup.Ct.1978).

Limitations on acceleration, Comment e. Many commonly used mortgage forms place substantial limitations on the acceleration process. For example, the most commonly used residential mortgage form in the United States provides:

> 18. **Borrower's Right to Reinstate.** If borrower meets certain conditions, Borrower shall have the right to have enforcement of this Security Instrument discontinued at any time prior to the earlier of: (a) 5 days (or such other period as applicable law may specify for reinstatement) before sale of the Property pursuant to any power of sale contained in this Security Instrument; or (b) entry of a judgment enforcing this Security Instrument. Those conditions are that Borrower: (a) pays Lender all sums which then would be due under this Security Instrument and the Note as if no acceleration had occurred; (b)

cures any default of any other covenants or agreements; (c) pays all expenses incurred in enforcing this Security Instrument, including, but not limited to, reasonable attorneys' fees; and (d) takes such other action as Lender may reasonably require to assure that the lien of this Security Instrument, Lender's rights in the Property and Borrower's obligation to pay the sums secured by this Security Instrument shall continue unchanged. Upon reinstatement by Borrower, this Security Instrument and the obligations secured shall remain fully effective as if no acceleration had occurred.

Federal National Mortgage Association—Federal Home Loan Mortgage Corporation (FNMA-FHLMC)—Uniform Mortgage-Deed of Trust Covenants—Single Family, Clause 18.

In addition, "arrearages" legislation permitting the mortgagor to "deaccelerate" prior to foreclosure by curing the default that existed prior to acceleration is increasingly common. See, e.g., West's Ann. Cal. Civ. Code § 2924(c); Colo. Rev. Stat. § 38–39–118(1)(a); D.C. Code § 45–715.1 (Repl. 1990); Ill. Rev. Stat. Ch. 95, ¶ 57; 14 Me. Rev. Stat. Ann. § 6111; Minn. Stat. Ann. § 580.30; Mo. Rev. Stat. § 408.555(4) (certain junior mortgages only); 41 Pa. Stat. § 404; Utah Code Ann. § 57–1–31. Some states confer such rights only on residential mortgagors. See, e.g., D.C. Code § 45–715.1 (Repl. 1990); 41 Pa. Stat. § 404. On the other hand, many of the statutes benefit *all* rather than merely residential mortgagors. See, e.g., West's Ann. Cal. Civ. Code § 2924(c); Minn. Stat. Ann. § 580.30; Utah Code Ann. § 57–1–31.

Moreover, mortgagors who file bankruptcy petitions have broad rights to "deaccelerate" mortgage obligations that were accelerated prepetition. For example, a mortgagor who files a Chapter 13 petition will usually be permitted to deaccelerate a home mortgage obligation so long as the property has not yet been sold at a foreclosure sale. In so doing, the mortgagor need not cure arrearages immediately, but only over the period of the Chapter 13 plan. See 11 U.S.C.A. §§ 1322(b)(2), 1322(b)(3), 1322(b)(5); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 8.15 (3d ed. 1993). There are also broad deacceleration rights for debtors in Chapter 11 reorganization proceedings and for family farmers who seek to reorganize under Chapter 12. See 11 U.S.C.A. §§ 1124(2), 1222(b)(3); Matter of Madison Hotel Associates, 749 F.2d 410 (7th Cir.1984); 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 8.14, 8.16 (3d ed. 1993).

This section also recognizes that a mortgagee's past conduct may result in a waiver of its present right to accelerate. Because waiver cases invariably are fact-specific, they are difficult to categorize and clear patterns are not easily discerned. However, because waiver cases usually involve prior forbearance by the mortgagee, and public policy generally favors such forbearance, waiver will not be easily established. Thus, there is case authority that a mere failure to accelerate on the first or second default in payment will not operate as a waiver of the option to accelerate because of later defaults. See Dunn v. Barry, 169 P. 910 (Cal.Ct.App.1917); Caulder v. Lewis, 338 S.E.2d 837 (S.C.1986); Bower v. Stein, 177 F. 673 (9th Cir. 1910). Moreover, mortgagee's acceptance of one or two late payments without accelerating, after notifying mortgagor that acceleration and foreclosure will result, does not result in waiver of mortgagee's right to accelerate for a later default. See, e.g., Caulder v. Lewis, 338 S.E.2d 837 (S.C.1986), upon which Illustration 11 is partially based.

On the other hand, this section reflects the numerous cases that relieve mortgagors from acceleration on a waiver theory where courts have detected a *consistent* prior pattern of mortgagee acceptance of late payments. See, e.g., Miller v. Uhrick, 706 P.2d 739 (Ariz.App. 1985); Dad's Properties, Inc. v. Lucas, 545 So.2d 926 (Fla.Dist.Ct.App.1989); La Boutique of Beauty Academy, Inc. v. Meloy, 436 So.2d 396 (Fla.Dist.Ct.App. 1983); Edwards v. Smith, 322 S.W.2d 770 (Mo.1959); Rosselot v. Heimbrock, 561 N.E.2d 555 (Ohio.Ct.App. 1988); Fairfield Financial Group, Inc. v. Gawerc, 814 S.W.2d 204 (Tex. Ct. App. 1991); McGowan v. Pasol, 605 S.W.2d 728 (Tex. Ct. Civ.App. 1980); Short v. A.H. Still Investment Corp., 147 S.E.2d 99 (Va.1966). Cf. Mid-State Trust II v. Jackson, 854 S.W.2d 734 (Ark.Ct.App.1993); Massachusetts Mutual Life Insurance Co. v. Transgrow Realty Corp., 475 N.Y.S.2d 418 (N.Y.App.Div.1984). However, there are cases that refuse to find waiver in similar circumstances. See Moseley v. Lathan, 448 So. 2d 341 (Ala. 1984); Dorn v. Robinson, 762 P.2d 566 (Ariz. Ct.App.1988); Barnes v. Resolution Trust Corp., 664 So.2d 1171 (Fla.Dist. Ct.App.1995); Scarfo v. Peever, 405 So.2d 1064 (Fla.Dist.Ct.App.1981); Postal Sav. & Loan Ass'n v. Freel, 698 P.2d 382 (Kan.Ct.App.1984); North Star Apartments v. Goppert Bank & Trust Co., 657 S.W.2d 253 (Mo.Ct.App.1983).

Courts are closely divided on the question of anti-waiver clauses. Some courts hold that such clauses are enforceable. See Federal National Mortgage Ass'n v. Cobb, 738 F.Supp. 1220 (N.D.Ind.1990) ("Under Indiana law, a non-waiver clause contained in a mortgage, which provides that the waiver of the option to accelerate note upon default at one time does not constitute waiver of the right to exercise such option at any other time, is effective to prevent the acceptance of late payments from operating as a waiver upon subsequent default"); First Federal Sav. & Loan Ass'n v. Stone, 467 N.E.2d 1226 (Ind. Ct.App.1984) (anti-waiver clause effective, but acceleration defective on other grounds); Van Bibber v. Norris, 419 N.E.2d 115 (Ind.1981) (chattel repossession); Hale v. Ford Motor Credit Co., 374 So.2d 849 (Ala.1979) (auto repossession); Postal Sav. & Loan Ass'n v. Freel, 698 P.2d 382 (Kan.Ct.App.1984) (real estate mortgage acceleration); Metropolitan Life Ins. Co. v. Triskett Illinois, Inc., 646 N.E.2d 528 (Ohio.Ct.App.1994); Gaul v. Olympia Fitness Center, Inc., 623 N.E.2d 1281 (Ohio.Ct.App.1993) (real estate mortgage acceleration). On the other hand, a substantial number of cases take the position adopted by this section that anti-waiver provisions are not automatically dispositive and are themselves capable of being waived by the mortgagee through its conduct. See Woods v. Monticello Development Co., 656 P.2d 1324 (Colo. Ct.App.1982) (real estate acceleration); Smith v. General Finance Co., 255 S.E.2d 14 (Ga.1979) (chattel repossession); Formall, Inc. v. Community National Bank of Pontiac, 360 N.W.2d 902 (Mich.Ct.App.1984) (acceleration of commercial debt); Cobb v. Midwest Recovery Bureau, 295 N.W.2d 232 (Minn.1980) (chattel repossession); Nevada National Bank v. Huff, 582 P.2d 364 (Nev.1978) (chattel repossession).

Illustrations 15 and 16 demonstrate how estoppel, fraud, or bad faith can be appropriate theories to defeat acceleration. The leading case for this proposition is Nassau Trust Co. v. Montrose Concrete Products Corp., 436 N.E.2d 1265 (N.Y. 1982). Several other recent cases recognize the foregoing proposition, but find insufficient facts to sustain it. See Ryder v. Bank of Hickory Hills, 585 N.E.2d 46 (Ill. 1991); Citibank, N.A. v. Nyland (CF8) Ltd., 878 F.2d 620 (2d Cir. 1989).

There is a clear division of authority as to whether a court may relieve a mortgagor from the consequences of acceleration in cases of extreme hardship. The traditional approach, which this section adopts, is that an acceleration clause works neither a forfeiture nor a penalty and that a mortgagor will not be relieved from acceleration for a default that arises from his or her negligence, mistake, or accident unless there is fraud, bad faith, or other conduct on mortgagee's part making reliance on it unconscionable. See, e.g., First Federal Sav. & Loan Ass'n v. Ram, 659 P.2d 1323 (Ariz.Ct.App.1982); Ciavarelli v. Zimmerman, 593 P.2d 697 (Ariz.Ct. App.1979); Community Federal Sav. & Loan Ass'n of Palm Beaches v. Orman, 473 So.2d 205 (Fla.1985); David v. Sun Federal Sav. & Loan Ass'n, 429 So.2d 1277 (Fla. Dist. Ct. App. 1983); Collins v. Nagel, 203 N.W. 702 (Iowa 1925); Poydan, Inc. v. Agia Kiriaki, Inc., 325 A.2d 838 (N.J. Super. Ct. 1974); Carle's Motorcycle Shop, Inc. v. Johnson, 301 A.2d 335 (N.H.1973); Graf v. Hope Building Corp., 171 N.E. 884 (N.Y.1930); New York Guardian Mortgagee Corp. v. Olexa, 574 N.Y.S.2d 107 (N.Y.App. Div.1991); Cohn v. Middle Road Riverhead Development Corp., 556 N.Y.S.2d 764 (N.Y.App.Div.1990); Verna v. O'Brien, 356 N.Y.S.2d 929 (N.Y. Sup. 1974) ("mere improvidence or neglect or poverty or illness is not sufficient basis for relief in equity from foreclosure under a mortgage acceleration clause. A mortgagee may be ungenerous, perhaps even uncharitable, but generosity and charity are voluntary attributes and cannot be enforced by the court."); First Federal Sav. & Loan Ass'n of Akron v. Cheton & Rabe, 567 N.E.2d 298 (Ohio.Ct.App.1989); Phipps v. First Federal Sav. & Loan Ass'n, 438 N.W.2d 814 (S.D.1989); Greenberg v. Service Business Forms Industries, Inc., 882 F.2d 1538 (10th Cir.1989); In re Nicfur-Cruz Realty Corp., 50 B.R. 162 (Bankr.S.D.N.Y.1985).

Illustration 19 is based in part on Graf v. Hope Building Corp., 171 N.E. 884 (N.Y.1930).

There is, however, a substantial body of case law that protects the mortgagor from acceleration that is the result of accident or a mistake while acting in good faith, or unusual circumstances beyond mortgagor's control. See Middlemist v. Mosier, 377 P.2d 110 (Colo.1962); Savarese v. Schoner, 464 So.2d 695 (Fla.Dist.Ct. App.1985); Federal Home Loan Mortgage Corp. v. Taylor, 318 So.2d 203 (Fla.Dist.Ct.App.1975); Redding v. Gibbs, 280 N.W.2d 53 (Neb.1979) (in deciding whether to grant equitable relief from acceleration, "the gravity of the fault must be weighed against the gravity of the hardship"); Fairmont Associates v. Fairmont Estates, 472 N.Y.S.2d 208 (N.Y.App.Div.1984); Karas v. Wasserman, 458 N.Y.S.2d 280 (N.Y.App.Div.1982); J.N.A. Realty Corp. v. Cross Bay Chelsea, Inc., 366 N.E.2d 1313 (N.Y. 1977) (expressing displeasure with, but not overruling, the *Graf* dictum); Rosenthal, The Role of Courts of Equity in Preventing Acceleration Predicated upon a Mortgagor's Inadvertent Default, 22 Syracuse L. Rev. 897 (1972) (some courts take the view that "equity has the power to relieve a mortgagor for an inadvertent default in payment of principal or interest where acceleration would work extreme hardship upon him.").

The *Taylor* case, supra, is illustrative of this approach. There, after three regular payments, there was a lapse of a month and 20 days in making a payment. Following that was a three-month lapse. However, immediately thereafter the mortgagor paid three installments with late charges, which the mortgagee accepted. However, a payment made on September 10, 1973, did not include the installment that fell due on September 1. The latter installment was paid prior to October 4, but the mortgagee refused to accept it because the October 1 installment was not included. In upholding relief from acceleration, the court noted the general delays caused by the fact that one of the mortgagors was a member of the military stationed overseas:

> The lag in mail deliveries was obviously a circumstance which contributed to much of the lack of communication and misunderstanding. It is to be noticed here that the mortgagors were not in the Philippines by mere choice but due to a military assignment. Though the personal hardship arising from the daughter's need of a state-side hospitalization is not a circumstance to excuse payment of a debt when due, the distance between the mortgagors and mortgagee's agent because of military obligations of the mortgagor is not to be ignored as a factor impairing the ability of the parties to communicate demands and responses thereto. The total evidence indicates a good faith effort on the part of the mortgagor to meet the mortgagee's conditions of bringing the account current.

Federal Home Loan Mortgage Corp. v. Taylor, 318 So.2d 203, 208 (Fla. Dist.Ct.App.1975).

This section, in adopting the traditional approach, reflects the view that, in the absence of fault on the part of the mortgagee, relief from acceleration is better dealt with by "arrearages" statutes or the language of the mortgage documents. This section serves an important policy goal of predictability in mortgage remedies.

Mortgagors have sometimes sought to defeat acceleration by asserting § 1-208 of the Uniform Commercial Code, which provision states that "[a] term providing that one party or his successor in interest may accelerate payment or performance ... 'at will' or 'when he deems himself insecure' or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired." U.C.C. § 1-208 (1995). Where a mortgage note actually contains such language, the good-faith requirement is applicable. See, e.g., Watseka First National Bank v. Ruda, 531 N.E.2d 28 (Ill. App. Ct. 1988); Jackson v. State Bank of Wapello, Iowa, 488 N.W.2d 151 (Iowa 1992). Courts have been unable to agree as to whether the good-faith standard is objective or subjective. See Wegner, Section 1-208: "Good Faith" and the Need for a Uniform Standard, 73 Marq. L. Rev. 639

(1990). However, most mortgage obligations do not contain such "at will" or "insecurity" language or, if they do, actual acceleration results from specific mortgagor defaults such as failure to pay the debt, real estate taxes, to maintain casualty insurance or the commission of waste. A few decisions have applied the good-faith requirement in the latter context. See State Bank of Lehi v. Woolsey, 565 P.2d 413 (Utah 1977); Williamson v. Wanlass, 545 P.2d 1145 (Utah 1976); Brown v. AVEMCO Investment Corp., 603 F.2d 1367 (9th Cir.1979). Moreover, some of these latter decisions have used the good-faith approach where the obligation apparently lacked "at will" or "insecurity" language. See *Williamson* and *Brown*, supra. However, most courts correctly focus on the literal language of § 1-208 and hold that it cannot be applied to defeat an acceleration based on specific mortgagor defaults. See Bowen v. Danna, 637 S.W.2d 560 (Ark.1982); Hickmon v. Beene, 640 S.W.2d 812 (Ark.Ct.App.1982); Ben Franklin Financial v. Davis, 589 N.E.2d 857 (Ill. App. Ct. 1992); Matter of Sutton Investments, Inc., 266 S.E.2d 686 (N.C.Ct.App.1980); Don Anderson Enterprises, Inc. v. Entertainment Enterprises, Inc., 589 S.W.2d 70 (Mo.Ct.App.1979); Greenberg v. Service Business Forms Industries, Inc., 882 F.2d 1538 (10th Cir.1989); Comment, 11 B.C. Ind. & Com. L. Rev. 531 (1970) ("Section 1-208 is not concerned with default type acceleration clauses.").

§ 8.2 Mortgagee's Remedies on the Obligation and the Mortgage

When an obligation secured by a mortgage becomes due, the mortgagee may eitber:

(a) obtain a judgment against any person who is personally liable on the obligation and, to the extent that the judgment is not satisfied, foreclose the mortgage on tbe real estate for the balance; or

(b) foreclose the mortgage and, to the extent that the proceeds of the foreclosure sale do not satisfy the obligation, obtain a judgment for the deficiency against any person who is personally liable on the obligation in accordance with § 8.4.

Cross-References:

Section 1.1, The Mortgage Concept; No Personal Liability Required; § 7.1, Effect of Mortgage Priority on Foreclosure; § 8.1, Accrual of the Right to Foreclose—Acceleration; § 8.3, Adequacy of Foreclosure Sale Price; § 8.4, Foreclosure: Action for a Deficiency.

Comment:

a. Mortgagee's choice of remedies. Once the mortgage goes into default and the obligation is accelerated, this section gives the mortgagee the choice to proceed initially on the underlying personal obligation or to foreclose on the mortgaged real estate. In so doing, it largely incorporates the traditional common-law approach to this question. This section does not require, as do a few states, that the mortgagee exhaust the mortgaged real estate prior to proceeding on the personal obligation. If a mortgagee chooses to proceed under Subsection (a), it may first obtain a judgment on the personal obligation and later foreclose on the mortgaged real estate for any part of the judgment that is not satisfied from mortgagor's otber property. Alternatively, it may utilize Subsection (b) first to foreclose against the mortgaged real estate and if the sale proceeds are insufficient to satisfy the mortgage obligation, it may then obtain a deficiency judgment for the balance in accordance with § 8.4. Of course, if the mortgage obligation is "non-recourse," the mortgagee's only remedy is foreclosure and the mortgagee is barred from obtaining a personal judgment prior to foreclosure or a deficiency judgment following foreclosure. See § 1.1.

To some extent, the mortgagee's election with respect to Subsection (a) or (b) will be influenced by the type of foreclosure that may be used in the jurisdiction where the real estate is located. Judicial foreclosure by sale must be used in approximately 40 percent of the states and is an available remedy in every jurisdiction. However, it is often complicated, costly, and time-consuming. A typical proceeding entails multiple steps: a filing of a foreclosure complaint and lis pendens notice; service of the complaint on the owner and all others having an interest in the real estate junior to the mortgage being foreclosed (since such persons must be made parties-defendant); a judicial hearing; the foreclosure decree; the notice of foreclosure sale; the actual public sale conducted by the sheriff or other court officer; proceedings with respect to surplus, if any; the entry of a decree for a deficiency, if any; and, in some cases, an appeal.

The other common method of foreclosure is by power of sale. Under this method, after varying types and degrees of notice to the parties, the property is sold at a public sale, either by some public official such as a sheriff, by the mortgagee, or by a trustee or other third party. In most states utilizing the power of sale method, the deed of trust is the most commonly used mortgage instrument. The mortgagor-trustor conveys the real estate to a trustee who holds the property for the mortgagee-beneficiary until full payment of the mortgage obligation. In the event of foreclosure, the power of sale is exercised by the trustee, who holds a public sale of the real estate. It is generally available only where authorized by statute and the mortgage instrument. Statutes currently authorize power of sale foreclosure in approximately 60 percent of the states.

No judicial proceeding is required in power of sale foreclosure. The underlying theory of power of sale foreclosure is that by complying with the statutory requirements, the mortgagee accomplishes the same purposes achieved by judicial foreclosure without the substantial additional burdens that the latter type of foreclosure entails. Those purposes are to terminate all interests junior to the mortgage being foreclosed and to provide the sale purchaser with a title identical to that of the mortgagor as of the time that mortgage was executed. See § 7.1. Where the foreclosure sale does not fully satisfy the mortgage obligation, the mortgagee may file a separate judicial action against the mortgagor for a deficiency judgment. Where it is in common use, power of sale foreclosure provides an effective foreclosure remedy with a cost in time and money substantially lower than that of its judicial counterpart.

Where only judicial foreclosure is authorized, the mortgagee's choice of remedies can sometimes entail the filing of two judicial actions. Once the mortgage obligation is accelerated, a mortgagee who chooses to proceed under Subsection (a) will file a suit on the mortgage obligation and obtain a personal judgment against the mortgagor and any other person personally liable on the obligation. If the judgment is not fully satisfied by levying on mortgagor's other assets, the mortgagee may then file a judicial action to foreclose on the mortgaged real estate for the balance. See Illustration 1. Alternatively, and more commonly, the mortgagee may choose to utilize Subsection (b) and to file a judicial foreclosure action against the mortgaged real estate, and, in the event the foreclosure sale proceeds are insufficient to satisfy the mortgage obligation, obtain, in the same proceeding, a deficiency judgment against the mortgagor in accordance with § 8.4. See Illustration 2. Subsection (a) will often prove more cumbersome and costly to the mortgagee and presumably will be avoided unless the value of the mortgaged real estate is small in relation to the amount of the mortgage obligation and mortgagor has other significant assets to satisfy that obligation.

Illustrations:

1. Mortgagor is personally liable on an obligation to Mortgagee that is secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee files an action against Mortgagor to obtain a personal judgment for the amount of the obligation. The court enters such a judgment for $100,000. Mortgagee levies execution on personal property and other real estate of mortgagor, but is able to satisfy only $70,000 of the judgment. Mortgagee then files a judicial

action to foreclose on Blackacre for the remaining $30,000. Mortgagee may foreclose on Blackacre for that amount.

2. Mortgagor is personally liable on an obligation to Mortgagee that is secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee files a judicial foreclosure action against Mortgagor to foreclose its mortgage on Blackacre. After the court enters a foreclosure decree, a foreclosure sale is held and Blackacre is sold for $70,000. Mortgagee then moves the court for the entry of a $30,000 deficiency judgment against Mortgagor. Mortgagee is entitled to such a judgment in accordance with § 8.4.

Where power of sale foreclosure is available, the mortgagee must resort to court process only if it seeks to enforce personal liability on the mortgage obligation. Once the mortgage obligation is accelerated, a mortgagee who proceeds under Subsection (a) will file a suit on the mortgage obligation and obtain a personal judgment against the mortgagor and any other person having personal liability on the obligation. If the judgment is not fully satisfied by levying on mortgagor's other assets, the mortgagee may then foreclose by power of sale against the mortgaged real estate to collect the balance. See Illustration 3. Alternatively, under Subsection (b) the mortgagee may foreclose the mortgage by power of sale. If the foreclosure sale fails to satisfy fully the mortgage obligation, the mortgagee may then file a judicial action to obtain a deficiency judgment in accordance with § 8.4. See Illustration 4.

Illustrations:

3. The facts are the same as Illustration 1, except that instead of filing a judicial action to foreclose on Blackacre, Mortgagee employs power of sale foreclosure to collect the remaining $30,000. This procedure is proper.

4. Mortgagor is personally liable on an obligation to Mortgagee that is secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee brings a power of sale foreclosure proceeding against Mortgagor to foreclose its mortgage on Blackacre. A foreclosure sale is held and Blackacre is sold for $70,000. Mortgagee then files a judicial action to obtain a $30,000 deficiency judgment based on the results of the power of sale foreclosure. Mortgagee is entitled to such a judgment in accordance with § 8.4.

Where a mortgagee proceeds under Subsection (a), but the judgment is not satisfied from mortgagor's other property, and any subsequent foreclosure of the real estate still does not fully satisfy the obligation, further collection of the obligation is treated as an action for the collection of a deficiency under § 8.4 and is subject to the fair market value principle articulated therein.

b. Limitations on mortgagee's remedies. A mortgagee may not proceed under Subsections (a) and (b) concurrently or consecutively. Once the mortgagee opts to proceed under one of the two subsections, it is prohibited from utilizing the other. See Illustrations 5 and 6. This restriction on using both approaches at the same time is designed to serve judicial economy and to protect the mortgagor from the burden of defending two proceedings simultaneously. Moreover, a prohibition on consecutive reliance on the two subsections does not prevent the mortgagee from achieving complete satisfaction of the mortgage obligation. This is because *each* subsection affords mortgagee the ability both to enforce mortgagor's personal liability and to foreclose on the mortgaged real estate. Any term of the mortgage documents or any other agreement that varies the provisions of this section is ineffective.

This section does not affect the mortgagee's right to enforce a mortgage on rents under § 4.2 or to the appointment of a receiver under § 4.3. This is because, under § 4.2, the mortgagee is proceeding against separate security and, under § 4.3, a receivership is an interim remedy ancillary to the remedies delineated in Subsections (a) and (b). Nor does this section limit the mortgagee's remedies for waste under § 4.6 or the recovery of sums expended by the mortgagee for the protection of the security under § 2.2.

Illustrations:

5. Mortgagor is personally liable on an obligation to Mortgagee that is secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee files a judicial action against Mortgagor to obtain a personal judgment for the amount of the obligation. While the latter action is pending, Mortgagee commences a power of sale foreclosure proceeding against Blackacre. Mortgagor files an action to enjoin the power of sale foreclosure pending the outcome of the judicial action. An injunction should be granted.

6. The facts are the same as Illustration 5, except that Mortgagee first commences the power of sale foreclosure proceeding and then files a judicial action against Mortgagor to obtain a personal judgment for the amount of the obligation. Mortgagor files an action to dismiss the judicial action. The motion should be granted.

This section does not prohibit the mortgagee from proceeding against mortgagor under either Subsection (a) or Subsection (b) while simultaneously bringing an action or proceeding to enforce the obligation against a guarantor or surety. On the other hand, if the guarantor has given the mortgagee a mortgage on the guarantor's real estate as security for the guaranty, the guarantor, as a mortgagor, will be able to require the mortgagee to proceed under either Subsection (a) or Subsection (b) in any proceeding against the guarantor.

REPORTERS' NOTE

Mortgagee's choice of remedies, Comment a. This section adopts the traditional and majority position that mortgagees are free, after acceleration, either (1) to obtain a judgment on the personal obligation and enforce it by levying upon any of mortgagor's property and, if a deficiency remains, to foreclose on the mortgaged real estate or (2) to foreclose on the real estate first and to seek a deficiency judgment thereafter. See, e.g., Moening v. Alaska Mut. Bank, 751 P.2d 5 (Alaska 1988) ("[u]nder the common law, a prior suit on the note does not preclude subsequent judicial or nonjudicial foreclosure"); Triple J Cattle, Inc. v. Chambers, 551 So.2d 280 (Ala.1989); Foothills Holding Corp. v. Tulsa Rig, Reel & Mfg. Co., 393 P.2d 749 (Colo.1964); Berg v. Liberty Federal Sav. & Loan Ass'n, 428 A.2d 347 (Del.1981); Gottschamer v. August, Thompson, Sherr, Clark & Shafer, P.C., 438 So.2d 408 (Fla.Dist.Ct.App.1983); Szego v. Kingsley Anyanwutaku, 651 A.2d 315 (D.C.Ct.App.1994) ("holders of notes secured by a deed of trust can both sue the maker or guarantor and foreclose on the property regardless of which action they pursue first"), Stewart v. Diehl, 466 S.E.2d 913 (Ga.Ct.App.1996); Eastern Illinois Trust & Sav. Bank v. Vickery, 517 N.E.2d 604 (Ill. Ct. App. 1987) (a mortgagee "may sue on the note underlying the mortgage and also may sue to foreclose the mortgage, but is limited to one satisfaction; further, ... electing to pursue one remedy does not bar the other until the underlying indebtedness is extinguished"); First Indiana Federal Sav. Bank v. Hartle, 567 N.E.2d 834 (Ind.Ct.App.1991); Kepler v. Slade, 896 P.2d 482 (N.M.1995); Marine Midland Bank, N.A. v. Virginia Woods, Ltd., 574 N.Y.S.2d 485 (N.Y.Sup.Ct.1991), affirmed, 608 N.Y.S.2d 473 (N.Y.App.Div.1994); Belote v. McLaughlin, 673 S.W.2d 27 (Mo.1984); In re Gayle, 189 B.R. 914 (Bankr.S.D.Tex.1995); American Federal Sav. & Loan Ass'n of Tacoma v. McCaffrey, 728 P.2d 155 (Wash.1986) ("The mortgagee may sue and obtain a judgment upon the notes and enforce it by levy upon any property of the debtor. If the judgment is not satisfied in this manner, the mortgagee still can foreclose on the mortgaged property to collect the balance. Alternatively, the mortgagee may foreclose on the mortgaged property and obtain a deficiency judgment").

The Uniform Land Security Interest Act (ULSIA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1985, is largely consistent with the foregoing approach. See ULSIA § 501, Comment 4.

This section rejects the "one action" rule that is followed in at least a half dozen states. Under that rule, after default and acceleration, the mortgagee's sole remedy is a foreclosure action, and any claim for a deficiency must be sought in that proceeding. The California statute, upon which other state legislation is patterned, provides:

> There can be but one form of action for the recovery of any debt for the enforcement of any right secured by mortgage upon real property, which action must be in accordance with the provisions of this chapter. In the action the court may, by its judgment, direct the sale of the encumbered property.

West's Ann. Cal. Code Civ. Pro. § 726(a). Four other states have "one action" legislation patterned after the California statute. See Idaho Code § 6–101; Mont. Code Ann. 71–1–22; Nev. Rev. Stat. 40.430; Utah Code Ann. 1969, 78–37–1. New Jersey has a "one action" statute, but it is applicable mainly to residential mortgages. See N.J. Stat. Ann. 2A:50–2. North Dakota, by judicial interpretation of its anti-deficiency legislation, has created a modified "one action" rule. See First State Bank of Cooperstown v. Ihringer, 217 N.W.2d 857 (N.D.1974). The "one action" rule has two purposes:

> One is to protect the mortgagor against a multiplicity of actions when the separate actions, though theoretically distinct, are so closely connected that normally they can and should be decided in one suit. The other is compel a creditor who has taken a mortgage on land to exhaust the security before attempting to reach any unmortgaged property to satisfy the claim.

1 G. Nelson & D. Whitman, Real Estate Finance Law 679–80 (3d ed. 1993).

While this section does not, as does the "one-action" rule, require the mortgagee to foreclose on the real estate first, the mortgagor is substantially protected against a multiplicity of actions by the prohibition against mortgagee proceeding under Subsections (a) and (b) concurrently or consecutively. See Comment *b* to this section. Nonetheless, the "security first" policy of the "one-action" rule is rejected by this section. As Professor Bernhardt has pointed out, "[i]t is, of course, difficult to justify the security-first principle on antimultiplicity grounds because multiplicity is avoided equally well by a simple election-of-remedies doctrine * * *." R. Bernhardt, California Mortgage and Deed of Trust Practice 188 (2d ed. 1990).

In the residential lending setting, the real estate is usually the sole or primary security for the loan transaction. Thus most residential mortgagees routinely foreclose against the encumbered real estate before proceeding against other assets of the mortgagor. For many commercial lenders, however, real estate security may be a relatively minor or secondary element of the transaction. Rather, the lender may be relying on the mortgagor's general creditworthiness or other assets as security for the loan. In such a setting, it seems unfair to require the lender to foreclose on the real estate before proceeding against the debtor personally. More important, courts, lawyers, and commentators (including supporters) have found the application of the "one-action" rule to pose perplexing interpretational difficulties, to be a trap for the unwary, and often to be Draconian in its consequences. See, e.g., Security Pacific National Bank v. Wozab, 800 P.2d 557 (Cal. 1990); Conley, The Sanction for Violation of California's One-Action Rule, 79 Cal. L. Rev. 1601 (1991); Hetland & Hanson, The "Mixed Collateral" Amendments to California's Commercial Code—Covert Repeal of California Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?, 75 Cal. L. Rev. 185 (1987); Hirsh, Arnold, Rabin & Sigman, The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?, 36 U.C.L.A. L. Rev. 1, 6, 10 (1988); Munoz & Rabin, The Sequel to Bank of America v. Daily: Security Pac. Nat'l Bank v. Wozab, 12 Real Prop. L. Rep. 204 (1989).

For a consideration of the characteristics of judicial and power of sale foreclosure, see 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 7.11–7.14, 7.19–7.30 (3d ed. 1993).

Limitations on mortgagee's remedies, Comment b. Some states permit the mortgagee to sue on the mortgage obligation and simultaneously to bring a judicial foreclosure action or power of sale proceeding. See, e.g., Hartford National Bank & Trust Co. v. Kotkin, 441 A.2d 593 (Conn.1981); Eastern Illinois Trust & Sav. Bank v. Vickery, 517 N.E.2d 604 (Ill. App. Ct. 1987); First Indiana Federal Sav. Bank v. Hartle, 567 N.E.2d 834 (Ind. Ct.App.1991); Kepler v. Slade, 896 P.2d 482 (N.M.1995); Elmwood Federal Savings Bank v. Parker, 666 A.2d 721 n.6 (Pa. Super. Ct. 1995); In re Gayle, 189 B.R. 914 (Bankr. S.D.Tex.1995). This section prohibits such a course of action. This reflects a policy of judicial economy and against harassment of the mortgagor by forcing him or her to defend two proceedings at once. This approach is supported by legislation in over a dozen states. See Alaska Stat. § 09.45.200; Ariz. Rev. Stat. § 33-722; Fla. Stat. Ann. § 702.06; Idaho Code § 45-1505(4); Iowa Code Ann. § 654.4; Mich. Comp. Laws Ann. §§ 600.3105(1), (2), .3204(2); Minn. Stat. Ann. § 580.02; Neb. Rev. Stat. §§ 25-2140,-2143; N.Y. Real Prop. Acts. & Proc. L. §§ 1301, 1401(2); N.D. Cent. Code § 32-19-05; Or. Rev. Stat. §§ 86.735(4), 88.040; S.D. Comp. Laws Ann. §§ 21-47-6,-48-4; Wash. Rev. Code Ann. § 61.12.120; Wyo. Stat. § 34-4-103.

For authority that an election of remedies statute similar to the language of this section does nct prohibit a mortgagee from foreclosing on a guarantor's real estate after having obtained a judgment against the principal debtor, see Ed Herman & Sons v. Russell, 535 N.W.2d 803 (Minn. 1995).

§ 8.3 Adequacy of Foreclosure Sale Price

(a) A foreclosure sale price obtained pursuant to a foreclosure proceeding that is otherwise regularly conducted in compliance with applicable law does not render the foreclosure defective unless the price is grossly inadequate.

(b) Subsection (a) applies to both power of sale and judicial forcclosure proceedings.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 8.4, Foreclosure: Action for a Deficiency; § 8.5, The Merger Doctrine Inapplicable to Mortgages.

Comment:

a. Introduction. Many commentators have observed that the foreclosure process commonly fails to produce the fair market value for foreclosed real estate. The United States Supreme Court recently emphasized this widely perceived dichotomy between "foreclosure sale value" and fair market value:

> An appraiser's reconstruction of "fair market value" could show what similar property would be worth if it did not have to be sold within the time and manner strictures of state-prescribed foreclosure. But property that *must* be sold with these strictures is simply *worth* less. No one would pay as much to own such property as he would pay to own real estate that could be sold at leisure and pursuant to normal marketing techniques. And it is no more realistic to ignore that characteristic of the property (the fact that state foreclosure law permits the mortgagee to sell it at a forced sale) than it is to ignore other price-affecting characteristics (such as the fact that state zoning law permits the owner of the neighboring lot to open a gas station).

BFP v. Resolution Trust Corp., 511 U.S. 531, 539, 114 S.Ct. 1757, 1762, 128 L.Ed.2d 556 (1994).

There are several reasons for low bids at foreclosure sales. First, because the mortgage lender can "credit bid" up to the amount of the mortgage obligation without putting up new cash, it has a distinct bidding advantage over a potential third party bidder. Second, while foreclosure legislation usually requires published notice to potential third party purchasers, this notice, especially in urban areas, is frequently published in the classified columns of legal newspapers with limited circulation. Moreover, because the publication is usually highly technical, unsophisticated potential bidders have little idea as to the nature of the real estate being sold. Third, many potential third party purchasers are reluctant to buy land at a foreclosure sale because of the difficulty in ascertaining whether the sale will produce a good and marketable title and the absence of any warranty of title or of physical quality from the foreclosing mortgagee. Finally, when a mortgagee forecloses on improved real estate, potential bidders may find it difficult to inspect the premises prior to sale. Even though it may be in the self-interest of the mortgagor to allow such persons to inspect the premises, mortgagors who are about to lose their real estate through a foreclosure sale understandably are frequently reluctant to cooperate.

Given the nature of the foreclosure sale process, courts have consistently been unwilling to impose a "fair market value" standard on the price it produces. Courts are rightly concerned that an increased willingness to invalidate foreclosure sales because of price inadequacy will make foreclosure titles more uncertain. When a foreclosure sale is set aside, the court may upset third party expectations. A third party may have acquired title to the foreclosed real estate by purchase at the sale or by conveyance from the mortgagee-purchaser. Thus, a general reluctance to set aside the sale is understandable and sensible. This reluctance may be especially justifiable when price inadequacy is the only objection to the sale. Consequently, the end result of additional judicial activism on this issue might well be further exacerbation of the foreclosure price problem. This section largely reflects this judicial concern.

However, close judicial scrutiny of the sale price is more justifiable when the price is being employed to calculate the amount of a deficiency judgment context. This is especially the case where the mortgagee purchases at the sale and, in addition, seeks a deficiency judgment. The potential for unjust enrichment of the mortgagee in this situation may well demand closer judicial scrutiny of the sale price. Moreover, the interests of third parties are not prejudiced by judicial intervention in an action for a deficiency judgment. Because a deficiency proceeding is merely an *in personam* action against the mortgagor for money, the title of the foreclosure purchaser is not placed at risk. Consequently, a more intensive examination of the foreclosure price in the deficiency context is appropriate. This view is reflected in § 8.4 of this Restatement.

Ultimately, however, price inadequacy must be addressed in the context of a fundamental legislative reform of the entire foreclosure process so that it yields a price more closely approximating "fair market value." In order to ameliorate the price-suppressing tendency of the "forced sale" system, such legislation could incorporate many of the sale and advertising techniques found in the normal real estate marketplace. These could include, for example, the use of real estate brokers and commonly used print and pictorial media advertising. While such a major restructuring of the foreclosure process is desirable, it is more appropriate subject for legislative action than for the Restatement process.

b. Application of the standard. Section 8.4 deals with the question of adequacy of the foreclosure price in the deficiency judgment context. This section, on the other hand, applies to actions to nullify the foreclosure sale itself based on price inadequacy. This issue may arise in any of several different procedural contexts, depending on whether the mortgage is being foreclosed judicially or by power of sale. Where the foreclosure is by judicial action, the issue of price typically will arise when the mortgagee makes a motion to confirm the sale.

On the other hand, where foreclosure is by power of sale, judicial confirmation of the sale is usually not required and the issue of price inadequacy will therefore arise only if the party attacking the sale files an independent judicial action. Typically this will be an action to set aside the sale; it may be brought by the mortgagor, junior lienholders, or the holders of other junior interests who were prejudiced by the sale. If the real estate is unavailable because title has been acquired by a bona fide purchaser, the issue of price inadequacy may be raised by the mortgagor or a junior interest holder in a suit against the foreclosing mortgagee for damages for wrongful foreclosure. This latter remedy, however, is not available based on gross price inadequacy alone. In addition, the mortgagee must be responsible for a defect in the foreclosure process of the type described in Comment *c* of this section.

This section articulates the traditional and widely held view that a foreclosure proceeding that otherwise complies with state law may not be invalidated because of the sale price unless that price is grossly inadequate. The standard by which "gross inadequacy" is measured is the fair market value of the real estate. For this purpose the latter means, not the fair "forced sale" value of the real estate, but the price which would result from negotiation and mutual agreement, after ample time to find a purchaser, between a vendor who is willing, but not compelled to sell, and a purchaser who is willing to buy, but not compelled to take a particular piece of real estate. Where the foreclosure is subject to senior liens, the amount of those liens must be subtracted from the unencumbered fair market value of the real estate in determining the fair market value of the title being transferred by the foreclosure sale.

"Gross inadequacy" cannot be precisely defined in terms of a specific percentage of fair market value. Generally, however, a court is warranted in invalidating a sale where the price is less than 20 percent of fair market value and, absent other foreclosure defects, is usually not warranted in invalidating a sale that yields in excess of that amount. See Illustrations 1–5. While the trial court's judgment in matters of price adequacy is entitled to considerable deference, in extreme cases a price may be so low (typically well under 20% of fair market value) that it would be an abuse of discretion for the court to refuse to invalidate it.

Foreclosures subject to senior liens can sometimes pose special problems in assessing price adequacy. For example, where one or more senior liens are also in default and their amount substantial or controverted, a court may properly recognize the added uncertainties facing the foreclosure purchaser and refuse to invalidate a sale even though it produces a price that is less than 20 percent of the fair market value of the mortgagor's equity. This problem may be particularly acute where a senior mortgage has a substantial prepayment fee or if it is uncertain whether the senior mortgage is prepayable at all. See Illustration 6.

Moreover, courts can properly take into account the fact that the value shown on a recent appraisal is not necessarily the same as the property's fair market value on the foreclosure sale date, and that "gross inadequacy" cannot be precisely defined in terms of a specific percentage of appraised value. This is particularly the case in rapidly rising or falling market conditions. Appraisals are time-bound, and in such situations are often prone to error to the extent that they rely on comparable sales data, for such data are by definition historical in nature and cannot possibly reflect current market conditions with complete precision. For this reason, a court may be justified in approving a foreclosure price that is less than 20 percent of appraised value if the court determines that market prices are falling rapidly and that the appraisal does not take adequate account of recent declines in value as of the date of the foreclosure. See Illustration 7. Similarly, a court may be warranted in refusing to confirm a sale that produces more than 20 percent of appraised value if the court finds that market prices are rising rapidly and that the appraisal reflects an amount lower than the current fair market value as of the date of foreclosure. See Illustration 8.

Illustrations:

1. Mortgagee forecloses a mortgage on Blackacre by judicial action. The mortgage is the only lien on Blackacre. Blackacre is sold at the foreclosure sale for $19,000. The fair market value of Blackacre at the time of the sale is $100,000. The foreclosure proceeding is regularly conducted in compliance with state law. A court is warranted in finding that the sale price is grossly inadequate and in refusing to confirm the sale.

2. The facts are the same as Illustration 1, except the foreclosure proceeding is by power of sale and Mortgagor files a judicial action to set aside the sale based on inadequacy of the sale price. A court is warranted in finding that the sale price is grossly inadequate and in setting aside the sale, provided that the property has not subsequently been sold to a bona fide purchaser.

3. The facts are the same as Illustration 2, except that the Mortgagee is responsible for conduct that chills bidding at the

sale. Blackacre is purchased at the foreclosure sale by a bona fide purchaser. Mortgagor files a suit against the Mortgagee to recover damages for wrongful foreclosure. A court is warranted in finding that the sale price is grossly inadequate and in awarding damages to Mortgagor.

4. Mortgagee forecloses a mortgage on Blackacre by judicial action. The foreclosure is subject to a senior lien in the amount of $50,000. Blackacre is sold at the foreclosure sale for $19,000. The fair market value of Blackacre free and clear of liens at the time of the sale is $150,000. The foreclosure proceeding is regularly conducted in compliance with state law. A court is warranted in finding that the sale price is grossly inadequate and in refusing to confirm the sale.

5. The facts are the same as Illustration 1, except that Blackacre has a fair market value of $60,000 at the time of the foreclosure sale. The court is not warranted in refusing to confirm the sale.

6. Mortgagee forecloses a mortgage on Blackacre by power of sale. The foreclosure is subject to a large (in relation to market value) senior lien that is in default, carries an above market interest rate, and provides for a substantial prepayment charge. At the time of the foreclosure sale, the current balance on the senior lien is $500,000. Blackacre is sold at the foreclosure sale for $10,000. The fair market value of Blackacre free and clear of liens at the time of the sale is $600,000. The foreclosure proceeding is regularly conducted in compliance with state law. Mortgagor files suit to set aside the sale. A court is warranted in refusing to set the sale aside.

7. Mortgagee forecloses a mortgage on Blackacre, a vacant lot, by judicial action. The mortgage is the only lien on Blackacre. Blackacre is sold at the foreclosure sale for $10,000. The appraised value of Blackacre, based on an appraisal performed shortly before the sale, is $100,000. The foreclosure proceeding is regularly conducted in compliance with state law. The real estate market in the vicinity of Blackacre has been declining rapidly, and this is especially the case with respect to raw land. If the court finds that, notwithstanding the appraisal, the actual fair market value of Blackacre at the date of sale was $50,000 or less, the court is warranted in confirming the sale.

8. Mortgagee forecloses a mortgage on Blackacre, a residential duplex, by judicial action. The mortgage is the only lien on Blackacre. Blackacre is sold at the foreclosure sale for $35,000. The appraised value of Blackacre, based on an appraisal per-

formed shortly before the sale, is $100,000. The foreclosure proceeding is regularly conducted in compliance with state law. The real estate market in the vicinity of Blackacre has been rising rapidly, and this is especially the case with respect to residential rental real estate. If the court finds that, notwithstanding the appraisal, the actual fair market value of Blackacre at the date of sale was $175,000 or more, the court is warranted in refusing to confirm the sale.

c. Price inadequacy coupled with other defects. Even where the foreclosure price for less than fair market value cannot be characterized as "grossly inadequate," if the foreclosure proceeding is defective under local law in some other respect, a court is warranted in invalidating the sale and may even be required to do so. Such defects may include, for example, chilled bidding, an improper time or place of sale, fraudulent conduct by the mortgagee, a defective notice of sale, or selling too much or too little of the mortgaged real estate. For example, even a slight irregularity in the foreclosure process coupled with a sale price that is substantially below fair market value may justify or even compel the invalidation of the sale. See Illustrations 9 and 10. On the other hand, even a sale for slightly below fair market value may be enough to require invalidation of the sale where there is a major defect in the foreclosure process. See Illustration 11.

Illustrations:

9. Mortgagee forecloses a mortgage on Blackacre by judicial action. The mortgage is the only lien on Blackacre. Blackacre is sold at the foreclosure sale for $15,000. The fair market value of Blackacre at the time of the sale is $50,000. The foreclosure proceeding is regularly conducted in compliance with state law except that at the foreclosure sale the sheriff fails to read the foreclosure notice aloud as required by the applicable statute. A court is warranted in refusing to confirm the sale.

10. The facts are the same as Illustration 9, except that the foreclosure is by power of sale. The foreclosure proceeding is regularly conducted in compliance with state law except that notice of the sale is published only 16 times rather than 20 times as required by the applicable statute. Mortgagor files suit to set aside the sale. A court is warranted in setting the sale aside.

11. Mortgagee forecloses a deed of trust on Blackacre by power of sale. Blackacre is sold at the foreclosure sale for $85,000. The fair market value of Blackacre as of the time of the sale is $100,000. Although the foreclosure proceeding is otherwise regu-

larly conducted in compliance with state law, the trustee at the sale fails to recognize a higher bid from a junior lienor who is present at the sale. Mortgagor files suit to set aside the sale. The sale should be set aside.

REPORTERS' NOTE

Introduction, Comment a. Numerous commentators point out that foreclosure sales normally do not generally produce fair market value for the foreclosed real estate. See, e.g., Goldstein, Reforming the Residential Foreclosure Process, 21 Real Est. L.J. 286 (1993); Johnson, Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy, 79 Va. L. Rev. 959 (1993) (observing that there is a "disparity in values between the perceived fair market value of the foreclosed premises prior to foreclosure and amount actually realized upon foreclosure"); Ehrlich, Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives, 71 Va. L. Rev. 933 (1985) ("contemporary foreclosure procedures are poorly designed to maximize sales price"); Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 S. Cal. L. Rev. 843 (1980); G. Nelson & D. Whitman, Real Estate Finance Law § 8.8 (3d ed. 1994). In an empirical study of judicial foreclosure prices and resales in one New York county, Professor Wechsler has gone so far to conclude that

> foreclosure by sale frequently operated as a meaningless charade, producing the functional equivalent of strict foreclosure, a process abandoned long ago. Mortgagees acquired properties at foreclosure sales and resold them at a significant profit in a large number of cases.... In short, ... foreclosure by sale is not producing its intended results, and in many cases is yielding unjust and inequitable results.

Wechsler, Through the Looking Glass: Foreclosure by Sale as *De Facto* Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale, 70 Cornell L. Rev. 850, 896 (1985). See Resolution Trust Corp. v. Carr, 13 F.3d 425 (1st Cir. 1993) ("It is common knowledge in the real world that the potential price to be realized from the sale of real estate, particularly in a recessionary period, usually is considerably lower when sold 'under the hammer' than the price obtainable when it is sold by an owner not under distress and who is able to sell at his convenience and to wait until a purchaser reaches his price.").

For a consideration of why foreclosure sales do not normally bring fair market value, see Nelson, Deficiency Judgments After Real Estate Foreclosures in Missouri: Some Modest Proposals, 47 Mo. L. Rev. 151, 152 (1982); Johnson, Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy, 79 Va. L. Rev. 959, 966–72 (1993); Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 So. Cal. L. Rev. 843, 848–851 (1980); Carteret Savings & Loan Ass'n v. Davis, 521 A.2d 831, 835 (N.J.1987) ("[I]t is likely that the low turnout of third parties who actually buy property at foreclosure sales reflects a general conclusion that the risks of acquiring an imperfect title are often too high").

Until recently, claims of foreclosure price inadequacy commonly arose in the context of mortgagor bankruptcy proceedings. Debtors in possession and bankruptcy trustees frequently challenged pre-bankruptcy foreclosure sales as constructively fraudulent transfers under § 548 of the Bankruptcy Code. See 11 U.S.C. § 548. Under the latter section, a trustee or a debtor in possession may avoid a transfer by a debtor if it can be established that (1) the debtor had an interest in property; (2) the transfer took place within a year of the bankruptcy petition filing; (3) the debtor was insolvent at the time of the transfer or the transfer caused insolvency; and (4) the debtor received "less than a reasonably equivalent value" for the transfer. 11 U.S.C. § 548(a)(2)(A). In Durrett v. Washington National Ins. Co., 621 F.2d 201 (5th Cir.1980), a controversial decision by the United States Court of Appeals for the Fifth Circuit, the court used the predecessor to § 548(a) to find, for the first time, that a foreclosure proceeding that otherwise complied with state law could be set aside if the sale price did not represent "reasonably equivalent value." In dictum the court suggested that a foreclosure price of less than 70 percent of fair market value failed to meet the "fair equivalency" test. Several other federal courts adopted *Durrett*. See, e.g., In re Hulm, 738 F.2d 323 (8th Cir.1984); First Federal Savings & Loan Ass'n of Warner Robbins v. Standard Building Associates, Ltd., 87 B.R. 221 (N.D.Ga.1988); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 8.17 & notes 10–17 (3d ed. 1993).

Other courts, while rejecting a "bright line" 70 percent test, endorsed *Durrett* as a general principle, but adopted the view that "in defining reasonably equivalent value, the court should neither grant a conclusive presumption in favor of a purchaser at a regularly conducted, noncollusive foreclosure sale, nor limit its inquiry to a simple comparison of the sale price to the fair market value. Reasonable equivalence should depend on all the facts of each case." Matter of Bundles, 856 F.2d 815, 824 (7th Cir. 1988). *Durrett* was the subject of significant scholarly commentary. See, e.g., Baird & Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829 (1985); Henning, An Analysis of *Durrett* and Its Impact on Real and Personal Property Foreclosures: Some Proposed Modifications, 63 N.C. L. Rev. 257 (1984); Zinman, Noncollusive Regularly Conducted Foreclosure Sales: Involuntary Nonfraudulent Transfers, 9 Cardozo L. Rev. 581 (1987). The Ninth Circuit, however, rejected *Durrett* and its variations and held, in a case where the foreclosure price was allegedly less than 60 percent of the real estate's fair market value, "that the price received at a noncollusive, regularly conducted foreclosure establishes irrebuttably reasonably equivalent value" under § 548. In re BFP, 974 F.2d 1144 (9th Cir.1992). See also Matter of Winshall Settlor's Trust, 758 F.2d 1136 (6th Cir.1985).

The United States Supreme Court, in a 5–4 decision, affirmed the Ninth Circuit and rejected *Durrett* and its progeny:

> [W]e decline to read the phrase "reasonably equivalent value" ...

> to mean, in its application to foreclosure sales, either "fair market value" or "fair foreclosure price" (whether calculated as a percentage of fair market value or otherwise). We deem, as the law has always deemed, that a fair and proper price, or a "reasonably equivalent value," for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with.

BFP v. Resolution Trust Corp., 511 U.S. 531, 545, 114 S.Ct. 1757, 1765, 128 L.Ed.2d 556 (1994). As a result, § 548 of the Bankruptcy Code now provides no basis for invalidating state foreclosure sales based on inadequacy of the price.

The *Durrett* principle has been rejected in another important context, the Uniform Fraudulent Transfer Act (UFTA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1984. Because of a fear that bankruptcy judges and state courts would interpret state fraudulent conveyance law as incorporating *Durrett* principles, the UFTA provides that "a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale ... under a mortgage, deed of trust or security agreement." U.F.T.A. § 3(b). The UFTA has been adopted by at least 30 states. See 7A Uniform Laws Ann. 170 (1993 Supp.).

For suggestions for statutory reform of the foreclosure process, see Goldstein, Reforming the Residential Foreclosure Process, 21 Real Est. L. J. 286 (1993); Johnson, Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy, 79 Va. L. Rev. 959 (1993); Nelson, Deficiency Judgments After Real Estate Foreclosures in Missouri: Some Modest Proposals, 47 Mo. L. Rev. 151 (1982).

The United States Supreme Court has yet to resolve whether an inadequate foreclosure sale price may under some circumstances be the basis for a preference attack under § 547 of the Bankruptcy Code. At least four cases hold that, assuming the mortgagor was insolvent at the time of foreclosure, a mortgagee foreclosure purchase for the amount of the mortgage obligation or less within 90 days of a mortgagor bankruptcy petition is a voidable preference to the extent that real estate was worth more than the mortgage obligation at the time of the foreclosure sale. See In re Park North Partners, Ltd., 80 B.R. 551 (N.D.Ga.1987); In re Winters, 119 B.R. 283 (Bankr.M.D.Fla.1990); In re Wheeler, 34 B.R. 818 (Bankr.N.D.Ala. 1983); Matter of Fountain, 32 B.R. 965 (Bankr.W.D.Mo.1983). Cf. In re Quinn, 69 B.R. 776 (Bankr.W.D.Tenn. 1986) (foreclosure sale not a preference because mortgagor was not insolvent at time of the foreclosure sale). On the other hand, the United States Court of Appeals for the Ninth Circuit and at least one other court have rejected this use of § 547. See In re Ehring, 900 F.2d 184 (9th Cir. 1990); First Federal Savings & Loan Assoc. of Warner Robbins v. Standard Building Associates, Ltd., 87 B.R. 221 (D.Ga.1988). See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law 785–788 (3d ed. 1993). For criticism of the use of the preference approach in this context, see Kennedy, Involuntary Fraudulent Transfer, 9 Cardozo L. Rev. 531, 563–564 (1987).

Application of the standard, Comment b. An action to set aside a power of sale foreclosure may be brought not only by the mortgagor or other holder of the equity of redemption, but also by junior lienors. See generally 1 G. Nelson & D. Whitman, Real Estate Finance Law 537–540 (3d ed. 1993). This is also true with respect to actions for damages for wrongful foreclosure. Id. at 540–544.

All jurisdictions take the position that mere inadequacy of the foreclosure sale price, not accompanied by other defects in the foreclosure process, will not automatically invalidate a sale. See, e.g., Security Savings & Loan Ass'n v. Fenton, 806 P.2d 362 (Ariz.Ct.App.1990); Gordon v. South Central Farm Credit, ACA, 446 S.E.2d 514 (Ga.Ct.App.1994); Boatmen's Bank of Jefferson County v. Community Interiors, Inc., 721 S.W.2d 72 (Mo.Ct.App.1986); Greater Southwest Office Park, Ltd. v. Texas Commerce Bank, N.A., 786 S.W.2d 386 (Tex. Ct. App. 1990); Kurtz v. Ripley County State Bank, 785 F.Supp. 116 (E.D.Mo.1992).

In general, courts articulate two main standards for invalidating a foreclosure sale based on price. First, many courts require that, in the absence of some other defect or irregularity in the foreclosure process, the price be "grossly inadequate" before a sale may be invalidated. See, e.g., Estate of Yates, 32 Cal.Rptr.2d 53 (Cal. Ct. App. 1994); Moody v. Glendale Federal Bank, 643 So.2d 1149 (Fla.Dist.Ct.App.1994); Gordon v. South Central Farm Credit, ACA, 446 S.E.2d 514 (Ga.Ct.App.1994); Union National Bank v. Johnson, 617 N.Y.S.2d 993 (N.Y.App.Div.1994); United Oklahoma Bank v. Moss, 793 P.2d 1359 (Okla. 1990); Vend-A-Matic, Inc. v. Frankford Trust Co., 442 A.2d 1158 (Pa. Super. Ct. 1982). Second, other courts require a disparity between the sale price and fair market value so gross as to "shock the conscience of the court or raise a presumption of fraud or unfairness." See, e.g., Allied Steel Corp. v. Cooper, 607 So.2d 113 (Miss.1992); Armstrong v. Csurilla, 817 P.2d 1221 (N.M.1991); Crown Life Insurance Co. v. Candlewood, Ltd., 818 P.2d 411 (N.M.1991); Trustco Bank New York v. Collins, 623 N.Y.S.2d 642 (N.Y.App.Div.1995); Key Bank of Western New York, N.A. v. Kessler Graphics Corp., 608 N.Y.S.2d 21 (N.Y.App.Div.1993); Bascom Construction, Inc. v. City Bank & Trust, 629 A.2d 797 (N.H.1993); Crossland Mortgage Corp. v. Frankel, 596 N.Y.S.2d 130 (N.Y.App.Div.1993); Verex Assurance, Inc. v. AABREC, Inc., 436 N.W.2d 876 (Wis.Ct.App.1989). A few courts seem to conflate the foregoing standards by holding that a sale will be set aside only where the price is so "grossly inadequate as to shock the conscience." United Oklahoma Bank v. Moss, 793 P.2d 1359 (Okla.1990).

At least one jurisdiction takes the position that "[i]f the fair market value of the property is over twice the sales price, the price is considered to be grossly inadequate, shocking 'the conscience of the court' and justifying the setting aside of the sale." Burge v. Fidelity Bond & Mortgage Co., 648 A.2d 414, 419 (Del.1994). At the other extreme, one state supreme court, in dealing with a price that was "shockingly inadequate" abandoned the "conscience shocking" standard as "impractical" and instead held that "[i]f a foreclosure sale is legally held, conducted and consummated, there must be some evidence of irregularity, misconduct, fraud, or unfairness on the part of the trustee or mortgagee that caused or contributed to an inadequate price, for a court of equity to set aside the sale." Holt v. Citizens Central Bank, 688 S.W.2d 414, 416 (Tenn.1984). See also Security Savings & Loan Ass'n v. Fenton, 806 P.2d 362 (Ariz.Ct.App.1990).

It is unlikely that the "grossly inadequate" and "shock the conscience" standards differ materially. However, this section adopts the former standard on the theory that in form, if not in substance, it may afford a court somewhat greater flexibility in close cases to invalidate a foreclosure sale than does its "shock the conscience" counterpart.

Illustrations 1–4 establish that only rarely will a court be justified in invalidating a foreclosure sale based on substantial price disparity alone. Courts routinely uphold foreclosure sale prices of 50 percent or more of fair market value. See, e.g., Danbury Savings & Loan Ass'n v. Hovi, 569 A.2d 1143 (Conn. App. Ct. 1990); Moody v. Glendale Federal Bank, 643 So.2d 1149 (Fla.Dist.Ct.App.1994); Guerra v. Mutual Federal Savings & Loan Ass'n, 194 So.2d 15 (Fla.Ct.App. 1967); Union National Bank v. Johnson, 617 N.Y.S.2d 993 (N.Y.App.Div. 1994); Long Island Savings Bank v. Valiquette, 584 N.Y.S.2d 127 (N.Y.App.Div.1992); Glenville & 110 Corp. v. Tortora, 524 N.Y.S.2d 747 (N.Y.App.Div.1988); Zisser v. Noah Industrial Marine & Ship Repair, Inc., 514 N.Y.S.2d 786 (N.Y.App.Div. 1987); S & T Bank v. Dalessio, 632 A.2d 566 (Pa. Super. Ct. 1993); Cedrone v. Warwick Federal Savings & Loan Ass'n, 459 A.2d 944 (R.I.1983); Federal Deposit Ins. Corp. v. Villemaire, 849 F.Supp. 116 (D.Mass. 1994); Kurtz v. Ripley County State Bank, 785 F.Supp. 116 (E.D.Mo. 1992). But see Murphy v. Financial Development Corp., 495 A.2d 1245 (N.H.1985) (sale price of 59% of fair market value indicated failure of due diligence on part of foreclosing mortgagee in exercising power of sale).

Moreover, courts usually uphold sales even when they produce significantly less than 50 percent. See, e.g., Hurlock Food Processors Investment Associates v. Mercantile-Safe Deposit & Trust Co., 633 A.2d 438 (Md.Ct. App.1993) (35% of fair market value (FMV)); Frank Buttermark Plumbing & Heating Corp. v. Sagarese, 500 N.Y.S.2d 551 (N.Y.App.Div.1986) (30% of FMV); Shipp Corp., Inc. v. Charpilloz, 414 So.2d 1122 (Fla.Dist. Ct.App.1982) (33% of FMV); Moeller v. Lien, 30 Cal.Rptr.2d 777 (Cal.Ct. App.1994) (25% of FMV). See generally Dingus, Mortgages—Redemption After Foreclosure Sale in Missouri, 25 Mo. L. Rev. 261, 262–63 (1960).

On the other hand, there are cases holding that a trial court is warranted in invalidating a foreclosure sale that produces a price of 20 percent of fair market value or less. See United Oklahoma Bank v. Moss, 793 P.2d 1359 (Okla.1990) (approximately 20% of FMV); Crown Life Insurance Co. v. Candlewood, Ltd., 818 P.2d 411 (N.M.1991) (15% of FMV); Rife v. Woolfolk, 289 S.E.2d 220 (W.Va.1982) (14% of FMV); Ballentyne v. Smith, 205 U.S. 285, 27 S.Ct. 527, 51 L.Ed. 803 (1907) (14% of FMV); Polish National Alliance v. White Eagle Hall Co., Inc., 470 N.Y.S.2d 642 (N.Y.App. Div.1983) ("foreclosure sales at prices below 10% of value have consistently been held unconscionably low"). According to the New Mexico Supreme Court, when the price falls into the 10–40 percent range, it should not be confirmed "absent good reasons why it should be." Armstrong v. Csurilla, 817 P.2d 1221, 1234 (N.M.1991). A Mississippi decision takes the position that a sale for less than 40 percent of fair market value "shocks the conscience." Allied Steel Corp. v. Cooper, 607 So.2d 113, 120 (Miss.1992). One commentator maintains that there "is general agreement at the extremes as to what constitutes gross inadequacy. Sale prices less than 10 percent of value are generally held grossly inadequate, whereas those above 40 percent are held not grossly inadequate." Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 So. Cal. L. Rev. 843, 866 (1980).

On rare occasions, a trial court may abuse its discretion in confirming a grossly inadequate price. See First National Bank of York v. Critel, 555 N.W.2d 773 (Neb.1996) (reversing trial court's confirmation of a foreclosure sale that yielded 14% of appraised value).

Illustration 6 takes the position that a court may properly take into account that senior liens under some circumstances may make bidding at a junior foreclosure sale an especially precarious enterprise, and may thus be warranted in upholding the sale of the mortgagor's equity for an amount that would otherwise be deemed grossly inadequate. Support for this approach is found in Allied Steel Corp. v. Cooper, 607 So.2d 113, 120 (Miss.1992). See also Deibler v. Atlantic Properties Group, Inc., 652 A.2d 553, 558 (Del.1995); Briehler v. Poseidon Venture, Inc., 502 A.2d 821, 822 (R.I.1986).

The "grossly inadequate" standard applied by this section is measured by reference to the fair market value of the mortgaged real estate at the time of the foreclosure sale. The definition of fair market value is derived from BFP v. Resolution Trust Corp., 511 U.S. 531, 537–538, 114 S.Ct. 1757, 1761, 128 L.Ed.2d 556 (1994), which itself relies on Black's Law Dictionary 971 (6th ed. 1990):

> The market value of ... a piece of property is the price which it might be expected to bring if offered for sale in a fair market; not the price which might be obtained on a sale at public auction or a sale forced by the necessities of the owner, but such a price as would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing (but not compelled) to sell and a purchaser who desires to buy but is not compelled to take the particular ... piece of property.

The formulation of "fair market value" used in this section also finds support in the definition used by the Internal Revenue Service. Under this approach, "fair market value" is defined as:

> the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property ... is not to be determined by a forced sale price. Nor is the fair market value ... to be determined by the sale price of the item in a market other than that which such item is most commonly sold to the public.

Treas. Reg. § 20.2031–1(b).

Price inadequacy coupled with other defects, Comment c. Even if the price is not so low as to be deemed "grossly inadequate," the foreclosure sale may nevertheless be invalidated if it is otherwise defective under state law. See, e.g., Rosenberg v. Smidt, 727 P.2d 778 (Alaska 1986) (sale for 28% of fair market value set aside where trustee failed to use due diligence to determine last known address of mortgagor); Bank of Seoul & Trust Co. v. Marcione, 244 Cal.Rptr. 1 (Cal.Ct.App.1988) (sale set aside where foreclosure price was for one third of fair market value and trustee refused to recognize a higher bid from a junior lienholder who was present at the sale); Estate of Yates, 32 Cal.Rptr.2d 53 (Cal. Ct. App. 1994) (sale for 12% of fair market value set aside where trustee failed to mail notice of default to executor); Whitman v. Transtate Title Co., 211 Cal.Rptr. 582 (Cal.Ct.App.1985) (sale for 20% of FMV set aside where trustee refused request for one-day postponement of sale); Federal National Mortgage Ass'n v. Brooks, 405 S.E.2d 604 (S.C.Ct.App.1991) (sale for 3% of FMV set aside where improper information supplied to bidders); Kouros v. Sewell, 169 S.E.2d 816 (Ga.1969) (sale for 3% of FMV set aside where mortgagee gave mortgagor incorrect sale date). Conversely, more than nominal price inadequacy must exist notwithstanding other defects in the sale process in order to establish the requisite prejudice to sustain an attack on the sale. See Cragin Federal Bank For Savings v. American National Bank & Trust Co. of Chicago, 633 N.E.2d 1011 (Ill. App. Ct. 1994).

Illustration 11 is based in part on Bank of Seoul & Trust Co. v. Marcione, 244 Cal.Rptr. 1 (Cal.Ct.App. 1988).

It is not uncommon for the *mortgagee*, rather than the mortgagor or a junior lienor, to attempt to set aside a sale based on an inadequate price. Note that in this setting, the real estato not only will be sold for less than fair market value, but usually, though not always, for a price that will not qualify as "grossly inadequate." Moreover, the foreclosure proceeding itself is normally not defective under state law. Rather, the mortgagee intends to enter a higher bid at the sale, but because of mistake or negligence on its part, actually makes a lower bid and a third party becomes the successful purchaser. Courts are deeply divided on this issue. Some take the position that mistake or negligence on the mortgagee's part should be treated as the functional equivalent of a defect under state law. As a result, these courts reason, the inadequate price plus the mistake or negligence are sufficient to justify setting aside the sale. See Burge v. Fidelity Bond & Mortgage Co., 648 A.2d 414 (Del. 1994) (sale for 71% to 80% of FMV set aside based on mistaken bid by mortgagee); Alberts v. Federal Home Loan Mortgage Corp., 673 So.2d 158 (Fla.Dist.Ct.App.1996) (affirming trial court that set aside a foreclosure sale after mortgagee's agent, through a mistake in communications, entered a bid of $18,995, instead of $118,995 and property was sold to third party for a grossly inadequate $19,000); RSR Investments, Inc. v. Barnett Bank of Pinellas County, 647 So.2d 874 (Fla.Dist.Ct.App.1994) (sale for 6% of FMV set aside because mortgagee inadvertently failed to appear at the sale); Crown Life Insurance Co. v. Candlewood, Ltd., 818 P.2d 411 (N.M.1991) (sale for 15% to 23% of FMV set aside based on mistaken bid by mortgagee). Other courts, however, have less sympathy for the mortgagee in this setting. See Wells Fargo Credit Corp. v. Martin, 605 So.2d 531 (Fla.Dist.Ct.App.1992) (trial court refusal to set aside sale affirmed even though mortgagee's agent, through a misunderstanding, entered bid of $15,500 instead of $115,000 and property was sold to another for the grossly inadequate amount of $20,000); Mellon Financial Services Corp. #7 v. Cook, 585 So.2d 1213 (La.Ct.App.1991) (sale upheld even though attorney for mortgagee, who was deaf in his right ear, failed to bid higher against a third party because he "contributed to the problem by not positioning himself in a more favorable position, considering his hearing disability."); Crossland Mortgage Corp. v. Frankel, 596 N.Y.S.2d 130 (N.Y.App.Div.1993) (sale to mortgagor's father for 28% to 34% of FMV upheld even though erroneous bidding instructions to mortgagee's agent caused him to cease bidding prematurely). According to the *Crossland* court, "[mortgagee's] mistake was unfortunate, [but] it did not provide a basis to invalidate the sale which was consummated in complete accord with lawful procedure ... since the mistake was unilateral on [mortgagee's] part." Id. at 131.

On balance, the latter approach to mortgagee mistake seems preferable. In general, third party bidding should be encouraged, and this section reflects that policy by making it extremely difficult to invalidate foreclosure sales based on price inadequacy alone. Where the foreclosure process itself complies with state law and the other parties to the process have not engaged in fraud or similar unlawful conduct, courts should be especially hesitant to upset third party expectations. This is especially the case where, as here, mortgagees can easily protect themselves by employing simple common-sense precautions.

§ 8.4 Foreclosure: Action for a Deficiency

(a) If the foreclosure sale price is less than the unpaid balance of the mortgage obligation, an action may be brought to recover a deficiency judgment against any person who is personally liable on the mortgage obligation in accordance with the provisions of this section.

(b) Subject to Subsections (c) and (d) of this section, the deficiency judgment is for the amount by which the mortgage obligation exceeds the foreclosure sale price.

(c) Any person against whom such a recovery is sought may request in the proceeding in which the action for a deficiency is pending a determination of the fair market value of the real estate as of the date of the foreclosure sale.

(d) If it is determined that the fair market value is greater than the foreclosure sale price, the persons against whom recovery of the deficiency is sought are entitled to an offset against the deficiency in the amount by which the fair market value, less the amount of any liens on the real estate that were not extinguished by the foreclosure, exceeds the sale price.

Cross-References:

Section 8.1, Accrual of the Right to Foreclose—Acceleration; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage; § 8.3, Adequacy of Foreclosure Sale Price; § 8.5, The Merger Doctrine Inapplicable to Mortgages.

Comment:

a. Deficiency judgments generally available. This section adopts the widely held view that when the foreclosure process does not fully satisfy the mortgage obligation, the mortgagee may obtain a deficiency judgment against any person who is personally liable on that obligation. Thus, this section rejects the approach of those states that prohibit a deficiency judgment after foreclosure of a purchase money mortgage, or that prohibit deficiency judgments after a foreclosure by power of sale. On the other hand, it also rejects the traditional view that the amount realized at the foreclosure sale is automatically applied to the mortgage obligation and that the mortgagee is entitled to a judgment for the balance. Instead, it adopts the position of the substantial number of states that, by legislation or judicial decision, afford the deficiency defendant the right to insist that the greater of the fair market value of the real estate or the foreclosure sale price be used in calculating the deficiency. This approach enables the mortgagee to be made whole where the mortgaged real estate is insufficient to satisfy the mortgage obligation, but at the same time protects against the mortgagee purchasing the property at a deflated price, obtaining a deficiency judgment and, by reselling the real estate at a profit, achieving a recovery that exceeds the obligation. Thus, it is aimed primarily at preventing the unjust enrichment of the mortgagee. This section also protects the mortgagor from the harsh consequences of suffering both the loss of the real estate and the burden of a deficiency judgment that does not fairly recognize the value of that real estate.

This limitation on deficiency judgments operates in the commonly encountered situation in which the mortgagee first forecloses on the real estate and thereafter seeks a deficiency (see § 8.2(b)). It also applies in the less common case in which the mortgagee first sues on the obligation and thereafter forecloses on the real estate (see § 8.2(a)). If the latter foreclosure does not yield enough to satisfy fully the obligation, any subsequent collection efforts are regarded as the seeking of a deficiency, and hence are subject to the fair market value limitation stated by Subsections (c) and (d) of this section.

The approach of this section is embodied in statutes in many jurisdictions, but the principles of this section are applicable whether a statute requires it or not.

b. Application of the standard. The fair market value determination of this section is not self-executing. Unless the deficiency defendant affirmatively requests such a determination, the foreclosure sale price, rather than the property's fair market value, will be used to compute the deficiency. See Illustration 1. However, where there is such a request, the fair market value as of the date of the foreclosure sale will be determined and any deficiency will be reduced by the amount by which that fair market value exceeds the foreclosure sale price. See Illustrations 2 and 3. Where the foreclosure is subject to senior liens, the amount of those liens must be subtracted from the fair market value in calculating the deficiency. See Illustrations 4–6. This section applies irrespective of whether the foreclosure purchaser is the mortgagee or a third party. In no event will any offset against a deficiency under Subsection (d) create a surplus for purposes of § 7.4. The fair market value determination under this section may be made either by the court or a jury in accordance with local law.

For purposes of this section, the mortgage obligation includes not only the principal balance and accrued interest but also, to the extent recognized by local law, late charges, attorneys' and trustee's fees, expenditures for the protection of security (see § 2.2), and publication and court costs.

Illustrations:

1. Mortgagor is personally liable on an obligation to Mortgagee secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee commences a proceeding (either by judicial action or by power of sale) against Mortgagor to foreclose its mortgage on Blackacre. A foreclosure sale is held and Blackacre is sold for $70,000. No other liens on Blackacre survive the sale. The balance owing on the mortgage obligation at the time of the sale is $100,000. Mortgagee seeks a deficiency judgment for $30,000. Mortgagor has evidence that the fair market value of Blackacre at the time of sale was $110,000, but does not request a fair market value determination. Mortgagee is entitled to a deficiency judgment against mortgagor for $30,000.

2. The facts are the same as Illustration 1, except that Mortgagor requests a fair market value determination and the fair market value of Blackacre as of the date of the foreclosure sale is determined to be $90,000. Mortgagee is entitled to a deficiency judgment against Mortgagor for $10,000.

3. The facts are the same as Illustration 2, except that the fair market value of Blackacre as of the date of the foreclosure

sale is $105,000. Mortgagee is not entitled to a deficiency judgment against Mortgagor.

4. Mortgagor is personally liable on an obligation to Mortgagee secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee commences a proceeding (either by judicial action or by power of sale) to foreclose its mortgage on Blackacre. A foreclosure sale is held and Blackacre is sold for $70,000 subject to a senior lien with a $15,000 outstanding balance. The mortgage obligation at the time of sale is $100,000. Mortgagee seeks a deficiency judgment for $30,000. Mortgagor requests a fair market value determination and it is determined that the fair market value of Blackacre at the time of the foreclosure sale was $105,000. Mortgagee is entitled to a deficiency judgment against Mortgagor for $10,000.

5. The facts are the same as Illustration 4, except that the fair market value of Blackacre at the time of the foreclosure sale is determined to be $85,000. Mortgagee is entitled to a deficiency judgment against Mortgagor for $30,000.

6. The facts are the same as Illustration 4, except that the fair market value of Blackacre at the time of the foreclosure sale is determined to be $125,000. Mortgagee is not entitled to a deficiency judgment against Mortgagor.

Because Subsection (c) of this section may be asserted by "any person against whom [a deficiency] may be sought," it protects not only mortgagors and assuming grantees of the foreclosed real estate, but guarantors and sureties of the mortgage obligation as well. To permit the mortgagee to recover a deficiency judgment against the latter persons unrestricted by the limitations of this Subsection (c) would be inconsistent with the goal of preventing unjust enrichment of the mortgagee.

Any agreement in or created contemporaneously with the mortgage documents by which any person against whom a deficiency may be sought purports to waive the protection of this section is ineffective.

c. Defining "fair market value." For purposes of this section, "fair market value" is defined in the same manner as in § 8.3: "the price which would result from negotiation and mutual agreement, after ample time to find a purchaser, between a vendor who is willing, but not compelled to sell, and a purchaser who is willing to buy, but not compelled to take a particular piece of real estate." See § 8.3, Comment *b*. "Fair market value" is not "fair foreclosure value" and should not be affected by the impact of the foreclosure proceedings. The determination of fair market value may appropriately utilize a variety of approaches including (1) the "market data" approach indicated by recent sales of comparable properties; (2) the "income approach," or the value which the real estate's net earning power will support based upon a capitalization of net income; and (3) the current cost of reproducing the property less depreciation.

Where the mortgagee is the foreclosure purchaser, after the fair market value is determined, the court must deduct from that amount the mortgagee's anticipated reasonable costs of resale. This amount will include a reasonable broker's commission, seller's title expenses and related costs. See Illustration 7. It is appropriate to give the mortgagee a credit for such costs because sellers almost always incur them and thus doing so will not unjustly enrich the mortgagee. On the other hand, a court may not credit the mortgagee with its anticipated holding costs, such as real estate taxes and interest on the funds used to purchase the real estate. See Illustration 8. To estimate the holding period would be speculative at best. If holding costs were allowed and the mortgagee were able to make a sale before the expiration of the anticipated holding period, unjust enrichment of the mortgagee would occur. It might also be inequitable to credit the mortgagee with such costs if it would have the benefit of income from the real estate during the holding period.

Illustrations:

7. Mortgagor is personally liable on an obligation secured by a mortgage on Blackacre. Mortgagor defaults and Mortgagee validly accelerates the obligation. Mortgagee commences a proceeding (either by judicial action or by power of sale) to foreclose its mortgage on Blackacre. A foreclosure sale is held and Blackacre is sold to Mortgagee for $70,000, subject to a senior lien with a $15,000 outstanding balance. The mortgage obligation at the time of sale was $100,000. Mortgagee seeks a deficiency judgment for $30,000. Mortgagor requests a fair market value determination, and it is determined that the fair market value of Blackacre at the time of foreclosure sale was $105,000. Mortgagee claims anticipated resale costs of $7,000 (brokerage commission and title costs). If the court finds these costs to be a reasonable approximation of mortgagee's actual resale costs, they should be used to reduce the fair market value of Blackacre by $7,000 and Mortgagee will be entitled to a deficiency judgment for $17,000.

8. Same facts as in Illustration 7, except that Mortgagee also claims anticipated holding costs of $15,600 (three years of real estate taxes [$3,000] and interest on the foreclosure purchase price [$12,600]). These anticipated costs may not be deducted

from the fair market value. Mortgagee is entitled to a deficiency judgment against Mortgagor for $17,000.

d. Application of the standard to foreclosed junior lienholders. In certain circumstances, the fair market value limitation of this section applies to a foreclosed junior lienholder who seeks to recover on the junior mortgage obligation. This will be the case where the junior mortgagee is the purchaser at the senior sale. In this situation a judgment on the junior obligation should be permitted only to the extent that the combined senior and junior obligations exceed the fair market value of the real estate. This result is consistent with the major purpose of this section, which is to protect against a mortgagee purchasing the real estate at a deflated price, obtaining a deficiency judgment, and then, by selling the real estate at a profit, achieving a total recovery that exceeds the mortgage obligation. See Illustration 9. The same reasoning applies where one lender forecloses the senior of two mortgages it holds on the same real estato and purchases at the senior sale. See Illustration 10. This result is also consistent with § 8.5. See § 8.5, Comment *c(2)* and Illustration 16.

Where the purchaser is a party other than the junior lienholder, the fair market value limitation of Subsection (d) will not be used to limit the terminated junior lienholder's recovery on the junior obligation. See Illustration 11. Because the junior lienholder in this setting does not acquire the real estate, it is not in a position to achieve a recovery that exceeds the mortgage obligation and thus no unjust enrichment will occur. Of course, it could be argued that application of the fair market value limitation still serves to protect mortgagors from the double burden of losing the land and suffering an unfairly measured deficiency judgment. Moreover, the junior lienholder arguably is able to protect itself by bidding at the senior sale and, in so doing, either obtain real estate that is worth enough to cover its obligation or, if another person is the ultimate purchaser, insure that the sale yields enough surplus to satisfy its lien out of the sale proceeds. However, unlike the foreclosing mortgagee who is able to bid up to the mortgage obligation without advancing new funds, each dollar the junior lienholder bids at the senior sale will represent an additional investment in the real estate. Thus, it seems unfair te compel the junior lienholder to take such a course of action in order to preserve its right to recover on the junior obligation.

Illustrations:

9. Mortgagor borrows money from Mortgagee-1 and gives Mortgagee-1 a promissory note secured by a mortgage on Blackacre. This mortgage is immediately recorded. Mortgagor subse-

quently borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor is personally liable on both promissory notes. Mortgagor defaults on the obligation secured by Mortgage–1 and that obligation is validly accelerated. Mortgagee–1 forecloses its mortgage, and Mortgagee–2 purchases at that sale for $40,000, the then balance on the Mortgagee–1 obligation. Mortgagee–2 then files suit to obtain a personal judgment against Mortgagor for $20,000, the then outstanding balance on the Mortgagee–2 obligation. Mortgagor requests a fair market value determination and it is determined that the fair market value of Blackacre as of the date of the foreclosure sale was $50,000. The fair market value limitation of this section applies to Mortgagee–2's suit and, as a result, Mortgagee–2 is entitled to a judgment against Mortgagor for $10,000, rather than $20,000.

10. Mortgagor borrows money from Mortgagee and gives Mortgagee a promissory note secured by a first mortgage on Blackacre. The first mortgage is immediately recorded. Mortgagor subsequently borrows more money from Mortgagee and gives Mortgagee a promissory note secured by a second mortgage on Blackacre. This second mortgage is also immediately recorded. Mortgagor is personally liable on both promissory notes. Mortgagor defaults on the obligation secured by the first mortgage, and that obligation is validly accelerated. Mortgagee forecloses the first mortgage, and Mortgagee purchases at that sale for $40,000, the then balance on the first mortgage obligation. Mortgagee then files suit to obtain a personal judgment against Mortgagor for $20,000, the then outstanding balance on the second mortgage obligation. Mortgagor then requests a fair market value determination and it is determined that the fair market value of Blackacre as of the date of the foreclosure sale was $50,000. The fair market value limitation of this section applies to Mortgagee's suit and, as a result, Mortgagee is entitled to a judgment against Mortgagor for $10,000, rather than $20,000.

11. The facts are the same as Illustration 9, except that the purchaser at the foreclosure sale is a person other than Mortgagee–2. The fair market value limitation of this section is inapplicable to Mortgagee–2's suit and, as a result, Mortgagee–2 is entitled to a judgment against Mortgagor for $20,000, the amount requested.

REPORTERS' NOTE

Deficiency judgments generally available, Comment a. Several states continue to adhere to the common-law rule that when a foreclosure sale does not yield at least the amount of the mortgage obligation, the mortgagee is entitled to a deficiency judgment measured by the difference between the foreclosure price and the mortgage obligation. Under this approach, the foreclosure sale price is the conclusive measure of the amount to be applied to the obligation unless the mortgagor can prove that the foreclosure process itself was defective. See, e.g., New England Sav. Bank v. Lopez, 630 A.2d 1010 (Conn. 1993) (power of sale foreclosure only); Garland v. Hill, 357 A.2d 374 (Md. 1976); Drannek Realty Co. v. Nathan Frank, Inc., 139 S.W.2d 926 (Mo. 1940); Lindell Trust Co. v. Lieberman, 825 S.W.2d 358 (Mo.Ct.App. 1992); Rhode Island Depositors' Economic Protection Corp. v. Macomber, 658 A.2d 511 (R.I.1995); McDill Columbus Corporation v. The Lakes Corp., 1992 WL 115576 (Tenn.Ct.App. 1992); Fitch v. Buffalo Federal Savings & Loan Ass'n, 751 P.2d 1309 (Wyo.1988); Abrams v. Federal Deposit Ins. Corp., 5 F.3d 1013 (6th Cir.1993) (Kentucky); Resolution Trust Corp. v. Carr, 13 F.3d 425 (1st Cir.1993) (Massachusetts). Cf. Resolution Trust Corp. v. Holtzman, 618 N.E.2d 418 (Ill. App. Ct. 1993) (foreclosure sale should be confirmed and deficiency judgment entered unless "the terms of sale were unconscionable, ... the sale was conducted fraudulently or ... justice was not otherwise done.").

At the opposite extreme, some states flatly prohibit deficiency judgments in certain contexts. Some statutes bar a deficiency judgment after a power of sale foreclosure. See Alaska Stat. 34.20.100; Ariz. Rev. Stat. § 33-814(E); West's Ann. Cal. Code Civ. Proc. § 580(d); Mont. Code Ann. § 71-1-317; Wash. Rev. Code Ann. § 61.24.010, 040, 100. In addition, several state statutes prohibit a deficiency judgment after the foreclosure of a purchase money mortgage. See Ariz. Rev. Stat. § 33-729(A); West's Ann. Cal. Code Civ. Proc. § 580(b); Mont. Code Ann. § 71-1-232; N.C. Gen. Stat. § 45-21.38; Or. Rev. Stat. § 88.070; So. Dak. Cod. Laws §§ 44-8-20 to 44-8-25. A few of these states apply the deficiency prohibition to vendor purchase money mortgagees only. See Mont. Code Ann § 71-1-232; N.C. Gen. Stat. § 45-21.38.

The Uniform Land Security Interest Act (ULSIA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1985, permits deficiency judgments in general, but prohibits them as to purchase money mortgages given by mortgagor-occupants of residential real estate to vendors or third party lenders. ULSIA § 511(b). See Mixon and Shepard, Antideficiency Relief for Foreclosed Homeowners: ULSIA Section 511(b), 27 Wake F. L. Rev. 455 (1992).

This section not only rejects each of the foregoing limitations on deficiency judgments, but also the traditional common-law view that the foreclosure sale price should be automatically applied in measuring deficiency judgments. Instead, the section adopts the approach of the numerous states that through legislation or judicial decision define the deficiency as the difference between the mortgage obligation and the "fair value" of the foreclosed real estate. See Ariz. Rev. Stat. § 33-814 ("fair market value" as of the date of sale); West's Ann. Cal. Code Civ. Proc. §§ 580a ("fair market value" as of date of sale in power of sale foreclosure), 726(b) ("fair value" as of sale date in judicial foreclosure); Colo. Rev. Stat. Ann. § 38-38-106 ("fair market value"); Conn. Gen. Stat. Ann. § 49-14(a) ("actual value" as of date title vested in mortgagee in strict foreclosure); Ga. Code Ann. § 44-14-161 ("true market value" as of sale date); Idaho Code § 6-108 ("reasonable value"); Kan. Stat. Ann. § 60-2415 ("fair value"); Me. Rev. Stat. Ann. tit. 14, § 6324 ("fair market value" at time of sale); Mich. Comp. Laws Ann. § 600.3280 ("true value" at time of sale); Minn. Stat. Ann. § 582.30, subd. 5(a) ("fair market value"); Neb. Rev. Stat. § 76-1013 ("fair market value" as of sale date); Nev. Rev. Stat. §§ 40.455-40.457 ("fair market value" as of sale date); N.J. Rev. Stat. § 2A:50-3 ("fair market value"); N.Y. Real Prop. Acts. § 1371 ("fair and reasonable market value" as of sale date); N.C. Gen. Stat. § 45-21.36 ("true value" as of sale date); N.D. Cent. Code §§ 32-19-06, 32-19-06.1 ("fair value"); Okla. Stat. Ann. tit. 12, § 686 ("fair and reasonable market value" as of sale date); Pa. Stat. Ann. tit. 42, § 8103 ("fair market value"); S.C. Code Ann. § 29-3-700 et seq. ("true value"); S.D. Codified Laws Ann. § 21-47-16 ("fair and reasonable value"); Tex. Prop. Code Ann. § 51.003 ("fair market value" as of sale date); Utah Code Ann. § 57-1-32 ("fair market value"); Wash. Rev. Code Ann. § 61.12.060 ("fair value"); Wis. Stat. Ann. § 846.165 ("fair value").

A few states appear to have adopted the fair value approach through judicial decision. Florida courts have significant flexibility in determining whether to use the foreclosure price or the fair market value in measuring the deficiency. See First Union National Bank of Florida v. Goodwin Beach Partnership, 644 So.2d 1361 (Fla.Dist.Ct.App.1994); Howell v. Gaines, 608 So.2d 64 (Fla. Dist.Ct.App.1992); Mizner Bank v. Adib, 588 So.2d 325 (Fla.Dist.Ct.App. 1991) (party seeking deficiency judgment must present competent evidence that the mortgage indebtedness exceeds the fair market value of the property); G. Nelson & D. Whitman, Real Estate Finance Law § 8.3 (3d ed. 1994). But see Federal Deposit Insurance Corp. v. Hy Kom Development Co., 603 So.2d 59 (Fla.Dist. Ct.App.1992) (deficiency judgment based on foreclosure sale price "is the rule rather than the exception" unless fraud or other inequitable conduct infects the sale process). In Mississippi, in a deficiency proceeding, the mortgagee "must give the debtor fair credit for the commercially reasonable value of the collateral." Shutze v. Credithrift of America, 607 So.2d 55, 65 (Miss.1992). The Montana Supreme Court has used its inherent equitable powers to require that fair market value of the foreclosed real estate be the measure in a deficiency proceeding. See Trustees of the Wash.-Idaho-Mont.-Carpenters-Employers Retirement Trust Fund v. Galleria Partnership, 780 P.2d 608, 614 (Mont. 1989) ("When the fair market value of property is determined by the District Court, that figure would be the basis of a deficiency judgment, if any"). Vermont, a strict foreclosure state, requires that the value of the foreclosed real estate be applied to the mortgage obligation.

See Licursi v. Sweeney, 594 A.2d 396, 398 (Vt.1991) ("The property was valued by the court far in excess of the amounts owed. There is no deficiency, and the plaintiff cannot recover.").

Application of the standard, Comment b. In many jurisdictions, the court must conduct a hearing as to value and apply the "fair value" amount in computing a deficiency even though the deficiency defendant fails to request it. See, e.g., Ga. Code Ann. § 41-44-61; Idaho Code Ann. § 6-108; Neb. Rev. Stat. § 76-1013; N.Y. Real Prop. Laws § 1371; Nev. Rev. Stat. § 40.457; Okla. Stat. Ann. tit. 12, § 686; Pa. Stat. Ann. tit. 42, § 8103. Other states place the burden on the deficiency defendant to raise the "fair value" defense. See, e.g., Kan. Stat. Ann. § 60-2415; Me. Rev. Stat. Ann. tit. 14, § 6324; Mich. Comp. Laws Ann. § 600.3280; N.C. Gen. Stat. § 45-21.36; N.J. Rev. Stat. § 2A:50-3; Tex. Prop. Code Ann. § 51.003. This section adopts the latter approach on the ground that it is wasteful of judicial resources to require a valuation hearing when the defendant fails to assert a right to one. Indeed, the Texas statute specifically provides that "[i]f no party requests the determination of fair market value or if such a request is made and no competent evidence of fair market value is introduced, the sale price at the foreclosure sale shall be used to compute the deficiency." Tex. Prop. Code Ann. § 51.003(c). The Texas approach is reflected in this section. See Comment *b* and Illustration 1.

In a few states, a jury, and not the court, makes the fair value determination. See, e.g., Minn. Stat. Ann. § 582.30, subd. 5(a); N.D. Cent. Code § 32-19-06. This section takes no position on whether the determination should be made by the court or a jury.

For the view that senior liens must be subtracted from the fair market value of the real estate in calculating a deficiency, see, e.g., First Union National Bank of Florida v. Goodwin Beach Partnership, 644 So.2d 1361 (Fla.Dist.Ct.App.1994); American Mortgage Corp. v. Hope, 675 A.2d 912 (Conn. App. Ct. 1996).

A few states apply the "fair value" approach to deficiency judgments only where the mortgagee is the foreclosure sale purchaser. Where any other person is the purchaser, the foreclosure sale price is used in measuring the deficiency. See Me. Rev. Stat. Ann. tit 14, § 6324; Mich. Comp. Laws Ann. § 600.3280; N.C. Gen. Stat. § 45-21.36; Washburn, The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales, 53 So. Cal. L. Rev. 843, 912 (1980). Since the fair value concept is primarily aimed at preventing unjust enrichment of the mortgagee and since the latter cannot be unjustly enriched if a third party is the foreclosure purchaser, applying a fair value limitation in the third party purchase setting may seem problematic. However, limiting the application of the fair value determination to mortgagee purchasers may discourage mortgagees who contemplate obtaining deficiency judgments from taking part in the foreclosure bidding and hence may remove a significant impetus to higher bidding by third parties. In addition, even when a third party is the purchaser, the mortgagor may still suffer the unjustifiable double burden imposed by the loss of his or her real estate and an unfairly measured deficiency judgment. Consequently, under this section foreclosing mortgagees are subject to the fair value limitation on deficiency judgments irrespective of who purchases at the sale.

There is a substantial body of case law that denies guarantors the protection of anti-deficiency legislation. See, e.g., Long v. Corbet, 888 P.2d 1340 (Ariz.Ct.App.1994); Mariners Savings & Loan Ass'n v. Neil, 99 Cal.Rptr. 238 (Cal.Ct.App.1971); First Security Bank of Idaho, N.A. v. Gaige, 765 P.2d 683 (Idaho 1988); Sumner v. Enercon Development Co., 771 P.2d 619 (Or.1989); 1 G. Nelson & D. Whitman, Real Estate Finance Law 689–690 (3d ed. 1993). However, this denial of protection to guarantors often involves "purchase money" anti-deficiency legislation, "one-action" rules, and prohibitions of deficiency judgments after power of sale foreclosure. The latter statutes are aimed primarily at protecting debtors. On the other hand, some state "fair value" legislation specifically protects guarantors. See, e.g., Ariz. Rev. Stat. Ann. § 33–814(A); Tex. Prop. Code Ann. §§ 51.004, 51.005. Moreover, at least one decision has extended "fair value" protection to guarantors even though the statute was silent on the question. See Bank of Southern California v. Dombrow, 46 Cal.Rptr.2d 656 (Cal.Ct.App.1995) (ordered not published by California Supreme Court). Fair value legislation is primarily aimed at preventing the unjust enrichment of the mortgagee and the extension of "fair value" protection to guarantors clearly serves that purpose. This rationale supports the extension of the protection of this section to guarantors and sureties.

This section prohibits advance waiver of its "fair value" protection. If such waiver were permitted, most mortgage forms would routinely incorporate waiver language and the impact of this section would be significantly weakened. The anti-waiver approach of this section is consistent with Cal. Civ. Code § 2953 ("Any express agreement made or entered into by a borrower at the time of or in connection with the making of ... any loan secured by a deed of trust, mortgage or other instrument creating a lien on real property, whereby the borrower agrees to waive the rights, or privileges conferred upon him by ... [Section 726] of the Code of Civil Procedure, shall be void and of no effect."). Accord, Pa. Stat. Ann. tit. 42, § 8103(3) ("Any agreement made by any debtor, obligor, surety or guarantor ... either before or after or at the time of incurring any obligation, to waive the benefits of this section ... shall be void"). This section applies the waiver restriction to gnarantors and sureties as well as mortgagors. By doing so, it seeks to ensure that its primary goal of preventing unjust enrichment of the mortgagee is not subverted by the routine exaction of waivers from guarantors and sureties.

Defining "fair market value," Comment c. States use a variety of terms to define the "value" of real estate for purposes of measuring a deficiency judgment, including "fair value," "fair market value," "true value," "true market value," "reasonable value," "fair and reasonable value," "commercially reasonable value," "actual value," and "market value." See Reporters' Note to Comment *b*, supra. The two most commonly used terms are "fair market value" and "fair value." Whether these terms differ substantially is conjectural. For example, one California court in interpreting the term "fair value" stated:

> "[F]air value" must be determined in light of the property's marketability at the time of the sale. It does not equate "fair value" with "fair foreclosure value".... The "fair value" of foreclosed property is thus its intrinsic value. Under normal conditions this intrinsic value will often coincide with its fair market value; the value a willing purchaser will pay to a willing seller in an open market. This correlation is not fixed, however, and market value is only one factor the court should consider when determining "fair value."

Rainer Mortgage v. Silverwood, Ltd., 209 Cal.Rptr. 294, 300 (Cal. Ct. App. 1985). In contrast, the Washington Supreme Court stated:

> The statute calls not for what the court would determine to be the minimum value, but rather its fair value. As we said, ... the court "should assume the position of the competitive bidder determining a fair bid at the time of sale under normal conditions." This means that, in deciding upon fair value at a foreclosure sale, the court may consider the state of the economy and local economic conditions, the usefulness of the property under normal conditions, its potential and future value, the type of property involved, its unique qualities, if any, and any other characteristics and conditions affecting its marketability along with any other factors which such a bidder might consider in determining a fair bid for the mortgaged property.

National Bank v. Equity Investors, 506 P.2d 20, 46 (Wash.1973). See also Olathe Bank v. Mann, 845 P.2d 639, 647 (Kan. 1993) ("the price paid for property at foreclosure should reflect the intrinsic value of the property, 'taking into consideration all the circumstances affecting the underlying worth of the property at the time of sale,' and should not be affected by the impact of foreclosure proceedings on its value."); First Financial Savings Ass'n v. Spranger, 456 N.W.2d 897 (Wis.Ct.App.1990).

"Fair market value" is the most commonly used approach and is the standard used in this section. The definition is largely derived from BFP v. Resolution Trust Corp., 511 U.S. 531, 537–538, 114 S.Ct. 1757, 1760–1761, 128 L.Ed.2d 556 (1994). See § 8.3, Comment *b* and Reporters' Note. The three methods of determining fair market value set out in Comment *c* to this section are frequently used in the eminent domain context and are derived from Annon II, Inc. v. Rill, 597 N.E.2d 320, 326–27 (Ind.Ct.App.1992) and Ohio Casualty Ins. Co. v. Ramsey, 439 N.E.2d 1162, 1167 (Ind.Ct.App.1982). See also, Marine Midland Bank v. New Horizons Investors, Inc., 653 N.Y.S.2d 685 (N.Y.App.Div.1997).

There is significant disagreement concerning whether a mortgagee-purchaser's "holding costs" should be deducted from fair market value in determining the amount of the deficiency. Such costs include real estate taxes and interest on the funds used to purchase the real estate for the anticipated holding period and reasonable costs of resale, including a brokerage commission. Some courts hold that mortgagee should be credited for such costs. See, e.g., Fidelity Union Trust Co. v. Ritz Holding Co., 8 A.2d 235, 246 (N.J. 1939) (holding that the purchaser was entitled to deduct its loss of interest earnings on the funds used to purchase the real estate and stating: "The mortgagee who has been compelled to purchase the [real estate] and retain it as an investment should not be expected to retain it at a continuing loss, and equity does not require that he do so."). A few statutes also authorize the consideration of such costs in determining fair market value. See, e.g., Tex. Prop. Code Ann. § 51.003(b) ("Competent evidence of value may include, but is not limited to, ... (3) anticipated marketing time and holding costs [and] (4) cost of sale."). On the other hand, there is substantial authority rejecting crediting the mortgagee-purchaser for holding costs. See, e.g., Rainer Mortgage v. Silverwood, Ltd., 209 Cal. Rptr. 294 (Cal.Ct.App.1985); Olathe Bank v. Mann, 845 P.2d 639, 647 (Kan.1993) ("We conclude ... anticipated holding costs [taxes, interest, and real estate commission] are not deductible from fair market value to determine fair value of the foreclosed real estate, as a matter of law."); First Financial Savings Ass'n v. Spranger, 456 N.W.2d 897, 899 (Wis. Ct.App.1990) (mortgagee "may sell the property immediately, without a broker's commission, and without incurring any holding or carrying costs. [Mortgagee] does not offer, if that should occur, to reimburse [mortgagor]. That result is inequitable"). This section largely incorporates the latter position, but permits the court to credit the mortgagee with anticipated reasonable costs of resale (brokerage commission, title fees, and related costs) because such costs are almost always incurred by real estate sellers; consequently, unjust enrichment of the mortgagee is unlikely.

Application of the standard to foreclosed junior lienholders, Comment d. A foreclosed junior lienholder who purchases at the senior sale and then brings suit on the junior obligation is subject to the fair market value limitation of this section. Illustration 9 is based on Bank of Hemet v. United States, 643 F.2d 661 (9th Cir.1981). In that case the United States Court of Appeals, in interpreting section 580a of the California Code of Civil Procedure, fair market value legislation applicable to power of sale foreclosure, drew a distinction between the foreclosed junior lienholder who purchases at the senior sale and one who does not. In the former case, a deficiency judgment should be permitted "only to the extent the combined debts exceed the fair market value of the property. ... In addition, in no event should the deficiency judgment exceed the amount by which the combined debts are greater than the amount for which the property sold." Id. at 669. According to the court, this approach was "consistent with the general purpose of section 580a, *viz.*, to protect against buying in a property at a deflated price, obtaining a deficiency judgment, and achieving a recovery in excess of the debt by reselling the property at a profit." Id. at 669.

Where a person other than the junior lienholder is the senior sale purchaser, this section does not limit recovery on the junior obligation. Illustration 11 is based on Roseleaf Corp. v. Chierighino, 378 P.2d 97 (Cal. 1963). The *Roseleaf* court provides the following rationale for this result:

> The position of a junior lienor whose security is lost through a senior sale is different from that of a selling senior lienor. A selling senior can make certain that the security brings an amount equal to his claim against the debtor or the fair market value, whichever is less, simply by bidding in for that amount. He need not invest any additional funds. The junior lienor,

however, is in no better position to protect himself than is the debtor. Either would have to invest additional funds to redeem or buy in at the sale. Equitable considerations favor placing this burden on the debtor, not only because it is his default that provokes the senior sale, but also because he has the benefit of his bargain with the junior lienor who, unlike the selling senior, might otherwise end up with nothing.

Id. at 100.

§ 8.5 The Merger Doctrine Inapplicable to Mortgages

The doctrine of merger does not apply to mortgages or affect the enforceability of a mortgage obligation.

Cross-References:

Section 4.9, Acquisition of Foreclosure Title by the Holder of the Equity of Redemption or Other Junior Interests: Effect upon Junior Interests; § 6.4, Redemption from Mortgage by Performance or Tender; § 7.1, Effect of Mortgage Priority on Foreclosure; § 7.6, Subrogation; § 8.1, Accrual of the Right to Foreclose—Acceleration; § 8.2, Mortgagee's Remedies on the Obligation and the Mortgage; § 8.4, Foreclosure: Action for a Deficiency.

Comment:

a. Introduction and historical perspective. Under the traditional statement of the merger doctrine, when two consecutive estates in land are held by the same person, the estates coalesce into one unless the owner intends to keep them separate. Even though this centuries-old principle developed initially as a title simplification device, it took root in the law of mortgages as well. As applied in the mortgage setting, the theory holds that when a mortgagee's interest and a fee title become owned by the same person, the lesser estate, the mortgage, merges into the greater, the fee, and is extinguished unless the holder intends a contrary result. This extension of the merger principle has created one of the most complex, confusing, and frequently litigated areas of mortgage law. Not only is merger often invoked for the proposition that the mortgage no longer exists, but it is also asserted as a defense to the mortgage obligation itself. This situation is especially unfortunate because the doctrine is simply unnecessary in the modern mortgage law context. In every mortgage context a court will be able to reach a just and equitable result without resort to the vagaries of the merger doctrine. Moreover, ending reliance on merger makes mortgage law more predictable and efficient. Consequently, this section seeks to end mortgage law's misplaced reliance on merger by making it clear that the doctrine is inapplicable both to mortgages and the obligations they secure.

The doctrine of merger has existed since the feudal era in England and was well established by the time of the earliest English law reports. As applied by the courts of law at that time, the doctrine automatically applied whenever a person held two consecutive interests in land. The most commonly stated reason for the doctrine was *Nemo potest esse dominus et tenens* (No man can be both tenant and lord). This maxim stated an accurate legal conclusion for the feudal system of land tenure in which it originated. Rather than receive an outright transfer of ownership of land, a grantee (the "tenant in fee") would receive only the right to possess the land for so long as he performed certain services for the grantor. The tenant in fee could transfer the right to possess to another in exchange for a promise to perform services. This process, called subinfeudation, could continue through several transfers.

In this context, *Nemo potest esse dominus et tenens* provided an accurate rationale for merger. If a person acquired two consecutive links in the chain of subinfeudations, it would be nonsensical to say that he held the more junior interest only for so long as he provided services to himself as the holder of the more senior interest. Merger was the legal doctrine for explaining the process by which two formerly separate interests coalesced into one. Merger was intended to serve solely as a title simplification device in an era when writings were not used to release property interests.

Over the succeeding centuries, however, the courts of law vigorously applied the doctrine of merger whenever a person owned two consecutive interests in property, even if valuable rights were destroyed as a result. For example, merger was one of the mechanisms by which the doctrine of destructibility of contingent remainders operated. When one person acquired both the possessory estate preceding a contingent remainder and the reversion following it, the contingent remainder was destroyed. Because the contingent remainder was characterized as being the mere expectancy of a property interest rather than an actual property interest, it did not constitute an intervening estate that would prevent the possessory estate from merging with the reversion. The courts of law also distorted merger by destroying valuable property in mortgages for the stated reason that the same person cannot be debtor and creditor.

In response to the law courts' destructive applications of the doctrine of merger, the courts of equity created an exception to the doctrine: Merger would occur only if the holder of the interests so intended. Chancery generally equated intent with the owner's best interests. Today, the equitable exception has swallowed the legal rule. In fact, if preventing merger is in the owner's best interests, American courts generally will not apply the doctrine even if the owner previously recorded a release or otherwise expressed an apparent intent that merger should occur.

This limitation on merger is clearly appropriate in the mortgage context because a mortgagee that acquires fee title to the encumbered land virtually always has practical reasons for keeping the mortgage lien distinct from the fee title. For example, if the mortgagee acquires the fee title and thereafter discovers junior liens on the title, the mortgage (if it is regarded as continuing to subsist) can be foreclosed to eliminate them.

Merger can be detrimental to mortgagees in other contexts as well. If a mortgagee's acquisition of title to the property is overturned in a subsequent bankruptcy action by the former owner, the mortgagee may be an unsecured creditor if the acquisition is regarded as having merged the mortgage into the fee title. If a court characterizes the deed by which the mortgagee acquired fee title as an equitable mortgage or invalidates the deed based on unconscionability or overreaching, the mortgagee will want to retain the priority and covenants of the original mortgage. See Comment *b.*

Despite the usual judicial solicitude for mortgagee-owners in the merger context, however, the doctrine generates a significant amount of litigation, primarily by junior lienors attempting to establish that the mortgagee-owner's mortgage merged into the fee title, and therefore cannot be foreclosed to eliminate the junior lien. The resulting case law is a morass. Courts have developed a bewildering and unnecessary variety of factors to be considered in merger cases.

Merger has caused more harm, however, than simply creating an unnecessarily complex body of case law. Some courts have applied merger to eliminate a mortgage though the mortgagee had a valid need for it, or have refused to apply merger though a property purchaser relied on government property records that showed the fee title and mortgage to be owned by the same person at the same time. Other courts have incorrectly permitted a property owner who paid off a senior mortgage debt to foreclose the senior mortgage, thereby eliminating the junior liens, on the theory that the owner purchased the mortgage and did not intend for it to merge into the fee. Most surprisingly, some courts have used merger to determine the enforceability of a debt, which is properly a matter of contract law. Merger was not designed to have such substantive effects; it was created solely to serve the nonsubstantive function of simplifying property titles. Because mortgagee-owners virtually always have practical reasons for keeping the mortgage distinct from the fee title, merger's value as a title simplification device with respect to mortgages has been largely negated.

Merger's limited utility with respect to mortgages, coupled with the quantity of litigation it generates and the untoward results it can cause, present substantial reasons for eliminating the doctrine as applied to mortgages. Modern recording acts and practices render that conclusion ineluctable. Before the existence of written title documents and recording acts, merger was a convenient and necessary tool. Today, however, a mortgagee-owner can publicly and unambiguously express an intent that the mortgage lien be eliminated by recording a written release. Indeed, the mortgagee-owner must do so to prevent the lien from rendering title unmarketable.

Moreover, the central role of intent in the application of merger is incompatible with the recording acts. Courts normally will not apply merger to eliminate a recorded mortgage lien because intent cannot be determined from the property records. The value of the recording acts is undermined if titles can be affected by a doctrine that requires judicial fact-finding. Discarding the doctrine of merger with respect to mortgages will strengthen the public property records by increasing the incentive to record mortgage assignments and releases, thereby creating greater certainty of title.

b. The deed in lieu of foreclosure. It is common for a mortgagee to take a conveyance from the mortgagor in full or partial satisfaction of the mortgage obligation and as a substitute for foreclosure. This practice occurs frequently in both the commercial "workout" context and in residential mortgage default settings. This device is attractive to the parties for several reasons. The mortgagee may seek to avoid the delay and expense associated with foreclosure. This consideration may be especially compelling in a jurisdiction where a judicial proceeding is the only foreclosure remedy, and the delay and expense may well be exacerbated if the mortgagor files a bankruptcy petition prior to the completion of the foreclosure. In addition, the mortgagor is frequently of dubious solvency and the mortgagee may be perfectly willing to forego seeking a deficiency judgment. In some jurisdictions legislation may, in any event, prohibit or significantly limit the availability of deficiency judgments. Further, the mortgagee may find the deed-in-lieu transaction advantageous as a means of avoiding long post-foreclosure redemption periods in those states that have statutory redemption. Finally, a mortgagee may be motivated either by a genuine desire to aid the mortgagor or by an aversion to the publicity associated with a court action.

The mortgagor in default, on the other hand, is frequently willing to give the deed to avoid a possible personal judgment, which, even if it is currently uncollectible, can create future problems in the event the mortgagor's financial fortunes ultimately improve. The mortgagor may also be able to use the deed in lieu to persuade the mortgagee to avoid taking action that might jeopardize the mortgagor's credit rating.

This commonly used and socially desirable foreclosure substitute normally does not run afoul of the prohibition against clogging the equity of redemption. This is because the latter doctrine is inapplicable to executed transactions *subsequent* to the creation of the original mortgage. See § 3.1, Comment *f*.

The mortgagee, however, must be especially concerned about the presence of junior liens on the mortgaged real estate. The deed in lieu of foreclosure is not, after all, a foreclosure, and it will not operate to terminate such liens. A prudent mortgagee will seek to avoid this problem by conducting a thorough title search prior to taking the deed in lieu. If junior interests are found and their holders will not relinquish them voluntarily, the deed-in-lieu transaction will be abandoned and a foreclosure proceeding will be conducted. However, sometimes an incautious mortgagee may fail to ascertain the state of the title before accepting the deed in lieu. Further, a careful title examination will not always disclose the existence of junior liens. For example, a mechanic's lien may exist prior to the delivery of the deed in lieu but may not be recorded until after its acceptance. Because of the nature of mechanics' lien legislation, the lien may relate back to a date that antedates the delivery of the deed in lieu.

Where a junior lien is discovered after the deed in lieu is delivered, it is crucial for the mortgagee to be able to foreclose its mortgage to eliminate that lien. Otherwise, instead of being destroyed by foreclosure, the latter lienor will be the beneficiary of a windfall promotion in priority. Such an advance in priority is a windfall because the junior lienor never advanced credit with the expectation of senior lien status. In this setting, however, the junior lienor may attempt to use the merger doctrine to assert that since, as a result of the deed in lieu, the mortgage and fee interest are now held by the senior mortgagee, the senior mortgage has been merged into the fee estate and has thus been destroyed. Junior lienors usually fail in this attempt to gain priority, since under the usual view, whether merger applies depends on the intent of the party in whom the interests unite and, if merger is against that person's interest, an intent to merge will not be found. Nevertheless, courts apply merger in the deed in lieu setting just frequently enough to encourage a persistent stream of litigation over the issue.

Another potential problem for the mortgagee is that, based on the mortgagor's allegations, a court might determine that the deed in lieu conveyance is simply another mortgage transaction. See § 3.2. The grantor-mortgagor may be able to establish that the deed in lieu was intended as additional security for the mortgage obligation. If the grantor-mortgagor is successful, the court will conceptualize the deed in lieu as an equitable mortgage rather than a title conveyance. More important, if the court finds that merger has occurred with respect to the original mortgage, the mortgagee's position will be seriously impaired. The deed in lieu will not contain the normal covenants protecting the mortgagee that were provided for in the original mortgage. Perhaps most important, because the deed in lieu contains deed, rather than mortgage, language, the mortgagee will typically be unable to utilize power of sale foreclosure even where it is otherwise permitted by local law. This is the case because in most jurisdictions the power of sale must be specifically conferred in the mortgage document. Consequently, it is clearly in mortgagee's interest to prevent merger in such a setting.

Merger poses further problems for the mortgagee where the mortgagor files a bankruptcy petition after delivering the deed in lieu. If the bankruptcy trustee is able to set aside the deed-in-lieu transaction as a fraudulent transfer or preference, or by utilizing other avoidance powers, and the bankruptcy court finds that the original mortgage lien has merged into the fee, the mortgagee may under some circumstances be treated as an unsecured creditor. Here again, merger represents a significant threat to the mortgagee.

Because this section rejects the application of the merger doctrine to mortgage law, the foregoing problems are obviated. Thus, a conveyance of the equity of redemption by a mortgagor or subsequent grantee to a mortgagee will not, except in extremely rare circumstances, terminate the latter's mortgage as against liens or other interests that prior to the conveyance were junior to it. This will be the case even where, as part of the deed-in-lieu transaction, the obligation is canceled and the mortgage is released of record. Moreover, the fact that the mortgagee is negligent in failing to discover the junior interest does not change this result. See Illustrations 1–4. The junior lienholder suffers no unjustifiable injury in these settings, but is in the same position as if there had been a judicial foreclosure to which the junior lienor was not made a party: The junior lien is not terminated, but neither is it elevated. To reach a contrary result would confer on the junior lienor an unbargained-for windfall. Thus, the approach of this section prevents unjust enrichment of that junior interest.

The mortgagee will be prevented from foreclosing only in certain narrowly defined circumstances. This will be the case, for example, where the mortgagee-grantee assumes an existing junior lien. See Illustration 5. In such a setting, the assumption constitutes part of the consideration for the conveyance. By agreeing to pay the junior lien, mortgagee unmistakably promises not to foreclose it. Moreover, the mortgagee-grantee also becomes primarily liable for the mortgage obligation and the mortgagor becomes simply a surety. See § 5.1, Comment *i*; Restatement Third, Suretyship and Guaranty § 2, Comments *d* & *e*. If a junior lienor recovers the mortgage obligation from the original mortgagor, the mortgagor will be subrogated to the junior lienor's right to foreclose. To the extent that the mortgagee-grantee is permitted to foreclose its mortgage and eliminate the junior lien, the mortgagor will be deprived of its subrogation right to enforce that lien. Consequently, by assuming primary liability for the obligation secured by the junior lien, the mortgagee-grantee waives the right to eliminate the security for that debt.

The mortgagee-grantee will also be deemed to have waived the right to foreclose when it accepts title to the mortgaged real estate with actual knowledge of the junior lien. See Illustration 6. The mortgagee-grantee's decision to take the conveyance in such a setting takes into account the extent to which the lien reduces the value of the grantor's equity in the real estate. Even though the mortgagee-grantee does not assume the junior lien, its acquisition of title subject to it renders the real estate the primary payment source. If the junior lienor thereafter recovers from the mortgagor-grantor, the latter is subrogated to the lien and can foreclose on the land to satisfy the obligation. See § 5.2, Comment *c*. However, if the mortgagee-grantee is permitted to use foreclosure to terminate the junior lien, the mortgagor-grantor will be unable to reach the real estato. In addition, the mortgagee-grantee will be unjustly enriched because it will own the real estate free and clear of liens.

Even though the senior mortgagee waives its right to eliminate junior liens by foreclosure in the above two circumstances, the senior mortgage is not extinguished for all purposes. Thus, if the mortgagor files a bankruptcy petition and the deed in lieu is successfully avoided, the trustee will be unable to use the merger doctrine to extinguish the senior mortgage as well.

Illustrations:

1. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor defaults on the obligation secured by Mortgagee–1's mortgage. As part of an agreement between Mortgagor and Mortgagee–1, Mortgagor agrees to deliver to Mortgagee–1 a deed to Blackacre, in return for which Mortgagee–1 releases Mortgagor from liability for the

balance on the mortgage obligation. Pursuant to the agreement, a deed to Blackacre is delivered to Mortgagee–1. Thereafter Mortgagee–1 discovers the existence of Mortgagee–2's mortgage. Mortgagee–1's mortgage is still effective against Blackacre and Mortgagee–1 will be permitted to foreclose it to eliminate Mortgagee–2's lien.

2. The facts are the same as Illustration 1, except that instead of Mortgagee–2 taking a mortgage on Blackacre, Creditor obtains a judgment against Mortgagor and a judgment lien against Blackacre after Mortgagee–1 has recorded its mortgage. After taking delivery of Mortgagor's deed to Blackacre, Mortgagee–1 discovers the existence of the judgment lien. Mortgagee–1's mortgage is still effective against Blackacre, and Mortgagee–1 will be permitted to foreclose it to eliminate the judgment lien.

3. The facts are the same as Illustration 1, except that after giving a mortgage to Mortgagee–2, Mortgagor conveys Blackacre to Grantee, who either assumes or takes subject to the two existing mortgages. Grantee then defaults on the obligation secured by Mortgagee–1's mortgage and carries out the deed-in-lieu transaction described in Illustration 1. Mortgagee–1's mortgage is still effective against Blackacre, and Mortgagee–1 will be permitted to foreclose it to eliminate Mortgagee–2's lien.

4. The facts are the same as Illustration 1, except that Mortgagee–1 releases Mortgagor completely from liability on the mortgage obligation, the promissory note is canceled, and the mortgage is released of record. Mortgagee–1's mortgage is still effective against Blackacre, and Mortgagee–1 will be permitted to foreclose it to eliminate Mortgagee–2's lien.

5. The facts are the same as Illustration 1, except that as part of the transaction Mortgagee–1 specifically assumes Mortgagee–2's mortgage. Mortgagee–1's mortgage is ineffective against Mortgagee–2, and Mortgagee–1 will not be permitted to foreclose it to eliminate Mortgagee–2's lien.

6. The facts are the same as Illustration 1, except that prior to Mortgagor's conveyance to Mortgagee–1, the latter has actual knowledge of the existence of Mortgagee–2's mortgage. Mortgagee–1's mortgage is ineffective against Mortgagee–2, and Mortgagee–1 will not be permitted to foreclose it to eliminate Mortgagee–2's lien.

c. Enforceability of secured debt. When a lender makes a loan secured by a mortgage, it acquires two separate sets of rights for recovering the obligation if a default occurs. The lender can sue the original borrower and anyone else who is personally liable for the obligation, and the lender can foreclose on the land pursuant to the mortgage. See § 8.2. Enforceability of the obligation and of the mortgage are governed by different bodies of law; the obligation's enforcement is governed by the Uniform Commercial Code and by contract law, while mortgage enforcement is governed by a specialized body of property law.

Merger should be inapplicable to issues of personal liability for an obligation because merger is designed solely to serve the nonsubstantive purpose of simplifying property titles. As self-evident as this proposition seems, some courts have applied merger to determine the enforceability of an obligation. For example, courts have held that an obligation is unenforceable if the mortgage securing it has merged into the fee. The continued existence of the mortgage lien, however, is irrelevant to the issue of personal liability on the obligation, as demonstrated by the availability of a deficiency judgment after a mortgage has been foreclosed and thereby extinguished. See § 8.4.

Courts' misapplications of merger to determine enforceability of the obligation occur when one person owns both fee title to the encumbered land and the mortgage. This situation can arise in three analytically distinct fact patterns: (1) the mortgagee acquires fee title to the encumbered land by a voluntary conveyance, such as a deed in lieu of foreclosure; (2) the mortgagee acquires fee title to the encumbered land by an involuntary conveyance; and (3) the property owner "acquires" the note and mortgage. Each situation is governed by well-established contract principles that are unaffected by the merger doctrine.

(1) The mortgagee acquires fee title to the encumbered land by a voluntary conveyance. When a mortgagee acquires title to the encumbered land by a voluntary conveyance, the mortgagee's continued right to enforce the obligation is determined by the mutual intent of the mortgagee-grantee and the mortgagor-grantor. If the parties agreed that the conveyance constituted full or partial payment of the obligation, it is deemed to have been paid to that extent. If the conveyance was made before the due date contained in the note, the conveyance constitutes substituted performance. See Restatement, Second, Contracts § 278. If the conveyance was made after the due date, the conveyance constitutes an accord and satisfaction. See Illustration 7. See id. at § 281. The mortgagee-grantee's unilateral intent concerning merger *vel non* of the mortgage into the fee is irrelevant in determining the parties' mutual intent concerning the obligation.

The clearest expression of the parties' mutual intent with respect to the obligation is a written release or other document. See Illustrations 8–9. Other circumstances may also demonstrate the parties' intent. For example, if the mortgagee-grantee expressly assumes the obligation in connection with the conveyance, the mortgagee-grantee becomes primarily liable for the obligation and, therefore, cannot enforce it against anyone who was personally liable for it before the conveyance. See Illustration 10. Similarly, if the deed by which the mortgagee-grantee acquires title provides that the transfer is subject to the mortgage, the land becomes the primary source of payment for the debt. As a result, the debt is discharged to the extent of the land's value. See Illustration 11.

Illustrations:

7. Mortgagee agrees in writing to accept a deed in lieu of foreclosure in complete satisfaction of the secured debt. Mortgagee takes delivery of the deed. Mortgagee cannot enforce the obligation because the conveyance constitutes substituted performance if it is delivered before the due date specified in the note, or an accord and satisfaction if it is delivered after the due date.

8. Mortgagor is liable to Mortgagee for an obligation with a current balance of $50,000. The obligation is secured by a mortgage on Blackacre, which currently has a fair market value of $45,000. Mortgagee agrees in writing to accept a deed in lieu of foreclosure, and Mortgagor and Mortgagee agree that the amount of the obligation will be reduced by $45,000. Mortgagee takes delivery of the deed. Mortgagor remains personally liable to Mortgagee for $5,000.

9. Mortgagor is liable to Mortgagee on two obligations. Obligation–1 is secured by a mortgage on Blackacre. Mortgagee agrees in writing to accept title to Blackacre in complete satisfaction of Obligation–2. Mortgagee takes delivery of a deed to Blackacre. Obligation–1 is still fully enforceable by Mortgagee regardless of whether it releases or otherwise extinguishes the mortgage.

10. Mortgagor is liable to Mortgagee for an obligation with a current balance of $50,000. This obligation is secured by a mortgage on Blackacre. Mortgagee takes delivery of a deed to Blackacre, in which Mortgagee assumes the mortgage obligation. There is no other express agreement concerning whether Mortgagor continues to be liable on the obligation. At the time Mortgagee takes delivery of the deed, Blackacre has a fair market value of $40,000. Mortgagor is completely released of personal liability on the obligation.

11. The facts are the same as Illustration 10, except that in the deed Mortgagee takes subject to, but does not assume, the mortgage obligation. Mortgagor remains personally liable to Mortgagee for $10,000.

(2) The mortgagee acquires fee title to the encumbered land by an involuntary conveyance. When a mortgagee acquires title to the encumbered land by an involuntary conveyance, such as at a foreclosure sale, the continued enforceability of the obligation does not depend on the doctrine of merger, but rather on whether the mortgagee acquired title subject to the mortgage that secures it. If the mortgagee acquired title unencumbered by its mortgage, the obligation is enforceable. On the other hand, if the mortgagee acquired title subject to its mortgage, the obligation is usually unenforceable. The reason for the result in both situations is to prevent unjust enrichment.

If the mortgagee forecloses its mortgage and buys at the sale, it acquires title to the property free of the foreclosed mortgage. A primary function of a foreclosure sale is to extinguish the lien being foreclosed and any junior liens. See § 7.1. If the bid at the foreclosure sale is insufficient to pay the mortgage obligation in full, the foreclosing mortgagee can recover a deficiency judgment based on the note. See Illustration 12 and § 8.4. Because the foreclosure extinguishes the mortgage, suit on the note is the mortgagee's only recourse for recovering the remaining portion of the obligation. Preventing the mortgagee from recovering the remaining portion of the obligation would result in unjust enrichment of those who are personally liable.

If the foreclosing mortgagee holds more than one lien on the property being foreclosed, the continued enforceability of the obligation again turns on whether the mortgagee acquired title subject to its lien. For example, if the mortgagee holds two mortgages on the land and forecloses the senior mortgage, the foreclosure sale will extinguish both mortgage liens. Therefore, to the extent that the obligations secured by these mortgages remain unpaid after the sale, the mortgagee can enforce the underlying obligations. See Illustration 13. Because the mortgages have been extinguished, suit on the underlying notes is the mortgagee's only recourse for recovering the obligations. Eliminating the mortgagee's right to enforce those obligations would unjustly enrich those who are personally liable. Of course, if the fair market value limitation of § 8.4 is asserted, mortgagee's total recovery on those obligations is limited to the amount by which their sum exceeds the fair market value of the land.

On the other hand, if the mortgagee forecloses the junior mortgage and buys at the sale, it will acquire title to the land subject to its senior mortgage. In this case, the mortgagee usually cannot sue to recover the senior mortgage debt because, when land is purchased subject to a mortgage, the land becomes the primary fund for payment of the secured obligation. See Illustration 14. Those who are personally liable for the debt become sureties to the extent of the land's value. Both logic and fairness support this result. When the mortgagee purchased at the foreclosure sale of the junior mortgage, it presumably should have bid the fair market value of the land less the amount of the senior lien. Thus, the mortgagee should not be able to collect on the first mortgage obligation because it has already subtracted the amount of that obligation in arriving at its bid at the foreclosure sale of the junior lien. A contrary result would unjustly enrich the mortgagee. The foregoing reasoning also applies where senior and junior mortgages are held by different persons and the senior mortgagee purchases the land at the foreclosure sale of the junior mortgage. See Illustration 15.

However, the foregoing principle should not be applied where the fair market value of the land is less than the sum of the two obligations. In such a situation the mortgagor would be unjustly enriched if the mortgagee is prevented from recovering on the senior obligation. Consequently, the rule preventing the mortgagee-owner from enforcing the senior obligation is inapplicable in this situation. However, § 8.4's fair market value limitation is applicable to the mortgagee's suit on the senior obligation, and to the extent that it is asserted, the mortgagee may recover on the senior obligation only the amount by which the sum of the junior and senior obligations exceed the fair market value of the land. See Illustration 16.

Illustrations:

12. Mortgagor borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. Mortgagor is personally liable on the mortgage obligation. Mortgagor subsequently defaults in payment on the note and Mortgagee validly accelerates the mortgage obligation. Mortgagee forecloses the mortgage and purchases Blackacre at the sale. Mortgagee's successful bid at the sale is for less than the outstanding debt amount. Mortgagee is entitled to a deficiency judgment against Mortgagor in accordance with § 8.4.

13. Mortgagor borrows money from Mortgagee and gives Mortgagee Promissory Note–1, secured by Mortgage–1 on Blackacre. Mortgagee immediately records Mortgage–1. Mortgagor subsequently borrows more money from Mortgagee and gives

Mortgagee Promissory Note–2, secured by Mortgage–2 on Blackacre. Mortgagee immediately records Mortgage–2. Mortgagor is personally liable on both promissory notes. Mortgagor defaults on the obligation secured by Mortgage–1 and that obligation is validly accelerated. Mortgagee forecloses Mortgage–1. Mortgagee purchases Blackacre at the sale for less than the outstanding debt secured by Mortgage–1. Mortgagee is entitled to a deficiency judgment with respect to Promissory Note–1 in accordance with § 8.4. Mortgagee also is entitled to recover the outstanding obligation secured by Mortgage–2 in accordance with § 8.4 if that obligation is in default.

14. The facts are the same as Illustration 13, except that Mortgagor defaults on the obligation secured by Mortgage–2, and Mortgagee forecloses Mortgage–2. Mortgagee purchases Blackacre at the sale for less than the outstanding debt secured by Mortgage–2. Blackacre has a fair market value that exceeds the sum of the balances on the two notes. Mortgagee may seek a deficiency judgment with respect to Promissory Note–2 in accordance with § 8.4, but if Mortgagor requests a fair market value determination under that section, Mortgagee will not be entitled to such a judgment. Mortgagee is not entitled to recover the obligation secured by Mortgage–1.

15. Mortgagor borrows money from Mortgagee–1 and gives Mortgagee–1 a promissory note secured by a mortgage on Blackacre. Mortgagee–1 immediately records the mortgage. Mortgagor then borrows money from Mortgagee–2 and gives Mortgagee–2 a promissory note secured by a mortgage on Blackacre. Mortgagee–2 immediately records the mortgage. Mortgagor is personally liable on both promissory notes. Mortgagor defaults on the obligation to Mortgagee–2 and the latter validly accelerates the obligation. Mortgagee–2 then forecloses its mortgage. Mortgagee–1 is the successful bidder at the sale. Blackacre has a fair market value that exceeds the sum of the balances on the two notes. Mortgagee–1 is not entitled to recover the obligation secured by its mortgage.

16. Mortgagor borrows money from Mortgagee and gives Mortgagee Promissory Note–1, secured by Mortgage–1 on Blackacre. Mortgagee immediately records Mortgage–1. Mortgagor subsequently borrows more money from Mortgagee and gives Mortgagee Promissory Note–2, secured by Mortgage–2 on Blackacre. Mortgagee immediately records Mortgage–2. Mortgagor is personally liable on both promissory notes. Mortgagor defaults on the obligation secured by Mortgage–2 and Mortgagee validly accelerates the obligation. Mortgagee then forecloses Mortgage–2.

At the time of the foreclosure sale, the balance due on Note-1 is $40,000 and balance due on Note-2 is $20,000. The fair market value of Blackacre at that time is $35,000. Mortgagee purchases the property at the foreclosure sale for the amount of the balance on Note-2. Mortgagee may recover $25,000 on Note-1.

(3) The property owner "acquires" the note and mortgage. In some cases, a property owner who has paid an obligation secured by the owner's land then brings suit to recover the obligation from another person. In some of these cases, the owner characterizes the payment as a "purchase" of the note and mortgage. Some courts have been misled by this characterization and have held that the obligation is enforceable if the mortgage has not merged into the fee. Because the owner intended to keep the interests distinct, these courts have held that the obligation is enforceable. As with the other situations described in this Comment *c*, however, the doctrine of merger is irrelevant to the issue of enforceability of the obligation.

When a property owner pays a mortgage debt, the owner's ability to enforce the debt against another is determined by the doctrine of subrogation. (1) An owner who is primarily liable for an obligation cannot recover from anyone: The owner's payment extinguishes the obligation. Primary liability will exist either because the owner is the original mortgagor or is a grantee who assumes the mortgage obligation. See Illustrations 17 and 18 and § 5.1. (2) An owner who is not primarily liable for the obligation, because that owner acquired title to the encumbered land subject to the mortgage but did not assume liability for the obligation, cannot recover the obligation if the purchase price for the property was reduced by the debt amount. In this situation, the land is the primary fund for payment of the obligation, and the purchase price reduction creates a quasi-contractual obligation to make payments on the mortgage obligation while the purchaser owns the property. The purchaser, while not primarily liable, is primarily responsible. See § 6.4, Comment *a*; § 5.2, Comment *c*. By paying the obligation, the owner is fulfilling this responsibility, and hence does not have recourse against anyone. See Illustration 19 and § 5.2. (3) The one situation in which an owner can sue another to recover a payment of the obligation is where the owner acquires title subject to the mortgage but pays the full purchase price for the property. In this case, the seller remains primarily liable for paying the debt. If the owner pays the debt, subrogation rights exist against the seller. See Illustration 20. See also § 7.6, Comment *c*.

Illustrations:

17. Borrower borrows money from Mortgagee and gives Mortgagee a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Borrower then sells Blackacre to Buyer, and Buyer assumes personal liability for the debt. Buyer pays the obligation. Buyer cannot enforce the obligation against Borrower because Buyer is primarily liable.

18. The facts are the same as Illustration 17, except that when Buyer pays the obligation, Buyer purports to purchase the debt and mortgage and receives an assignment of the note and mortgage. Buyer cannot enforce the obligation against Borrower because Buyer is primarily liable.

19. The facts are the same as Illustration 17, except that Buyer does not assume personal liability for the obligation. Buyer acquires title to Blackacre subject to the mortgage, and the purchase price is reduced by the amount of the outstanding mortgage obligation. Buyer pays the obligation. Buyer cannot enforce the debt against Borrower.

20. The facts are the same as Illustration 17, except that Buyer does not assume personal liability for the obligation. Buyer acquires title to Blackacre subject to the mortgage, but the purchase price is not reduced by the amount of the outstanding mortgage debt. Buyer pays the debt. Buyer can enforce the debt against Borrower.

d. Enforceability of mortgage when "acquired" by owner. There are several reported cases in which a property owner who has paid an obligation secured by a mortgage on the property has characterized the payment as a "purchase" of the note and mortgage. The owner then brings a foreclosure action on the mortgage to eliminate the junior liens. Surprisingly, some courts have accepted the owner's characterization and have permitted the foreclosure on the theory that the owner did not intend the mortgage to merge into the fee title. As it does in other contexts, this section rejects the application of a merger analysis in this situation. Rather, subrogation principles are applicable.

When a property owner who is either primarily liable or primarily responsible pays an obligation in full, that obligation is extinguished. Because the obligation is extinguished, the mortgage necessarily also is extinguished. See § 6.4. Thus, where payment of the obligation is made by the original mortgagor (Illustration 21), or an assuming grantee (Illustration 22), there are no subrogation rights in the mortgage. The same result applies to a payment by a grantee who takes subject to the mortgage because such a grantee is primarily responsible on the obligation. See Illustration 23. Moreover, subrogation will be denied even where payment is accompanied by the receipt of a formal assignment of the note and mortgage. This approach is also consistent with § 4.9, which mandates that an owner who purchases at the foreclosure sale of any lien on owner's real estate acquires title subject to any lien or other interest that was junior to the foreclosed lien.

A different result is justified in the unusual situation in which the owner acquires title subject to the mortgage but pays the full purchase price for the property. Here the owner is entitled to subrogation and will be able to enforce the obligation. Note that the roles of grantor-seller and grantee are reversed. The grantor-seller is primarily liable for payment and the grantee is, to the extent of the value of the land, a surety. If the grantor-seller fails to pay the mortgage obligation when due, the grantee may pay the obligation and be subrogated to it. See Illustration 24. See also § 7.6, Comment *c*.

A variation on the foregoing problem arises when a grantee takes subject to or assumes a senior mortgage, but has no actual knowledge of an existing junior mortgage on the real estate. In this setting, the cash price paid for the land will be reduced by the balance on the senior mortgage obligation, but not by the junior mortgage balance. Later, when the grantee discovers the junior mortgage, the grantee may pay the full balance of the senior mortgage obligation and, by subrogation, foreclose the senior mortgage to destroy the junior lien. This result may seem to violate the principle that subrogation is unavailable with respect to a mortgage obligation for which one is primarily responsible. However, the latter principle is aimed at preventing unjust enrichment. No unjust enrichment will occur here because the grantee has already paid the junior mortgage debt once as part of the original cash purchase price. See § 6.4, Illustration 1 and Comment *a*.

Illustrations:

21. Mortgagor borrows money from Mortgagee–1 and delivers to Mortgagee–1 a promissory note secured by a mortgage on Blackacre. The mortgage is immediately recorded. Mortgagor then borrows money from Mortgagee–2 and delivers to Mortgagee–2 a promissory note secured by a mortgage on Blackacre. The latter mortgage is immediately recorded. Mortgagor then tenders the full amount due on Mortgagee–1's note and requests an assignment of the mortgage. Mortgagee–1 delivers the assignment to Mortgagor and the latter records it. Mortgagor may not foreclose the E–1 mortgage against Mortgagee–2.

22. The facts are the same as Illustration 21, except that after delivering the note and mortgage to Mortgagee-2, Mortgagor sells and conveys Blackacre to Grantee, who assumes the debts secured by the two mortgages. Grantee then tenders the full amount due on Mortgagee-1's note and requests an assignment of the mortgage. Mortgagee-1 delivers the assignment to Grantee and the latter records it. Grantee may not foreclose the E-1 mortgage against Mortgagee-2.

23. The facts are the same as Illustration 21, except that after delivering the note and mortgage to Mortgagee-2, Mortgagor sells and conveys Blackacre to Grantee, who takes subject to the two mortgages. The purchase price is reduced by the amount of the outstanding mortgage obligation. Grantee then tenders the full amount due on Mortgagee-1's note and requests an assignment of the mortgage. Mortgagee-1 delivers the assignment to Grantee and the latter records it. Grantee may not foreclose the E-1 mortgage against Mortgagee-2.

24. The facts are the same as Illustration 21, except that after delivering the note and mortgage to Mortgagee-2, Mortgagor sells and conveys Blackacre to Grantee, who takes subject to the two mortgages, but pays the full purchase price in cash with the understanding that Mortgagor will pay the mortgage debts. Mortgagor defaults in payment to Mortgagee-1, and Grantee pays that mortgage debt in full. Grantee is subrogated to the E-1 mortgage and may foreclose it against Mortgagee-2.

REPORTERS' NOTE

Introduction and historical perspective, Comment a. The leading and most comprehensive analysis of the merger doctrine is Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283 (1987). See also 1 G. Nelson & D. Whitman, Real Estate Finance Law §§ 6.15–6.19 (3d ed. 1993); 1 G. Glenn, Mortgages §§ 45.1, 45.2 (1943); Note, The Effect of Merger Upon Mortgage Debts, 15 Harv. L. Rev. 740 (1902).

Professor Burkhart makes a compelling case for the elimination of the merger doctrine from mortgage law:

> Modern courts' application of the merger doctrine to mortgages primarily results from the fact that at certain points in the early common law the paths of their legal development crossed. Because some early mortgage counterparts legitimately were subject to the operation of merger, it has clung tenaciously to mortgages ever since, although mortgages have evolved beyond the form to which merger applied. The law has grown up around merger, developing systems, such as title records, that reflect modern practices and obviate the need for merger. Elimination of merger will strengthen this infrastructure.

Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 386–87 (1987).

The deed in lieu of foreclosure, Comment b. Courts are generally hostile to the assertion by junior lienors that merger destroys the lien of the senior mortgagee who takes a deed in lieu of foreclosure. The underlying policy justification for this hostility is best expressed by the Texas Supreme Court as follows:

> It is often true ... that it is decidedly to the advantage of the mortgagor and mortgagee to avoid the necessity of a foreclosure suit by a conveyance of the premises to the mortgagee. A rule penalizing them for so doing would be contrary to our policy that litigation is not to be encouraged. The junior lienholder suffers no injury thereby, but is in the same position as if there had been a foreclosure without his having been made a party. His equity of redemption is not affected, neither is his lien thereby elevated to a first lien.... It is immaterial, as between the senior and junior lienholders, whether the mortgagee retains the note and mortgage in his possession or surrenders them to the mortgagor. It is likewise immaterial whether or not the deed of conveyance from the mortgagor to the mortgagee recites ... that the cancellation of the note and mortgage was a part of the consideration for the conveyance.

North Texas Bldg. & Loan Ass'n v. Overton, 86 S.W.2d 738, 741 (Tex. 1935). Professor Durfee aptly described the technical analysis typically employed by courts to avoid the application of merger in the deed in lieu setting:

> [T]he classical approach to a [deed in lieu] case takes several steps. (1) At common law there is a merger of the mortgage in the equity of redemption. (2) Equity will prevent merger if the party in whom the interests unite is found to have intended to keep both interests on foot. (3) In the absence of evidence of a contrary intent, equity will presume the existence of that intent that is most beneficial to the party holding the two interests.

E. Durfee, Cases on Security, 396 (1951). There are numerous cases employing such an analysis to prevent the application of merger to preserve the mortgagee's foreclosure rights against junior interests. See, e.g., Bay Minette Production Credit Association v. Federal Land Bank, 442 So.2d 47 (Ala.1983); Federal Land Bank v. Colorado National Bank, 786 P.2d 514 (Colo.Ct.App.1989); Ennis v. Finanz Und Kommerz–Union Etabl., 565 So.2d 374 (Fla.Dist.Ct.App.1990); Gourley v. Wollam, 348 So.2d 1218 (Fla.Dist.Ct.App.1977); Tom Riley Law Firm v. Padzensky, 430 N.W.2d 416 (Iowa 1988); Fidelity Savings Association of Kansas v. Witt, 665 P.2d 1108 (Kan. Ct. App. 1983); London Bank & Trust Co. v. American Fidelity Bank & Trust Co., 697 S.W.2d 956 (Ky.Ct.App.1985); Lampert Yards, Inc. v. Thompson–Wetterling Construction & Realty Inc., 223 N.W.2d 418 (Minn.1974); GBJ, Inc., II v. First Avenue Investment Corporation, 520 N.W.2d 508 (Minn.Ct.App.1994); Riggs v. Kellner, 716 S.W.2d 3 (Mo. Ct.App.1986); Aladdin Heating Corp. v. Trustees of Central States, 563 P.2d 82 (Nev.1977); Eldridge v. Salazar, 464 P.2d 547 (N.M.1970); Branch Banking & Trust Company v. Home Federal Savings & Loan Association of Eastern North Carolina, 354

S.E.2d 541 (N.C.Ct.App.1987); Small v. Cunningham, 120 N.W.2d 13 (N.D. 1963); Citizens Security Bank of Bixby v. Courtney, 572 P.2d 1302 (Okla. Ct.App.1977); Altabet v. Monroe Methodist Church, 777 P.2d 544 (Wash.Ct.App.1989). Contra: Construction Machinery of Arkansas v. Roberts, 819 S.W.2d 268 (Ark.1991) (where mortgagees, after taking a deed in lieu, conveyed part of the real estate to third parties who were strangers to the title, this constituted convincing evidence that a merger was intended); Fort Dodge Building & Loan Association v. Scott, 53 N.W. 283 (Iowa 1892) (negligence in not discovering junior lien prevents senior mortgagee from foreclosing its lien); Rice v. Winters, 63 N.W. 830 (Neb. 1895).

Traditionally, where a mortgagee takes a deed in lieu but assumes an existing junior lien, courts apply merger and prohibit the mortgagee from foreclosing against the junior lienor. See Kneeland v. Moore, 138 Mass. 198 (1884); Drew v. Anderson, Clayton & Co., 252 P. 64 (Okla.1926); Bolln v. La Prele Live Stock Co., 196 P. 748 (Wyo.1921); Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 346–47 (1987). Courts reach the same result where the mortgagee who acquires title by a deed in lieu does not assume a junior lien but takes with actual, as opposed to constructive, knowledge of the junior lien and expresses an intent that its mortgage interest merge. See Janus Properties, Inc. v. First Florida Bank, N.A., 546 So.2d 785 (Fla.Dist.Ct.App. 1989) (court finds merger and elevates junior mortgage to senior status where senior mortgagee had actual knowledge of junior lien, relying to some extent on that fact that the senior mortgagee, upon accepting a deed in lieu, "solemnized its intent by executing and recording a satisfaction of mortgage"); Beacham v. Gurney, 60 N.W. 187 (Iowa 1894); Errett v. Wheeler, 123 N.W. 414 (Minn.1909); Talbott v. Garretson, 49 P. 978 (Or. 1897).

Under this section, however, as in Illustration 6, the mortgagee who takes a deed in lieu with actual knowledge of a junior lien will lose the right to foreclose irrespective of whether there is merger intent. As Professor Burkhart emphasizes:

> By focusing on merger, the courts have defined this second type of case too narrowly. In tune with the usual merger analysis, courts have defined this group of cases to include only mortgagees that express an intent to merge.... [H]owever, the senior mortgagee should be prohibited from exercising its lien in this situation regardless of whether it has manifested any intent concerning merger. Each time a deed in lieu transaction is negotiated with the understanding that the mortgagee will acquire title subject to junior liens, the senior mortgagee has waived its right to eliminate those liens. Courts' focus on merger diverts them from focusing on the substance of the transaction.

Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 348–49 (1987).

Enforceability of secured debt, Comment c. Merger is also inappropriately applied to determine the enforceability of the obligation when one person acquires the real estate and the mortgage. According to Professor Burkhart:

> [M]erger is absolutely inapplicable to the debt aspect of the mortgage

transaction. The debt relationship, if evidenced by a negotiable instrument as defined by the Uniform Commercial Code, is governed by Article 3 of the Code and by supplemental contract principles. If the debt relationship falls outside the ambit of the Uniform Commercial Code, it is governed by contract law.... The question of the continued existence of the debt can arise in several different factual contexts, but its resolution is governed in every case by contract principles.... [M]any courts fail even to consider contract law in their analysis of these cases. The most backward of these approaches focuses exclusively on the issue of merger. As a result, courts using this analysis hold that the debt is enforceable only if the mortgage has not merged in the fee. Other courts, while recognizing that contract principles are at least relevant, either have ignored the real estate context or have treated the debtor's conveyance of the mortgaged property to the lender as irrelevant to the debt though the parties intended otherwise. Each type of error leads to unsupportable results.

Id. at 369.

The mortgagee acquires fee title to the encumbered land by a voluntary conveyance, Comment (c)(1). When the mortgagee acquires fee title from the mortgagor, merger is frequently used to determine whether the obligation remains enforceable. See, e.g., Nash v. Miller, 441 S.E.2d 924 (Ga. Ct.App.1994); PNC Bank, N.A. v. Balsamo, 634 A.2d 645 (Pa. Super. Ct. 1993). This issue is most commonly raised in the context of a deed in lieu of foreclosure. Merger, however, is unnecessary to an appropriate resolution of such cases. "If the conveyance is made and accepted as payment of the mortgage debt no question of merger is possible. The debt is discharged by payment, or perhaps more accurately, by substituted performance or accord and satisfaction, but not by merger. The creditor now has full title to the property with no debt in existence for it to secure." 1 G. Nelson & D. Whitman, Real Estate Finance Law 538 (3d ed. 1993). See Restatement, Second, Contracts §§ 278, 281; Dennis v. McEntyre Mercantile Co., 65 So. 774 (Ala.1914); McCabe v. Farnsworth, 27 Mich. 52 (1873). Some courts conflate merger and payment in resolving this type of case. See, e.g., Nash v. Miller, 441 S.E.2d 924 (Ga.Ct.App.1994). In some jurisdictions, acceptance of a conveyance by the mortgagee creates a presumption that the mortgage obligation is extinguished. See Matter of Fox, 808 F.2d 552 (7th Cir.1986) (applying Wisconsin law). In Illinois, acceptance of a deed in lieu of foreclosure by the mortgagee relieves all persons from personal liability except to the extent a person agrees not to be relieved in an instrument executed contemporaneously. Ill. Rev. Stat. ch. 110, par. 15-1401.

Where the mortgagee not only takes a conveyance but also assumes the mortgage obligation, the mortgagee may not enforce the obligation against mortgagor. "If the mortgagee were permitted to recover from the mortgagor, the latter could turn around and sue to get back the same amount. To prevent this circuity of action a court of equity would give a complete defense to the mortgagor to any action on the debt.... No intent or self-interest on the part of the mortgage creditor could prevent this termination of the claim against the mortgagor." 1 G. Nelson & D. Whitman, Real Estate Finance Law 538 (3d ed. 1993). See § 5.1 (d), (e).

Usually, however, mortgagee will not assume the mortgage obligation, but only take subject to it. If there is an express agreement that it is accepted in satisfaction of the mortgage obligation it will, of course, so operate. Where such an agreement is missing, the obligation will be discharged up to the value of the real estate. This is because "such a conveyance makes the land in the hands of the mortgage creditor the principal and the personal obligation of the mortgagor, up to the value of the land, surety only. Consequently, up to the value of the land, the mortgagor has a defense to any enforcement of the debt against him regardless of whether it is technically alive by agreement." 1 G. Nelson & D. Whitman, Real Estate Finance Law 538–39 (3d ed. 1993). Where the value of the real estate is less than the mortgage obligation, the mortgagee may recover that deficiency from the mortgagor. See, e.g., Ray v. Alabama Central Credit Union, 472 So.2d 1012 (Ala.1985).

The merger doctrine has no relevance in deciding the foregoing cases, and there is a risk that attempting to apply it will confuse the issue. As already discussed, whether a mortgagor remains liable on the obligation after giving a deed in lieu of foreclosure is a matter of the parties' intent. However, a traditional element of the merger doctrine is that merger will occur only if that result is most beneficial to the person in whom the two interests merge. A court might erroneously employ that concept to give a mortgagee who takes a deed in lieu a right of recovery on the debt (on the supposed ground that the mortgagee did not intend a merger), quite contrary to the parties' intent with respect to further liability on the debt. "Obviously, a mortgagee always will enjoy the greatest benefit by holding title and by retaining the right to enforce the secured debt. Analysis of the debt relationship, however, requires that the court focus on the parties' mutual intent concerning the effect of the conveyance rather than on the lender's best interest." Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283 n.376 (1987).

The mortgagee acquires fee title to the encumbered land by involuntary conveyance, Comment (c)(2). A purchaser at a foreclosure sale acquires title to the mortgaged real estate free and clear of the lien being foreclosed and of any junior liens and other subordinate interests. This is equally the case when a mortgagee purchases at the foreclosure sale under its own mortgage. In such a situation, the mortgagee-purchaser retains the right to collect a deficiency judgment from anyone personally liable on the mortgage obligation. Because the foreclosure sale exhausts any security interest in the real estate, enforcing personal liability on the mortgage obligation is mortgagee's only recourse. See Burkhart, supra, at 377.

The same reasoning is applicable where a mortgagee, who owns multiple liens on the real estate, forecloses its senior lien and purchases at the sale. As Professor Burkhart has stressed, "unless the lender is permitted to sue on the debt, the lender will have no means of recovering the debt because the foreclosure sale eliminated its right of recourse against the land.... Because the mortgagee's lien interest is extinguished, its ownership of the land has no impact on liability for the debt." Id. at 378. The cases are consistent as to this approach. See Mid Kansas Federal Sav. & Loan Ass'n v. Dynamic Development Corp., 804 P.2d 1310 (Ariz.1991) (dictum); United Bank of Lakewood, N.A. v. One Center Joint Venture, 773 P.2d 637 (Colo.Ct.App.1989) ("[T]he purchase by the holder of a junior mortgage at a foreclosure sale of the senior mortgage does not extinguish the debt secured by the junior mortgage. This rule applies even though the foreclosed first mortgage also was owned by the purchasing second mortgagee"); Blackwood v. Sakwinski, 191 N.W. 207 (Mich.1922) (merger does not destroy junior debt when junior mortgagee purchases at the foreclosure of a senior mortgage which junior mortgagee owns); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 6.16 (3d ed. 1993). But see Southern Bank of Lauderdale County v. Commissioner, 770 F.2d 1001 (11th Cir.1985).

However, where the holder of both a junior and senior mortgage forecloses the junior and purchases at the sale, courts traditionally apply the merger doctrine to extinguish the first mortgage obligation. See, e.g., Mid Kansas Federal Sav. & Loan Ass'n v. Dynamic Development Corp., 804 P.2d 1310 (Ariz.1991); Belleville Savings Bank v. Reis, 26 N.E. 646 (Ill.1891); Board of Trustees of the Gen. Retirement Sys. v. Ren-Cen Indoor Tennis & Racquet Club, 377 N.W.2d 432 (Mich.Ct.App.1985); First Bank National Association v. Northside Mercury Sales & Service, Inc., 458 N.W.2d 424 (Minn.Ct.App.1990); Tri-County Bank & Trust Co. v. Watts, 449 N.W.2d 537 (Neb.1989); Wright v. Anderson, 253 N.W. 484 (S.D.1934). One court has used a specific element of the merger doctrine to permit suit on the senior obligation. The court reasoned that because a lien will not merge when it is in the holder's best interest to keep it alive, merger does not occur and the obligation, therefore, remains enforceable. See Londoff v. Garfinkel, 467 S.W.2d 298 (Mo.Ct.App.1971).

On the other hand, it is clearly unnecessary to rely on a merger analysis in order to prevent suit on the senior obligation. The language of the Arizona Supreme Court is instructive in this regard:

> Where the same mortgagee holds both a first and second mortgage on the mortgagor's land, and becomes the purchaser at the foreclosure sale of one of the mortgages, the question of merger of rights—often called extinguishment—rises. The merger of rights doctrine addresses the narrow question of whether the mortgagor's personal liability on the senior debt has been discharged.... The primary issue in the doctrine of merger of rights is whether the lender would be unjustly enriched if he were permitted to enforce the debt.
>
> Although the mortgagee's purchase of the property at the foreclosure of the senior mortgage will not extinguish the debt secured by a junior mortgage, the reverse is true where the junior mortgage is foreclosed. If one holding both junior and senior mortgages forecloses the junior and purchases the property at the foreclosure sale, the long-standing rule is that, absent a contrary agreement, the mortgagor's personal liability for the debt secured by the first mortgage is extinguished....
>
> The basis of the merger of rights doctrine is that the purchaser at a foreclosure sale of a junior lien

> takes subject to all senior liens. ... Although the purchaser does not become personally liable on the senior debt ... , the purchaser must pay it to avoid the risk of losing his newly acquired land to foreclosure by the senior lienholder. Therefore, the land becomes the primary fund for the senior debt, and the purchaser is presumed to have deducted the amount of the senior liens from the amount he bids for the land.

Mid Kansas Federal Sav. & Loan Ass'n v. Dynamic Development Corp., 804 P.2d 1310, 1316 (Ariz.1991). Moreover, another recent decision explains:

> The indebtedness will be presumed to have been discharged so soon as the holder of it becomes invested with title to the land upon which it is charged, on the principle that a party may not sue himself at law or in equity. The purchaser is presumed to have bought the land at its value, less the amount of indebtedness secured thereon, and equity will not permit him to hold the land and still collect the debt from the mortgagor.

Board of Trustees of the Gen. Retirement Sys. v. Ren-Cen Indoor Tennis & Racquet Club, 377 N.W.2d 432, 435 (Mich.Ct.App.1985). The primary focus of these decisions is not merger, but the avoidance of unjust enrichment. They emphasize that the mortgagee's purchase subject to its own lien makes the real estate the primary fund for payment and that this fact is reflected in the purchase price. They reason further that to allow the mortgagee also to collect the debt secured by its senior mortgage would result in the unjust enrichment of the mortgagee. Indeed, a decision of the Vermont Supreme Court expressly rejects the application of a merger analysis in this setting and instead adopts an unjust enrichment approach. According to the court, "plaintiff here would be unjustly enriched if she could obtain land worth well in excess of the secured debt and, in addition, obtain a personal judgment for that same debt...." Licursi v. Sweeney, 594 A.2d 396 (Vt. 1991).

Where, however, the mortgagee purchases at a junior sale and the sum of the two debts exceeds the value of the real estate, this section permits mortgagee to recover on the senior obligation to the extent that the value of the real estate is insufficient to fully satisfy those two debts. This approach is consistent with § 8.4 of this Restatement, which authorizes deficiency judgments but limits their amount by requiring that the fair market value of the foreclosed real estate be credited against the mortgage obligation. Reliance on a merger analysis is wholly unnecessary in this context. As one commentary has stressed, barring recovery on the senior obligation is neither fair nor logical unless the real estate is worth at least the amount of the two mortgage obligations:

> But where the land is not worth at least the sum of the two debts, to apply the merger doctrine to destroy completely the senior debt shortchanges the mortgagee. For example, suppose the fair market value of the land free and clear of liens is $20,000 and the [first and second mortgages are $20,000 and $40,000 respectively]. If the mortgagee purchases for $20,000 at the foreclosure of the second mortgage he obtains land that is worth $20,000. To allow him to recover the other $40,000 from the mortga-

gor personally would not result in unjust enrichment....

1 G. Nelson & D. Whitman, Real Estate Finance Law 541 (3d ed. 1993). To do otherwise results in unjust enrichment of the mortgagor. For a recent decision that employs the foregoing approach without mentioning merger, see In re Richardson, 48 B.R. 141 (Bankr.E.D.Tenn.1985) (permitting recovery on senior obligation where the mortgagee's second mortgage bid reflected the value of the real estate and the mortgagee, in addition, had credited the mortgagors with the amount in excess of the bid it received on reselling the property).

The property owner "acquires" the note and mortgage, Comment (c)(3). Sometimes a property owner "purchases" or otherwise acquires an obligation secured by a mortgage on his or her own real estate and seeks to enforce that obligation against another who is personally liable on it. For example, this situation can arise where a grantee who takes title to real estate either by assuming or taking subject to an existing mortgage pays off that mortgage and seeks to enforce the obligation against the original mortgagor. Too frequently, courts will apply a merger analysis because of the owner's purported ownership of the mortgage and the fee. In so doing, they reason that the enforceability of the obligation depends on whether the mortgage merged and what the owner-payor's intent was with respect to merger. See, e.g., Kelly v. Weir, 243 F.Supp. 588 (E.D.Ark.1965); Wilhelmi v. Leonard, 13 Iowa 330 (1862); Flanigan v. Sable, 46 N.W. 854 (Minn. 1890); Stevenson v. Stevenson, 618 S.W.2d 715 (Mo.Ct.App.1981); Citizens' Trust Co. v. Going, 232 S.W. 996 (Mo.1921); Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 383 (1987).

These cases are appropriately decided only under subrogation principles. As this Restatement stresses, "[o]ne cannot claim subrogation upon payment of an obligation on which he or she is primarily liable." Section 7.6, Comment *c*. Thus, a grantee of real estate who assumes a mortgage on it, and subsequently pays the mortgage on it, has no subrogation rights. Id. See Drury v. Holden, 13 N.E. 547 (Ill.1887); Lackawanna Trust & Safe Deposit Co. v. Gomeringer, 84 A. 757 (Pa.1912); Pee Dee State Bank v. Prosser, 367 S.E.2d 708 (S.C.Ct.App. 1988); 2 G. Nelson & D. Whitman, Real Estate Finance Law 5 (3d ed. 1993); Burkhart at 384. Moreover, the fact that the mortgagee assigns the debt and mortgage to the grantee does not change the result. See 1 G. Nelson & D. Whitman, Real Estate Finance Law 542 (3d ed. 1993) ("As the principal debtor in such a case, his acquisition of the claim not only extinguishes it as to him, but also as to the mortgagor who stands in the position of a surety.... [T]he debt may be regarded as extinguished by payment, substituted performance or accord and satisfaction rather than by merger"). Illustrations 17 and 18 reflect these principles.

Where the grantee takes subject to the mortgage without assuming personal liability on the obligation, his or her right to subrogation will depend on the price paid for the real estate. As Professor Burkhart observes:

> [I]f the price reflected the outstanding mortgage debt, she cannot enforce the debt after purporting to purchase it.... [T]he property in this case is the primary fund for payment, and the price reduction represents a quasi-

contractual obligation to pay the debt for as long as she owns the property. Therefore by discharging the debt, the owner, as the primary obligor in fact, simply is fulfilling her obligation and cannot be subrogated to the mortgagee's rights in the note.

Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 384 (1987). See 2 G. Nelson & D. Whitman, Real Estate Finance Law 5 (3d ed. 1993) ("[N]o subrogation against the mortgagor should be recognized. The reason is that the amount of the debt was included in the original purchase price of the land. Even though the agreement imposed no personal duty to pay, nevertheless the payment of the mortgage was a condition to grantee's retention of the land and grantee should not be able, by paying it, to recover any portion of it from the mortgagor, through the help of subrogation or otherwise"); Drury v. Holden, 13 N.E. 547 (Ill.1887); Baxter v. Redevco, Inc., 566 P.2d 501 (Or. 1977) (mixed merger and subrogation reasoning).

A different result is justified only in the rare case where the grantee takes title subject to the mortgage but the purchase price is not reduced to reflect the amount of that mortgage. In other words, the grantee pays in cash the full unencumbered value of the real estate. In this situation, reflected in Illustration 20, a grantee who pays the mortgage obligation is entitled to be subrogated to it. By accepting grantee's payment of the full purchase price and agreeing to pay the mortgage obligation, the mortgagor-seller remains primarily liable on that obligation and the grantee is secondarily liable as a surety. Thus, when the grantee pays the obligation to protect his or her fee interest in the real estate, the grantee is subrogated to mortgagee's rights in the obligation and, thus, can enforce it against the mortgagor-seller. See Burkhart, Freeing Mortgages of Merger, 40 Vand. L. Rev. 283, 386 (1987).

Enforceability of mortgage when "acquired" by owner, Comment d. Although merger principles should be completely inapplicable to a transaction in which an owner "purchases" a mortgage on his or her own real estate, a merger analysis is frequently found in the cases. In some cases, even though merger language is used, the correct result is reached. Thus, when an original mortgagor or an assuming grantee attempts to enforce a mortgage "purchased" from the mortgagee, courts will treat the transaction as a payment of the debt rather than a purchase or assignment. Even though the owner asserts that the intent was to prevent merger of fee and mortgage, courts recognize that this merger exception is being used unfairly. See Theisen v. Dayton, 47 N.W. 891 (Iowa 1891); Androscoggin Savings Bank v. McKenney, 6 A. 877 (Me.1886); Hussey v. Hill, 26 S.E. 919 (N.C.1897); Jeffrey v. Bond, 498 S.W.2d 31 (Tex.Civ.App.1973), reversed on other grounds, 509 S.W.2d 563 (Tex.1974). However, courts are more inclined to permit owners to use the foregoing merger exception to destroy junior interests where the grantee is personally liable on the mortgage obligation. See, e.g., Shaffer v. McCloskey, 36 P. 196 (Cal. 1894); Becker v. Snowden Dev. Corp., 323 N.Y.S.2d 79 (N.Y.Sup.Ct.1971); Kelly v. Weir, 243 F.Supp. 588 (E.D.Ark.1965).

The foregoing cases are more appropriately analyzed under subrogation principles. Thus, just as payment of a mortgage obligation by the original mortgagor or an assuming grantee does not confer subrogation rights with respect to the obligation, neither will subrogation be available to enforce the mortgage. In each instance, subrogation is unavailable with respect to payment by one who is primarily liable. So too, when a grantee takes subject to an existing mortgage, he or she reduces the purchase price by the amount of that lien and, while not primarily liable, is nevertheless primarily responsible for its payment. See § 6.4, Comment *a*. For cases supporting the foregoing approach, see Hieber v. Florida National Bank, 522 So.2d 878 (Fla.Dist.Ct. App.1988); Stastny v. Pease, 100 N.W. 482 (Iowa 1904); Lackawanna Trust & Safe Deposit Co. v. Gomeringer, 84 A. 757 (Pa.1912); De Roberts v. Stiles, 64 P. 795 (Wash.1901); Willson v. Burton, 52 Vt. 394 (1880). In Morris v. Twichell, 249 N.W. 905 (N.D.1933), a purchaser who assumed the first mortgage and, in addition, had actual knowledge of a second mortgage, paid the first mortgage and sought subrogation to it against the second mortgage. The court denied subrogation. Although the purchaser did not assume payment of the second mortgage, the court stressed the fact that its amount had been deducted from the purchase price. The court said: "The rule is that when payment has been made by one primarily liable, it operates as an absolute satisfaction.... Neither by assignment nor by subrogation can he keep the mortgage alive as against other liens on the land." Id. at 633. Contra: Joyce v. Dauntz, 45 N.E. 900 (Ohio 1896); Young v. Morgan, 89 Ill. 199 (1878).

Illustration 24 is based on Joyce v. Dauntz, 45 N.E. 900 (Ohio 1896). See also Hooper v. Henry, 17 N.W. 476 (Minn.1883).

§ 8.6 Marshaling: Order of Foreclosure on Multiple Parcels

(a) Except as provided in Subsection (b), when foreclosing a mortgage covering more than one parcel of real estate, upon the motion or application of the holder of a subordinate interest protected by this section, the mortgagee must proceed against the parcels in the following order:

(1) parcels on which no subordinate interests exist are foreclosed upon before parcels on which subordinate interests exist; and

(2) as among parcels on which subordinate interests exist, those with subordinate interests created more recently are foreclosed upon before those with subordinate interests created at a more remote time.

(b) The order of foreclosure specified in Subsection (a) does not apply to the extent that

(1) doing so would provide no benefit to a person protected by Subsection (a); or

(2) a person whose interest would be protected by Subsection (a) has relinquished that protection by a term of the mortgage or other conveyance granted to that person, by a term of the mortgage being foreclosed, or by other agreement; or

(3) that order of foreclosure would materially prejudice the foreclosing mortgagee.

Cross-References:

Section 7.1, Effect of Mortgage Priority on Foreclosure; § 7.4, Effect of Priority on the Disposition of Foreclosure Surplus; § 7.6, Subrogation; Restatement Third, Suretyship and Guaranty § 51.

Comment:

a. Introduction. This section deals with the doctrine of marshaling, which may arise when the mortgaged real estate consists of two or more parcels. Its purpose is to prevent unjust enrichment of the foreclosing mortgagee at the expense of holders of subordinate interests in the real estate. To accomplish this, marshaling restricts the discretion of a mortgagee in determining the order of foreclosure on multiple parcels of real estate covered by the same mortgage. Its premise is that, while a mortgagee may ultimately resort to all of its security, the mortgagee should do so in an order that will preserve, to the extent possible, the interests of other parties junior to the mortgage. Because the aggregate value of all of the security may well exceed the amount of the obligation on which foreclosure is sought, it may be possible to satisfy the obligation through foreclosure upon fewer than all of the parcels, or to satisfy it in a manner that will leave surplus proceeds for the subordinate parties. In this way unnecessary impairment of their interests may be avoided.

The marshaling doctrine reflects the fundamental notion that first in time is first in right. It not only recognizes the desirability of protecting junior interests when feasible, but also gives a preference, with respect to the order of foreclosure, to those who acquired such interests at an earlier date as against those who have acquired similar interests more recently.

Marshaling is an equitable accommodation to the junior interest holders. As such, it is applicable only when its operation will be equitable. It is a general guide to the courts, not an absolute rule. Thus, marshaling is not applied when it would be detrimental to the foreclosing mortgagee, or when its application would be unfair for other reasons.

Marshaling merely affects the order of foreclosure, and does not prevent access by the mortgagee to any of the mortgaged parcels if all are needed to satisfy the obligation. Nor does marshaling alter existing priorities among mortgages, or between mortgages and other interests in the real estate.

An order marshaling assets is granted by a court only when the holder of a junior interest who is entitled to its protection requests it. When foreclosure is by judicial action, the request is ordinarily made by motion to the court, and must be made prior to the foreclosure sale itself. When foreclosure is by nonjudicial power of sale, it is usually necessary for a party seeking the protection of marshaling to commence a judicial action to enjoin the sale. If the marshaling claim is not raised before the foreclosure, it will be regarded as lost unless there is very strong justification for the junior party's delay in raising it.

While this section is stated in terms of real estate mortgages, courts often apply similar principles where the security is exclusively personal property, or where the senior debtor holds both real property and personal property security. Marshaling is only one illustration of the law's insistence of avoidance of unnecessary harm to the interests of third parties. Another illustration is found in Restatement Third, Suretyship and Guaranty § 51, governing cases in which a creditor is protected both by a promise of suretyship and by collateral in the debtor's assets. The creditor is required first to seek enforcement against the collateral if doing so will not materially burden the creditor or other beneficiaries of the suretyship, and failure to do so will result in unusual hardship to the surety.

Where the parcel that would ordinarily be first subjected to foreclosure under the marshaling doctrine is a homestead under state law, there is substantial authority that marshaling should not be assertable against it. One explanation for this view is that a homestead is in a sense similar to a subordinate lien, and that it should have dignity and protection at least as great as actual subordinate liens held by others. The argument is sometimes augmented by assertions of the societal importance of homesteads. This Restatement takes no position on this issue, since it arises from particular and varied statutory and constitutional provisions.

b. Order of foreclosure when some parcels are encumbered by subordinate interests and others are not. Under Subsection (a)(1), a mortgagee must exhaust its security in parcels unencumbered by junior interests before resorting te parcels that are so encumbered. The objective of this rule is to avoid destroying junior interests unless it is necessary to do so. See Illustrations 1–3.

Illustrations:

1. Mortgagor borrows $100,000 from Mortgagee–1, giving Mortgagee–1 a promissory note for that amount, secured by a mortgage on both Blackacre and Whiteacre. Subsequently Mortgagor borrows an additional sum from Mortgagee–2, giving a mortgage on Blackacre alone to secure repayment of that debt. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee–1 initiates a foreclosure proceeding on Blackacre and Whiteacre. At Mortgagee–2's request, Mortgagee–1 will be required to foreclose first on Whiteacre, and may foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre are insufficient to discharge fully the debt owed to Mortgagee–1.

2. The facts are the same as in Illustration 1. Mortgagee–1 forecloses upon Whiteacre. The proceeds of the foreclosure sale (after payment of expenses) are $120,000. $100,000 of this sum is distributed to Mortgagee–1 in full satisfaction of its debt, and the surplus is distributed to Mortgagor. Mortgagee–2's mortgage on Blackacre is not extinguished by this proceeding.

3. The facts are the same as in Illustration 1. Mortgagee–1 forecloses upon Whiteacre. The proceeds of the foreclosure (after payment of expenses) are $80,000. This sum is distributed to Mortgagee–1 in partial satisfaction of its debt. Mortgagee–1 may now proceed to foreclose upon Blackacre, thus destroying Mortgagee–2's mortgage.

The principle involved in Illustrations 1–3 is often termed the "two funds" rule, and may be stated in simplified form as follows: where a mortgagee has two parcels securing its debt, and one of those parcels is also encumbered with a subordinate interest, the mortgagee should foreclose first on the parcel on which no subordinate interest exists.

In the Illustrations above the junior interest on Blackacre is a mortgage. However, the same principle protects holders of other sorts of subordinate interests, such as judgment liens, mechanics' liens, leaseholds, easements, and cotenancy interests. See Illustration 4.

Illustration:

4. Mortgagor borrows money from Mortgagee–1, giving Mortgagee–1 a promissory note secured by a mortgage on both Blackacre and Whiteacre. Subsequently Mortgagor employs Mechanic to construct a house on Blackacre. Whiteacre is not affected by the construction. Mortgagor fails to pay Mechanic for the work, and Mechanic records a notice of a construction lien on

Blackacre. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee-1 initiates a foreclosure proceeding. At Mechanic's request, Mortgagee-1 will be required to foreclose first on Whiteacre, and may foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre are insufficient to discharge fully the debt owed to Mortgagee-1.

c. Order of foreclosure among parcels on which subordinate interests exist. Subsection (a)(2) states what is often termed the "inverse order of alienation" rule. It is an expansion of the "two funds" rule of Subsection (a)(1), and provides a guideline for determining the order of foreclosure when more than one parcel is encumbered with a subordinate interest. See Illustrations 5 and 6.

Illustrations:

5. Mortgagor borrows money from Mortgagee-1, giving Mortgagee-1 a promissory note secured by a mortgage on Blackacre and Whiteacre. Subsequently Mortgagor borrows an additional sum from Mortgagee-2, giving a mortgage on Blackacre alone to secure repayment of that debt. Thereafter Mortgagor borrows further funds from Mortgagee-3, giving Mortgagee-3 a mortgage on Whiteacre alone to secure repayment. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee-1 initiates a foreclosure proceeding on Blackacre and Whiteacre. At Mortgagee-2's request, Mortgagee-1 will be required to foreclose first on Whiteacre, and may foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre are insufficient to discharge fully the debt owed to Mortgagee-1.

6. Mortgagor borrows money from Mortgagee, giving Mortgagee a promissory note secured by a mortgage on Blackacre and Whiteacre. Subsequently Mortgagor sells Blackacre to Grantee-1 subject to the blanket mortgage, with the understanding or express promise that Mortgagor will pay the mortgage debt in due course. Thereafter Mortgagor sells Whiteacre to Grantee-2 on the same basis. Mortgagor defaults in payment on the note secured by the mortgage, and Mortgagee initiates a foreclosure proceeding on Blackacre and Whiteacre. At Grantee-1's request, Mortgagee will be required to foreclose first on Whiteacre, and may foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre are insufficient to discharge fully the debt owed to Mortgagee.

The basis of the "inverse order" rule is the reasonable expectation of the earlier junior mortgagee or grantee. For example, in Illustration 5, when Mortgagee-2 acquires its lien, it may well know (and can easily determine from the public records) that Mortgagor still holds both parcels, and that Whiteacre is unencumbered except by the blanket first mortgage. Mortgagee-2 can reasonably expect, under the "two funds" doctrine of Subsection (a)(1), that Whiteacre will be exhausted before Blackacre in the event the blanket mortgage is foreclosed. The "inverse order" rule simply holds that a subsequent encumbrance or transfer of Whiteacre by Mortgagor should not be permitted to modify this expectation of Mortgagee-2. Moreover, there is no unfairness to Mortgagee-3 in this result, since Mortgagee-3 can readily examine the records before taking its mortgage. If it does so, Mortgagee-3 will see that Whiteacre is subject to the blanket mortgage, and that the *other* parcel covered by that mortgage, Blackacre, has already been subjected to Mortgagee-2's junior lien. Hence, Mortgagee-3 is warned that its security will be the first target of foreclosure if there is a default in performance of the obligation secured by the blanket mortgage.

The same reasoning is applicable to the facts of Illustration 6. Grantee-1 reasonably expects that Whiteacre will stand ahead of Blackacre if there is a foreclosure of the blanket mortgage. A subsequent transfer of Whiteacre should not change that expectation, and a search of the records by Grantee-2 before purchasing Whiteacre will disclose the risk that the blanket mortgagee will go against Whiteacre before Blackacre in the event of foreclosure. The practical effect of the "inverse order" rule is to permit earlier grantees or lienors to "lock in" their marshaling protection as against later transferees.

The fairness of marshaling to later grantees or lienors, such as Grantee-2 in Illustration 6, depends on their having at least constructive notice of not only the blanket mortgage, but also any earlier conveyances of or liens on other parcels subject to the blanket mortgage. Without notice of the prior conveyance, Grantee-2 would reasonably expect to have the benefits of marshaling, not the burdens. Thus, if the prior conveyances are unrecorded and the later grantee or lienor has no other notice of them, marshaling will not be imposed in favor of the earlier grantee or lienor.

Illustration 6 above assumes that the mortgagor has implicitly or explicitly undertaken to pay the blanket mortgage debt. However, a parcel of land subject to a blanket mortgage may be sold to a grantee who expressly assumes the mortgage, or who takes subject to the mortgage while receiving full credit for its balance against the purchase price, with the understanding that the grantee will pay it. In such cases, the earlier grantee is primarily responsible for payment.

Hence, marshaling in favor of the earlier grantee is inappropriate and will not be ordered, but marshaling in favor of the later grantee will be ordered. See Illustration 7.

Illustration:

7. Mortgagor borrows money from Mortgagee, giving Mortgagee a promissory note for $100,000, secured by a mortgage on Blackacre and Whiteacre. Subsequently, when the balance owing on the mortgage debt has been reduced to $40,000, Mortgagor sells Blackacre to Grantee–1 for $50,000, with Grantee–1 paying $10,000 of the price in cash and expressly assuming the $40,000 balance on the blanket mortgage. Thereafter Mortgagor sells Whiteacre to Grantee–2 for $50,000 cash, giving Grantee–2 assurance that the blanket mortgage will be retired in due course. Grantee–1 defaults in payment on the note secured by the mortgage, and Mortgagee initiates a foreclosure proceeding on Blackacre and Whiteacre. Notwithstanding Grantee–1's request, Mortgagee will not be required to forcclose on Whiteacre first, but, at Grantee–2's request, will be required to foreclose first on Blackacre.

d. Marshaling not ordered if it would provide no benefit. Marshaling is intended to benefit holders of subordinate interests in some portion of the mortgaged property. However, in some cases it is apparent that marshaling will do no good to such persons, and will only serve to delay the completion of the prior mortgagee's foreclosure. The usual reason for this conclusion is that the prior mortgage debt equals or exceeds the combined value of all of the parcels that secure it, so that resort to all of them will be necessary. See Illustration 8.

Illustration:

8. Mortgagor borrows $100,000 from Mortgagee–1, giving Mortgagee–1 a promissory note for that amount, secured by a mortgage on both Blackacre and Whiteacre. Subsequently Mortgagor borrows an additional sum from Mortgagee–2, giving a mortgage on Blackacre alone to secure repayment of that debt. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee–1 initiates a foreclosure proceeding on Blackacre and Whiteacre. Under the principles of Subsection (a) of this section Mortgagee–1 would be required to foreclose first on Whiteacre, and could foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre were insufficient to fully discharge the debt owed to Mortgagee–1. However, Mortgagee–1

proves that the value of Blackacre and Whiteacre combined is only $90,000. On these facts marshaling will delay Mortgagee-1 without giving any benefit to Mortgagee-2. A court is warranted in refusing to order marshaling, and in ordering Blackacre and Whiteacre foreclosed in the order requested by Mortgagee-1.

e. Waiver of marshaling protection. Any person holding an interest in real estate protected by the marshaling doctrine may waive that protection. The waiver may appear in the document by which the person's interest was created, or it may be given later. See Illustration 9.

Illustration:

9. Mortgagor borrows money from Mortgagee-1, giving Mortgagee-1 a promissory note secured by a mortgage on both Blackacre and Whiteacre. Subsequently Mortgagor borrows an additional sum from Mortgagee-2, giving a mortgage on Blackacre alone to secure repayment of that debt. Mortgagee-2's mortgage states: "Mortgagee waives all right to demand that foreclosure of any prior mortgage on this real estate be delayed until after foreclosure of other real estate securing such prior mortgage." Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee-1 initiates a foreclosure proceeding on Blackacre and Whiteacre. The court will refuse to order marshaling at the request of Mortgagee-2, and is warranted in ordering Blackacre and Whiteacre foreclosed in the order requested by Mortgagee-1.

Often a prior mortgagee will have sufficient bargaining strength to insist on a waiver of marshaling protection by a subordinate mortgagee. For example, if the prior mortgage contains a "due on encumbrance" clause, effectively requiring the prior mortgagee's consent to the placing of a junior mortgage on the real estate, the prior mortgagee may condition that consent on the inclusion of a waiver of marshaling protection in the junior mortgage.

A waiver of marshaling protection may also appear in the senior mortgage being foreclosed. See Illustration 10. Here the waiver term will appear in the chain of title of subsequent grantees or lienors, and they will take their interests with notice that they will not be able to claim the usual protection of the marshaling doctrine. In effect, their consent to the waiver is evidenced by their willingness to acquire junior interests in the real estate with notice of the waiver term in the senior mortgage.

Illustration:

10. Mortgagor borrows money from Mortgagee-1, giving Mortgagee-1 a promissory note secured by a recorded mortgage on both Blackacre and Whiteacre. The mortgage states: "No subsequent grantee of any part of the real estate or holder of a junior mortgage or lien shall have any right of marshaling against Mortgagee-1, and Mortgagee-1 may foreclose on the real estate in any order it may deem proper." Subsequently Mortgagor borrows an additional sum from Mortgagee-2, giving a mortgage on Blackacre alone to secure repayment of that debt. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee-1 initiates a foreclosure proceeding on Blackacre and Whiteacre. The court will refuse to order marshaling at the request of Mortgagee-2, and is warranted in ordering Blackacre and Whiteacre foreclosed in the order requested by Mortgagee-1.

f. Marshaling not ordered if foreclosing mortgagee would be materially prejudiced. Marshaling is based on the assumption that it may prevent a party to a foreclosure from suffering unnecessarily, while imposing no substantial burden on the foreclosing mortgagee. Hence it will not be ordered if the foreclosing mortgagee would be materially prejudiced. However, no material prejudice will ordinarily be found merely because the mortgagee prefers a different order of foreclosure, or because of the slight delay that is inherent in foreclosing one parcel before another. On the other hand, marshaling will be denied if it would result in a substantial and undue delay to the senior mortgagee. The burden of persuading the court that material prejudice will result from marshaling is on the foreclosing mortgagee. See Illustrations 11-13.

Illustrations:

11. Mortgagor borrows money from Mortgagee-1, giving Mortgagee-1 a promissory note for that amount, secured by a mortgage on both Blackacre and Whiteacre. Subsequently Mortgagor borrows an additional sum from Mortgagee-2, giving a mortgage on Blackacre alone to secure repayment of that debt. Mortgagor defaults in payment on the note secured by the first mortgage, and Mortgagee-1 initiates a foreclosure proceeding on Blackacre and Whiteacre. Under the principles of Subsection (a) of this section, Mortgagee-1 would be required to foreclose first on Whiteacre and could foreclose on Blackacre only if the proceeds of the foreclosure on Whiteacre were insufficient to fully discharge the debt owed to Mortgagee-1. However, Mortgagee-1 proves that Blackacre is located in an area in which numerous

arson fires have occurred recently, and that Mortgagee-1 reasonably fears damage to Blackacre if foreclosure is delayed for even a short time. A court is warranted in refusing to order marshaling and in ordering Blackacre foreclosed before Whiteacre.

12. The facts are the same as Illustration 11, except that Blackacre is not subject to an undue risk of loss by fire. However, Blackacre and Whiteacre are abutting parcels, and Mortgagee-1 proves that the only route of public access to Blackacre is over Whiteacre. On these facts, marshaling will have the effect of reducing the price that can be obtained individually for Blackacre at foreclosure. A court is warranted in refusing to order marshaling, and in ordering Blackacre and Whiteacre foreclosed together.

13. The facts are the same as Illustration 11, except that Blackacre is not subject to an undue risk of loss by fire. However, Whiteacre is located in a foreign country in which Mortgagee-1 has no office or other business, while Blackacre is located within the jurisdiction of a court convenient to Mortgagee-1's offices. On these facts Mortgagee-1 would be materially prejudiced by an order requiring foreclosure against Whiteacre first. A court is warranted in ordering Blackacre foreclosed before Whiteacre.

REPORTERS' NOTE

Introduction, Comment a. General discussions of the marshaling doctrine are found in 2 G. Nelson & D. Whitman, Real Estate Finance Law §§ 10.9-10.15 (3d ed. 1993); G. Glenn, Mortgages §§ 289-299 (1943); W. Walsh, Mortgages §§ 55-56 (1934); Restatement, Second, Restitution § 44 (Tentative Draft No. 2, 1984). See also Green, Marshaling Assets in Texas, 34 Tex. L. Rev. 1054 (1956); Melli, Subdivision Control in Wisconsin, 1953 Wis. L. Rev. 389; Storke and Sears, Subdivision Financing, 28 Rocky Mt. L. Rev. 1 (1956); Note, The Rights of a Junior Lienholder in Wisconsin, 43 Marq. L. Rev. 89, 94 (1959).

Decisions refusing to order marshaling against a homestead include Mercantile First Nat'l Bank v. Lee, 790 S.W.2d 916 (Ark.Ct.App.1990); Gibson v. Farmers & Merchants Bank, 81 B.R. 84 (N.D.Fla.1986) (based on Florida law); In re Martin, 875 P.2d 417 (Okla. 1994); Douglas County State Bank v. Steele, 210 N.W. 657 (N.D.1926); Aisenbrey v. Hensley, 17 N.W.2d 267 (S.D.1945).

Order of foreclosure when some parcels are encumbered by subordinate interests and others are not, Comment b. Illustrations 1-3 are supported by In re Beacon Distributors, Inc., 441 F.2d 547 (1st Cir.1971); In re Hansen, 77 B.R. 722 (Bankr. D.N.D.1987); All American Holding Corp. v. Elgin State Bank, 17 B.R. 926 (S.D.Fla.1982); Shedoudy v. Beverly Surgical Supply Co., 161 Cal. Rptr. 164 (Cal.Ct.App.1980); Bartley v. Pikeville Nat'l Bank, 532 S.W.2d 446 (Ky. Ct. App. 1975); Pongetti v. Bankers Trust Sav. & Loan Ass'n, 368 So.2d 819 (Miss.1979); Lineham v. Southern New England Prod. Credit

Ass'n, 442 A.2d 585 (N.H.1982); Waff Brothers, Inc. v. Bank of North Carolina, 221 S.E.2d 273 (N.C.1976); Community Bank v. Jones, 566 P.2d 470 (Or.1977); First Wisconsin Trust Co. v. Rosen, 422 N.W.2d 128 (Wis. Ct. App. 1988), review denied, 428 N.W.2d 554 (1988); Annot., 76 A.L.R.3d 327 n.2 (1977).

A few states have statutes adopting the "two funds" rule; see West's Ann. Cal. Civ. Code § 2899; 42 Okla. Stat. Ann. § 17.

If a mortgagee who would otherwise have a duty to marshal assets purposely releases from the mortgage the parcel that would have been required to suffer the first foreclosure, the courts will effectively impose marshaling by requiring the mortgagee to credit that parcel's market value against the debt before proceeding against the remaining parcels. The rule applies, however, only if the mortgagee had actual knowledge of the subsequent conveyances or liens at the time of giving the release. See, e.g., Continental Supply Co. v. Marshall, 152 F.2d 300 (10th Cir. 1945), cert. denied, 327 U.S. 803 (1946); Charles Constr. Co., Inc. v. Leisure Resources, Inc., 307 N.E.2d 336 (Mass.App.Ct.1974); Pongetti v. Bankers Trust Sav. & Loan Ass'n, 368 So.2d 819 (Miss.1979); Manufacturers & Traders Trust Co. v. Miner Homes, Inc., 419 N.Y.S.2d 381 (N.Y.App.Div.1979), appeal denied, 396 N.E.2d 206 (N.Y. 1979); Broughton v. Mount Healthy Flying Service, 143 N.E.2d 597 (Ohio.Ct. App.1957); Home Unity Savings & Loan Association v. Balmos, 162 A.2d 244 (Pa. Super. Ct. 1960).

Order of foreclosure among parcels on which subordinate interests exist, Comment c. Illustrations 5 and 6 are based on Hill v. Lane, 848 P.2d 43 (Okla.Ct.App.1992). Illustration 5, applying the "inverse order" rule as between junior mortgagees, is supported by In re Shull, 72 B.R. 193 (Bankr.D.S.C.1986); Sanborn, McDuffee Co. v. Keefe, 187 A. 97 (N.H. 1936), noted in 106 A.L.R. 1097; Riverside Apartment Corp. v. Capitol Constr. Co., 152 A. 763, 769 (N.J. Eq. 1930), affirmed, 158 A. 740 (N.J. 1932). Some cases refuse to follow the "inverse order" rule among competing junior mortgages or other liens, and instead prorate the senior debt between the two junior liens in proportion to the value of the parcel to which each is attached. See Harrington v. Taylor, 169 P. 690 (Cal.1917); Platte Valley Bank v. Kracl, 174 N.W.2d 724 (Neb.1970); Vandever Inv. Co., Inc. v. H.E. Leonhardt Lumber Co., 503 P.2d 185 (Okla. 1972), noted in 76 A.L.R.3d 315; St. Clair Sav. Ass'n v. Janson, 318 N.E.2d 538 (Ohio.Ct.App.1974).

Illustration 6, applying the "inverse order" rule as among grantees of the original mortgagor, is more widely followed by the cases. See In re Penn Central Trans. Co., 346 F.Supp. 1323 (E.D.Pa.1972); Mobley v. Brundidge Banking Co., 347 So.2d 1347 (Ala. 1977); Taylor v. Jones, 232 So.2d 601 (Ala.1970); Commonwealth Land Title Co. v. Kornbluth, 220 Cal.Rptr. 774 (Cal.Ct.App.1985); Ellickson v. Dull, 521 P.2d 1282 (Colo.Ct.App.1974); Voltin v. Voltin, 179 N.W.2d 127 (N.D.1970); Seasons, Inc. v. Atwell, 527 P.2d 792 (N.M.1974); Broughton v. Mount Healthy Flying Service, Inc., 143 N.E.2d 597 (Ohio.Ct.App. 1957); Haueter v. Rancich, 693 P.2d 168 (Wash.Ct.App.1984). See generally Annot., 131 A.L.R. 103; Note, Marshaling: Equitable Rights of Holders of Junior Interests, 38 Rutgers L. Rev. 287 (1986); 2 Nelson & Whitman, Real Estate Finance Law § 10.10 (3d ed. 1994). Contra, rejecting the inverse order rule and requiring the first mortgagee to satisfy its debt ratably against the properties on which subordinate interests existed, in proportion to their values, see Bates v. Ruddick, 65 Am. Dec. 774, 779 (Iowa 1856); Bartley v. Pikeville Nat'l Bank, 532 S.W.2d 446 (Ky. Ct. App. 1975); Vandever Inv. Co. v. H. E. Leonhardt Lumber Co., 503 P.2d 185 (Okla.1972), noted in 76 A.L.R.3d 315.

Illustration 7, denying marshaling to an assuming grantee, is based on Matter of Beacon Distributors, Inc., 441 F.2d 547 (1st Cir.1971). See also Toler v. Baldwin County Sav. & Loan Ass'n, 239 So.2d 751 (Ala.1970); Prudential Sav. and Loan Ass'n v. Nadler, 345 N.E.2d 782 (Ill. App. Ct. 1976); Smith v. Olney Fed. Sav. & Loan Ass'n, 415 S.W.2d 515 (Tex. Ct. Civ. App. 1967).

Marshaling not ordered if it would provide no benefit, Comment d. Illustration 8 is based on Victor Gruen Assoc., Inc. v. Glass, 338 F.2d 826 (9th Cir.1964) and Platte Valley Bank v. Kracl, 174 N.W.2d 724 (Neb.1970) (chattel mortgages).

Waiver of marshaling protection, Comment e. Illustration 10 is based on Platte Valley Bank v. Kracl, 174 N.W.2d 724 (Neb.1970) (personal property security) and Thompson v. Thomas, 185 Pac. 427 (Cal.Ct.App. 1919). The right to marshal may also be waived by a junior mortgagee or grantee by terms of his or her own mortgage; see Raynor v. Raynor, 193 S.E. 216 (N.C.1937); G. Glenn, Mortgages § 296 (1943).

Marshaling not ordered if foreclosing mortgagee would be materially prejudiced, Comment f. Cases adopting the rule that marshaling will not be ordered to the foreclosing mortgagee's material prejudice include Caplinger v. Patty, 398 F.2d 471 (8th Cir.1968); In re Payne & Haddock, Inc., 103 B.R. 166 (Bankr.E.D.Tenn. 1988); In re Oransky, 75 B.R. 541 (Bankr.E.D.Mo.1987); Lincoln First Bank v. Spaulding Bakeries, Inc., 459 N.Y.S.2d 696 (N.Y.Sup.Ct.1983); First Nat'l Bank of Omaha v. First Cadco Corp., 203 N.W.2d 770 (Neb.1973); Platte Valley Bank of North Bend v. Kracl, 174 N.W.2d 724, 729 (Neb. 1970) (personal property security).

Illustration 12 is suggested by Charles White Co. v. Percy Galbreath & Sons, Inc., 563 S.W.2d 478 (Ky.Ct. App.1978), which held that the fee title to the land and the rents under a lease on the land should not be separated for purposes of marshaling, since the sale of the fee title separate from the rents would probably produce a much lower price.

Illustration 13 is supported by Klinger v. New York State Nat'l Bank, 271 N.Y.S. 252 (N.Y.Sup.Ct. 1934). See also Philadelphia Home for Incurables v. Philadelphia Sav. Fund Soc., 8 A.2d 193 (N.J. 1939) (marshaling will be denied if a substantial and undue delay to the foreclosing mortgagee would result).

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* Prepared by West Group.

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1. **Digest System Key Numbers**

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1. **Digest System Key Numbers**

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2. A.L.R. Annotations

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1. Digest System Key Numbers

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2. A.L.R. Annotation

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2. A.L.R. Annotations

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2. A.L.R. Annotation

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2. A.L.R. Annotations

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2. A.L.R. Annotations

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1. Digest System Key Numbers

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2. A.L.R. Annotation

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1. **Digest System Key Numbers**

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2. **A.L.R. Annotation**

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2. A.L.R. Annotations

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