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MORTGAGE DRAFTING: LESSONS FROM THE RESTATEMENT OF MORTGAGES

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Editors' Synopsis: The American Law Institute's adoption of the Restatement (Third) of Property: Mortgages may have significant impact on the negotiation and drafting of mortgages. Rather than merely reciting the prevailing case law, the Restatement proposes approaches the American Law Institute believes are desirable as a matter of sound policy. This Article highlights key areas in which the new Restatement may affect mortgage drafting and suggests useful techniques for mortgage drafters.

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I. INTRODUCTION

In June 1997, The American Law Institute (Institute) published the Restatement (Third) of Property: Mortgages (Mortgages Restatement).[1] The Institute began publishing restatements of law shortly after the Institute's organization in 1923, but this is its first attempt to restate the mortgage law of the United States. The designation "Third" in the Mortgages Restatement's title is somewhat misleading. It is designated the third because the Institute has previously published two real property law restatements, the first between 1936 and 1944,[2] and the second between 1977 and 1983.[3] Neither of these past efforts, however, treated mortgage law.

A widely held misconception is that a restatement's function is to state the existing majority rule on each issue with which it deals, but that has never been the case.[4] Rather, the Institute has always

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[1] *See* RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES (1997).

[2] Restatement of Property volumes I and II were published in 1936, volume III in 1940, and volumes IV and V in 1944.

[3] *See* RESTATEMENT (SECOND) OF PROPERTY: LANDLORD & TENANT (1977); RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS (1983).

[4] Perhaps the earliest thorough discussion of this point is Herbert Wechsler, *Restatements and Legal Change*, 13 ST. LOUIS U. L.J. 185 (1968). The comments of Professor Wechsler, formerly the Director of the Institute, were written as a defense to an attack made by the Defense Research Institute on a proposed expansion of strict tort liability in the *Restatement (Second) of Torts*. The attack was based on the assertion that the

adopted the position it believed to be desirable as a matter of sound policy, whether or not it coincided with the prevailing case law. The Mortgages Restatement continues that philosophy, and it often adopts approaches that the Institute believes preferable even if they are not supported by a majority of the authorities. No apology is or should be made for refusing to restate the prevailing view because an important function of restatements is to contribute to the development of court-made law rather than merely to regurgitate the status quo.[5]

The Mortgages Restatement's proactive approach may have important implications for the negotiation and drafting of mortgage documents. Practitioners may see the Mortgages Restatement as a prediction of what courts may do in the future, as well as a recapitulation of what they have done in the past. Hence, drafters should consider how the Mortgages Restatement's positions will affect their documents, even in areas in which existing law seems settled and inoffensive. The Mortgages Restatement does not attempt to conceal the areas in which it calls for changes in the law. On the contrary, its comments and reporters' notes are detailed and explicit in pointing out areas in which it proposes change and in

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broadened strict liability was not a majority view, and thus, adoption of it by the Restatement was illegitimate. The Council of the Institute was unmoved by this argument. Wechsler wrote:

> I asked . . . if the statement of a rule does not involve something more than the conclusion that it is supported by the past decisions, namely, the implicit judgment that our courts today would not perceive a change of situation calling for the adaptation of the rule or even for a new departure. And if we ask ourselves what courts will do in fact within this area, can we divorce our answers wholly from our view of *what they ought to do*, given the factors that appropriately influence their judgments, under the prevailing view of the judicial function?

Id. at 189-90 (emphasis added). The *Restatement (Second) of Property* made this point clearer. Its foreword described the floor debate regarding the desirability of a "wait and see" revision of the Rule Against Perpetuities, which the *Restatement* endorsed despite Professor Richard Powell's vigorous opposition. The foreword then commented:

> The episode is a useful reminder that the Institute in its restatement work does not deem itself to be constrained by a count of jurisdictions, but rather undertakes to weigh all of the considerations relevant to the development of common law that our polity calls on the highest courts to weight in their deliberations.

RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS 38 (1983).

[5] *See generally* Wechsler, *supra* note 4, at 190 (stating in pertinent part that, "we should feel obliged in our deliberations to give weight to all of the considerations that the courts, under a proper view of the judicial function, deem it right to weigh in theirs").

highlighting the differences between old and new law. Thus, reading the comments and reporters' notes can be highly useful for those engaged in mortgage drafting. Although no guarantee exists that any particular court will follow the Mortgages Restatement where it diverges from existing law, there is a strong likelihood that some courts will do so.

This Article discusses several situations in which the Mortgages Restatement, if adopted by the courts, will have a significant impact on mortgage drafting. Its orientation is candidly practical. The purpose is not to persuade readers that the Mortgages Restatement's positions are correct, but to encourage lawyers who prepare mortgage documents to rethink their craft in light of the Mortgages Restatement. Not all of these ideas are new, and careful drafters have employed some of the techniques for many years. However, the Mortgages Restatement may give added clarity and focus to drafting issues.

II. FUTURE ADVANCES

Future advances, in which mortgages are executed and recorded but some or all of the loan funds are not disbursed to the borrower until a later time, have been remarkably problematic in American law. Future advance mortgages have historically included construction loans and commercial lines of credit. In recent years, the growth of the home equity loan has popularized another form of future advance mortgage.[6] But questions persist about what mortgage language is necessary to provide security for future advances and about the priority that should be given to the lien for repayment of such future advances, as against intervening liens. Because these questions raise undesirable risks for institutional lenders, they have lobbied successfully in several states for statutory clarification. The Mortgages Restatement contains a convenient table summarizing these statutes.[7] Nonetheless, in most states, the statutory resolution of these difficult issues remains incomplete or nonexistent.

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[6] *See generally* Julia P. Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373 (1994) (discussing the incentive for homeowners to place liens on their homes to secure loans for the acquisition of personal property following the Tax Reform Act of 1986).

[7] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 2.1 statutory note at 55-56.

A. Creation of a Future Advance Mortgage

If a mortgage secures future advances, that fact should appear on the face of the mortgage. Under the Mortgages Restatement, an agreement between the mortgagor and mortgagee concerning future advances is enforceable regardless of whether it is included in the mortgage or whether it is written.[8] However, the future advance agreement will only be effective against any third party subsequently acquiring an interest in the land without notice of the agreement if the mortgage either states that future advances are secured or states a maximum amount to be secured—an amount that must be at least as great as all of the advances, present and future, that are to be secured.[9]

These two requirements are disjunctive and may be satisfied either by a statement that future advances are secured or by a statement of maximum amount.[10] In a number of states, by statute these requirements are conjunctive, and thus the mortgage must state both that future advances are secured and the maximum principal amount that the balance (including future advances) may reach.[11] If either of these elements is omitted, the mortgage may lose priority over future advances; worse yet, in some states, the mortgage will simply be invalid as to future advances, rendering it

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[8] *See id.* § 2.1(b).

[9] *See id.* § 2.1(c).

[10] *See id.*

[11] *See, e.g.*, CONN. GEN. STAT. ANN. §§ 49-2 to 49-4b (West 1994 & Supp. 1998); DEL. CODE ANN. tit. 25, § 2118 (1974) (amended 1996); FLA. STAT. ANN. § 697.04 (West 1994) (amended 1996); IOWA CODE ANN. §§ 572.18, 654.12A (West 1995); KY. REV. STAT. ANN. § 382.520 (Michie 1972 & Supp. 1996); LA. CIV. CODE ANN. art. 3158 (West 1994); ME. REV. STAT. ANN. tit. 9B, § 436 (West 1997); MICH. COMP. LAWS ANN. §§ 565.901-.906 (West Supp. 1998) (regarding residential loans only); MO. ANN. STAT. § 443.055 (West 1986); NEV. REV. STAT. ANN. § 106.300-.400 (Michie 1994); N.H. REV. STAT. ANN. § 479:3-5 (1992); N.Y. REAL PROP. LAW § 281 (McKinney 1989) (amended 1993); N.C. GEN. STAT. §§ 45-67 to 45-74 and §§ 45-81 to 45-84 (1996) (amended 1997); OHIO REV. CODE ANN. § 5301.232 (Anderson 1989); OR. REV. STAT. § 86.155 (1987); 42 PA. CONS. STAT. ANN. §§ 8143, 8144 (West 1998); R.I. GEN. LAWS §§ 34-25-8, 34-25-9 (1995); S.C. CODE ANN. §§ 29-3-40, 29-3-50 (1976); S.D. CODIFIED LAWS § 44-8-26 (Michie 1997); TENN. CODE ANN. §§ 47-28-101 to 47-28-110 (1995); VA. CODE ANN. §§ 55-58.2, 55-59 (Michie 1995) (amended 1997).

completely unsecured.[12] Drafters must therefore become thoroughly familiar with the relevant statutes.

B. Advances to Protect Security

From the mortgagee's viewpoint, every mortgage should provide that it secures reimbursement of all expenditures made by the mortgagee for the protection of the security. This includes payment for such items as property taxes, assessments, repairs to correct waste, removal of unauthorized prior liens, and the like. In a sense, these items are future advances, but they are so essential to the mortgagee's protection that the Mortgages Restatement and a significant amount of case law[13] gives them a special status. Under the Mortgages Restatement, the mortgagee may expend money for these items when reasonably necessary, and reimbursement of such expenditures will be secured by the mortgage with its original priority regardless of what the documents provide.[14] Of course, one cannot count on all jurisdictions

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[12] *See, e.g.*, CONN. GEN. STAT. ANN. § 49-2 to 49-4b (West 1994 & Supp. 1998); DEL. CODE ANN. tit. 25, § 2118 (1974) (amended 1996); FLA. STAT. ANN. § 697.04 (West 1994) (amended 1996); KY. REV. STAT. ANN. § 382.520 (Michie 1972 & Supp. 1996); ME. REV. STAT. ANN. tit. 9B, § 436 (West 1997); NEV. REV. STAT. ANN. § 106.300-.400 (Michie 1994); N.H. REV. STAT. ANN. § 479:3-5 (1992); OHIO REV. CODE ANN. § 5301.232 (Anderson 1989); 42 PA. CONS. STAT. ANN. §§ 8143, 8144 (West 1998). In several cases it is difficult to determine whether the legislature intended a non-complying mortgage to be invalid with respect to future advances, or merely to lose its priority.

[13] *See, e.g.*, Goldsboro Milling Co. v. Reaves, 804 F. Supp. 762 (E.D.N.C. 1991) (regarding payment of property taxes); *In re* Ferguson, 85 B.R. 89 (Bankr. W.D. Ark. 1988) (discussing payment of insurance premiums); Osbourne v. Capital City Mortgage Corp., 667 A.2d 1321 (D.C. 1995) (concerning payment of senior liens); Hemmerle v. First Fed. Sav. & Loan Ass'n, 338 So. 2d 82 (Fla. Dist. Ct. App. 1976) (regarding payment of cost for completing required construction); Thompson v. Kirsch, 677 P.2d 490 (Idaho 1984) (concerning payment of maintenance costs which mortgagor had covenanted but failed to perform); National Mortgage Co. v. Syriaque, 681 A.2d 1232 (N.J. Super. Ct. Ch. Div. 1994) (regarding entitlement to expenditures to preserve the premises between date of foreclosure order and date of sale); Vista Dev. Joint Venture II v. Pacific Mut. Life Ins. Co., 822 S.W.2d 305 (Tex. Ct. App. 1992) (regarding payment of property taxes).

[14] MORTGAGES RESTATEMENT, *supra* note 1, § 2.2(a) (authorizing such expenditures "to protect the value of the mortgaged real property and improvements on it; or . . . to protect against the assertion of liens having priority over the mortgage").

to follow this view,[15] and even the states that provide a statutory right on the part of the mortgagee to secured reimbursement vary widely with respect to the items covered by the statute.[16] Hence, a careful drafter will include in the mortgage the mortgagee's right to make protective advances and to treat them as secured.[17]

C. Cutoff Notices

Under common law principles, the priority of a mortgage securing future advances is subject to serious uncertainty. Such advances may lose priority to any intervening liens[18] if the advances are optional and the lender making them has notice of the intervening liens.[19] Optional advances refer

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[15] Some states provide this protection for protective payments by statute. *See, e.g.*, DEL. CODE ANN. tit. 25, § 2118 (1974) (amended 1996); FLA. STAT. ANN. § 697.04 (West 1994) (amended 1996); GA. CODE ANN. §§ 44-14-1, 44-14-2 (Michie 1982); 765 ILL. COMP. STAT. ANN. § 139 (West 1993); KY. REV. STAT. ANN. § 289.441 (Michie 1972); MICH. COMP. LAWS ANN. §§ 565.901-.906 (West Supp. 1998); MO. ANN. STAT. § 443.055 (West 1986) (amended 1991); N.J. STAT. ANN. §§ 46:9-8.1 to 46:9-8.4 (West 1989) (amended 1997); N.C. GEN. STAT. §§ 45-67 to 45-74 (1996) (amended 1997); OHIO REV. CODE ANN. § 5301.232 (Anderson 1989); R.I. GEN. LAWS §§ 34-25-8 to 34-25-9 (1995); TENN. CODE ANN. §§ 47-28-101 to 47-28-110 (1995); VA. CODE ANN. § 55-59 (Michie 1995).

[16] For example, some (but not all) of the statutes cited in the preceding footnote cover condominium and Planned Unit Development (PUD) homeowners association assessments, construction advances, insurance premiums, ground rents, attorneys' fees, and expenses of collection.

[17] While attorneys' fees are not, strictly speaking, advances to protect the security, the mortgage should also state that it secures attorneys' fees and costs expended by the mortgagee in enforcement proceedings. A few state statutes so provide. *See* MICH. COMP. LAWS ANN. § 565.901(1)(c)(iii) (West Supp. 1998); OR. REV. STAT. § 86.155 (1987) (amended 1997).

[18] Intervening liens are those liens that take effect after the mortgage is recorded but before the disbursement of the advances in question.

[19] *See* Provident Nat'l Bank v. First Pa. Bank (*In re* Johnson), 124 B.R. 648 (Bankr. E.D. Pa. 1991); La Cholla Group, Inc. v. Timm, 844 P.2d 657 (Ariz. Ct. App. 1992); Home Lumber Co. v. Kopfmann Homes, Inc., 535 N.W.2d 302 (Minn. 1995). *See generally* James B. Hughes, Jr., *Future Advance Mortgages: Preserving the Benefits and Burdens of the Bargain*, 29 WAKE FOREST L. REV. 1101 (1994) (rejecting the common law distinction between obligatory and optional advances and proposing a model based on the original English rule); John E. Moore, *Seeking Firmer Ground: Mortgages to Secure Future Advances and the Priorities Quagmire*, 12 SUFFOLK U. L. REV. 445 (1978) (tracing development, problems, and proposed solutions in Rhode Island law governing priority between future advance mortgages and intervening liens); Grant S. Nelson & Dale A.

to those advances that the lender has no contractual duty to make. This rule has been a serious problem for construction lenders because other lienholders can successfully argue that the advances the construction lender made on a construction project were optional and thus subject to loss of priority.[20]

As a result of lobbying efforts by lenders, about half of the states have repealed the optional advance rule by statute and have declared that repayment of all future advances, whether optional or obligatory on the part of the lender, will be secured with the priority of the original mortgage.[21] However, most of these statutes also provide a "cutoff notice" procedure for borrowers.[22] The cutoff notice works as follows: a borrower who has significant equity value in real estate, and who wishes to borrow more funds on the security of that equity but cannot convince the original lender to make any additional advances, can send a notice to the lender cutting off the future advance clause in the mortgage. The notice prevents any further advances from being secured by the mortgage. This means that the borrower may obtain junior financing from a different lender with the junior lender assured that no further advances will be made on the senior mortgage that might eat up the borrower's equity.

Whitman, *Rethinking Future Advance Mortgages: A Brief for the Restatement Approach,* 44 DUKE L.J. 657 (1995) (rejecting the common law distinction between obligatory and optional advances and advocating the solution of the *Mortgages Restatement.*

[20] *See, e.g.*, National Bank of Wash. v. Equity Investors, 506 P.2d 20 (Wash. 1973) (en banc) (finding lender's advances on construction loan to be discretionary rather than obligatory, and therefore subordinate to lien); J.I. Kislak Mortgage Corp. v. William Matthews Builder, Inc., 287 A.2d 686 (Del. Super. Ct. 1972), *aff'd*, 303 A.2d 648 (Del. 1973) (finding lender's advances on construction loan optional and therefore subordinate to mechanics liens, because the lender failed to insist that the contractor satisfy conditions prior to accepting advances).

[21] *See* Future Advances: Statutory Note, MORTGAGES RESTATEMENT, *supra* note 1, § 2.1 at 56-66.

[22] *See* FLA. STAT. ANN. § 697.04(b) (West 1994 & Supp. 1998); KY. REV. STAT. ANN. § 382.520(2) (Michie Supp. 1996); ME. REV. STAT. ANN. tit. 9B, § 436(1)(B) (West 1964); ME. REV. STAT. ANN. tit. 33, § 505 (5)(A) (West 1997) (applying only to optional advances); MO. ANN. STAT. § 443.055(6) (West 1986 & Supp. 1998); MONT. CODE ANN. § 71-1-206(3) (1997); NEB. REV. STAT. § 76-238.01(1)(a) (1996); NEV. REV. STAT. ANN. § 106.370-.400 (Michie 1994); N.C. GEN. STAT. § 45-72 (1996); OHIO REV. CODE ANN. § 5301.232(C) (Anderson 1989); 42 PA. CONS. STAT. ANN. § 8143(c) (West Supp. 1998); R.I. GEN. LAWS §34-25-4 (1995); TENN. CODE ANN. §47-28-105 (1995); VA. CODE ANN. §§55-58.2(7) (Michie 1995 & Supp. 1998).

This highly effective procedure permits borrowers to utilize all of their equity as security for borrowing; it prevents the initial future advance lender from tying up the borrower's equity so that it is unavailable as security to other lenders. At the same time, this procedure avoids the ambiguities and complexities of the optional advance doctrine and ensures that the original future advance lender will have mortgage priority for every dollar it has advanced before receiving a cutoff notice.[23]

However, in several states with cutoff notice statutes, the lender is guaranteed priority for the future advances only if the mortgage contains a clause opting in to the statutory scheme.[24] Surprisingly, lenders often fail to include such mortgage language, and thus lose the statute's obvious advantages for themselves.[25]

The Mortgages Restatement adopts the cutoff notice concept and encourages courts to use it, even if no statute in the jurisdiction so provides.[26] This is not a radical suggestion. After all, the old optional advance doctrine was invented by the courts; thus it should be possible for them to replace it with a more workable rule. Under the Mortgages Restatement, any borrower under a future advance mortgage can issue a cutoff notice to the mortgagee, terminating the borrower's right to receive further advances and preventing the mortgage from securing further advances. Whether courts will adopt this approach is yet to be determined, but at least one court has already cited it with approval.[27]

Obviously, lenders may not want their borrowers to issue cutoff notices because such notices mean that the lender cannot safely continue funding a loan that the lender may regard as advantageous.[28] Whether a borrower's

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[23] *See, e.g.,* South Side Nat'l Bank v. Commerce Bank, 897 S.W.2d 657 (Mo. Ct. App. 1995); Rita Carper Sowards, Comment, *Future Advances in Missouri*, 49 MO. L. REV 103, 116 (1984).

[24] *See, e.g.*, MO. ANN. STAT. § 443.055(1)(10) (West 1986 & Supp. 1998); NEV. REV. STAT. ANN. § 106.350 (Michie 1994).

[25] *See, e.g.*, Bank of Urbana v. Wright, 880 S.W.2d 921 (Mo. Ct. App. 1994).

[26] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 2.3(b).

[27] *See* Shutze v. Credithrift of America, Inc., 607 So. 2d 55, 63 (Miss. 1992).

[28] The Missouri statute expressly exempts construction loans from the cutoff notice procedure, presumably because a borrower who fails to complete a construction project with funds from the original lender may not finish it at all, or may do so with funds from another lender whose standards are lower, resulting in an inferior project. MO. REV. STAT.

right to issue a cutoff notice is waivable by language in the mortgage is unclear. Neither the Mortgages Restatement nor any of the state statutes providing for cutoff notices deals with this question. Including a waiver clause in the mortgage would cause no obvious harm, but mortgagees should recognize that courts might nonetheless conclude that the borrower could issue an effective cutoff notice despite the waiver. A covenant by the mortgagor not to issue a cutoff notice may be more useful to the mortgagee. A covenant would not necessarily stop the issuance of the notice, but issuance would be a breach of the covenant and an event of default. The lender could make a claim for damages against the borrower, foreclose, and assert other mortgage remedies. The Mortgages Restatement expressly recognizes the enforceability of such a covenant,[29] and none of the statutes on which it is based say anything that would prevent making the borrower's issuance of a cutoff notice an event of default. A careful lender might also wish to add a mortgage clause providing that any damages that the lender suffers because of the borrower's breach of a covenant not to cut off future advances will be added to the loan balance and will be secured by the mortgaged real estate.

The damages a lender suffers as a result of receiving a cutoff notice can be quite significant because issuing the notice and terminating the disbursal of funds under the future advance clause is analogous to a borrower's making a prepayment or refusing to draw down funds under a binding loan commitment. If interest rates have fallen since the loan was made, the lender may be forced to loan the additional funds to another borrower at a lower rate, and thus may prove that it has suffered damage.

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§ 443.055(3)(2) (Supp. 1998). The *Mortgages Restatement* takes a similar view. *See* MORTGAGES RESTATEMENT, *supra* note 1, § 2.3(c) (providing that "the mortgagor may not issue the notice . . . and any notice issued by the mortgagor is ineffective, if . . . a termination or subordination of further advances would unreasonably jeopardize the mortgagee's security for advances already made").

[29] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 2.3 ("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.").

D. Dragnet Clauses

A dragnet clause is a mortgage provision stating that future, but currently unspecified, debts that the borrower owes to the lender will automatically be secured by the present mortgage. Courts tend to regard dragnet clauses with suspicion because they rarely are negotiated specifically and often are unnoticed entirely or misunderstood by borrowers. Hence, courts often construe dragnet clauses in ways that limit their effectiveness.[30]

One of the most common limitations arises when a lender asserts a dragnet clause in a mortgage given for one purpose (such as a home purchase loan) as security for an entirely different type of debt (such as a business loan made to the same borrower). Courts widely hold that the dragnet clause is ineffective to secure the latter debt.[31] The Mortgages Restatement takes a similar view. It provides that a dragnet clause is enforceable only if the future indebtedness is (1) "similar in character" to the original loan transaction; (2) a transaction that is described with "reasonable specificity" in the mortgage; or (3) identified as being secured by the mortgage by agreement of the parties when the future indebtedness is incurred.[32]

Thus, lenders who wish to give as broad a scope as possible to their dragnet clauses will want to describe with reasonable specificity the range of types of future indebtedness the mortgage is intended to secure. For example, the dragnet clause in a home loan mortgage might provide:

> This mortgage shall also secure all future indebtedness which is incurred during the term of this loan that the mortgagor may owe to the mortgagee. Such future indebtedness shall include not only debts

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[30] *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 12.8 (3d ed. 1993) [hereinafter NELSON & WHITMAN]; Gerald L. Blackburn, *Mortgages to Secure Future Advances*, 21 MO. L. REV. 209 (1956); Harry E. Meek, *Mortgage Provisions Extending the Lien to Future Advances and Antecedent Indebtedness*, 26 ARK. L. REV. 423 (1973).

[31] *See, e.g.,* Foxborough Sav. Bank v. Ballarino (*In re* Ballarino), 180 B.R. 343 (D. Mass. 1995); Sowers v. FDIC, 96 B.R. 897 (S.D. Iowa 1989); First Sec. Bank v. Shiew, 609 P.2d 952 (Utah 1980).

[32] MORTGAGES RESTATEMENT, *supra* note 1, § 2.4(b).

> related to acquisition of the borrower's residence, but also debts incurred to repair, maintain, or improve the borrower's residence or any real estate held for trade or business use; debts incurred to acquire a trade or business; debts incurred to acquire business inventory, equipment, or fixtures or to pay other operating expenses of a business of the borrower; debts related to the borrower's (or the borrower's family's) education, recreation, travel, purchase of motor vehicles, or purchase of other goods or services, whether for personal, family, household, business, or professional use.

The lender should also flag the borrower's account in the lender's computer system so that when any future indebtedness is incurred, the lender can include a specific statement in the documentation for that debt that it is also secured by the previous dragnet mortgage.

Incidentally, a dragnet clause is a type of future advance agreement. Hence, the clause may be terminated if the borrower issues a cutoff notice under the Mortgages Restatement, as discussed in the preceding section of this Article.[33] Thus, in practice a borrower can always eliminate the effect of a dragnet clause unless the mortgage waives the borrower's cutoff right and the courts are willing to enforce the waiver.

III. CLOGGING THE EQUITY OF REDEMPTION

An agreement in a mortgage, or executed contemporaneously with it, under which the mortgagee can acquire title to the real estate without going through the foreclosure process is unenforceable because it is a "clog" on the equity of redemption. Although many agree that borrowers should not be permitted to assent to mortgage language that waives their right to foreclosure in the event of default,[34] commercial real estate lawyers generally argue that some types of arrangements in which the lender can acquire an equity position in the borrower's realty are entirely defensible

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[33] *See supra* text accompanying notes 19, 23.

[34] *See, e.g.*, First Illinois Nat'l Bank v. Hans, 493 N.E.2d 1171 (Ill. 1986); Oakland Hills Dev. Corp. v. Lueders Drainage Dist., 537 N.W.2d 258 (Mich. Ct. App. 1995); Basile v. Erhal Holding Corp., 538 N.Y.S.2d 831 (App. Div. 1989).

and useful, and should not be held void under the clogging doctrine.[35] These arrangements, sometimes called "equity kickers," are designed to give the lender ownership rights in the real estate (either by way of an option to purchase such rights or by an automatic vesting of them in the lender) in lieu of higher interest that the lender might otherwise charge on the loan. Equity kickers are quite different from the traditional clog on the equity of redemption because they are not designed as remedies for default by the borrower, but rather as additional compensation to the lender when the real estate venture is successful and increases in value. One example is the shared appreciation mortgage, which gives the lender a fractional share of ownership proportional to the property's increase in appraised value.

Unfortunately, little case law gives lawyers drafting such arrangements assurance that they will not be treated as clogs on the equity of redemption.[36] A few cases do suggest, somewhat obliquely, that equity kickers should not be treated as clogs. The Mortgages Restatement attempts to provide some comfort for such lawyers. It provides that an agreement giving the mortgagee a right to acquire an interest in the real estate is enforceable, provided that its effectiveness is not expressly dependent on mortgagor default.[37]

Lenders commonly attempt to rebut the clogging doctrine in these transactions by having the borrowers execute affidavits stating that the borrowers are sophisticated, represented by counsel, understand the clogging doctrine, and do not desire or intend that it apply to their

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[35] *See* Jeffrey L. Licht, *The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance*, 60 ST. JOHN'S L. REV. 452 (1986); Laurence G. Preble & David W. Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 REAL PROP. PROB. & TR. J. 821 (1985).

[36] *See* Cunningham v. Esso Standard Oil Co., 118 A.2d 611 (Del. 1955); MacArthur v. North Palm Beach Utils., Inc., 202 So. 2d 181 (Fla. 1967); Blackwell Ford, Inc. v. Calhoun, 555 N.W.2d 856 (Mich. Ct. App. 1996).

[37] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 3.1(c). The *Mortgages Restatement* provision is based on N.Y. GEN. OBLIG. LAW § 5-334 (McKinney 1989), which takes an essentially identical position, but 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. *See* CAL. CIV. CODE § 2906 (West 1993). The Mortgages Restatement provision is not limited either to loans above a fixed dollar limit or to nonresidential property.

transaction.[38] However, the effectiveness of such affidavits is entirely untested in reported case decisions. Drafters may now wish to use the Mortgages Restatement's language in section 3.1(c) to buttress this position by having their mortgages clearly recite that the mortgagee's right to acquire an interest in the real estate is not dependent upon the mortgagor's default. Drafters may even wish to include a specific reference to the Mortgages Restatement.

IV. INSTALLMENT LAND SALE CONTRACTS

Some may think of installment land sale contracts (sometimes called "contracts for deed") as mortgage substitutes because real estate is pledged as security for a debt. They require the purchaser to make installment payments over a long term, and the vendor is obligated to deliver a deed conveying legal title only when the final payment is received. If the purchaser fails to cure a default, an installment land sale contract typically gives the vendor a right to forfeit the contract, repossess the real estate, and retain all payments received up to the time of default.

The Mortgages Restatement simply provides that installment land sale contracts will be regarded as mortgages.[39] A few states agree.[40] Under this view, a forfeiture clause is unenforceable, and the vendor must foreclose the contract as a mortgage to realize on the security.

The difficulty with foreclosing the contract as a mortgage is that, when

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[38] *See, e.g.*, Richard R. Goldberg, *Convertible Mortgage Anti-Clogging Affidavit, in* MODERN REAL ESTATE TRANSACTIONS 665 (ALI-ABA Resource Materials 1993).

[39] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 3.4(b).

[40] *See* Kubany v. Woods, 622 So. 2d 22 (Fla. Dist. Ct. App. 1993); Skendzel v. Marshall, 301 N.E.2d 641 (Ind. 1973); Sebastian v. Floyd, 585 S.W.2d 381 (Ky. 1979); Mackiewicz v. J.J. & Assoc., 514 N.W.2d 613 (Neb. 1994); Bean v. Walker, 464 N.Y.S.2d 895 (App. Div. 1983). California has come very close to this position. *See* Petersen v. Hartell, 707 P.2d 232 (Cal. 1985). Several states suggest foreclosure of the contract as a mortgage if the purchaser would otherwise stand to lose substantial equity in the real estate. *See, e.g.*, WASH. REV. CODE ANN. §§ 61.30.010-61.30.911 (West 1990); Grombone v. Krekel, 754 P.2d 777 (Colo. Ct. App. 1988). Oklahoma has declared the contract for deed to be a mortgage by statute. *See* OKLA. STAT. ANN. tit. 16, § 11A (West 1986). *See also* Drew Kershen, *Contracts for Deed in Oklahoma: Obsolete, But Not Forgotten*, 15 OKLA. CITY U. L. REV. 715, 716 (1990) (discussing OKLA. STAT. ANN. tit. 16, § 11A).

viewed as mortgages, most installment contracts are inadequately drafted. For instance, they often do not even contain acceleration clauses. They also usually fail to make the appropriate references to the jurisdiction's power-of-sale foreclosure statute and procedure, thus making judicial foreclosure necessary. A drafter who insists on employing an installment contract should consider carefully whether the contract contains the clauses that will be desired if the courts treat the document as a mortgage.

The Mortgages Restatement recognizes that installment contracts make poor mortgages, and thus its objective is to discourage their use. From the drafter's viewpoint, use of installment contracts should generally be avoided. Few, if any, situations exist in which an installment land contract is the best choice for the parties. In planning the transaction, the lawyer would do well to consider using a mortgage or a deed of trust instead of an installment land contract.

V. NEGATIVE COVENANTS

Rather than obtaining a mortgage, creditors sometimes require the borrower to covenant not to convey or encumber certain real estate held by the borrower. A creditor may consider covenants not to convey or encumber real estate superior to a mortgage because they are not supposed to be subject to the jurisdiction's antideficiency, one-action, or other similar procedural limitations on recovery against defaulting borrowers.[41] If the creditor, at its option, may later characterize the negative pledge as a mortgage, then it seems to have an opportunity to have its cake and eat it too.[42]

However, under the Mortgages Restatement a negative covenant is not a mortgage.[43] The case law widely agrees.[44] Thus, the covenant cannot be

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[41] *See* NELSON & WHITMAN, *supra* note 30, § 3.38.

[42] *See* JOHN R. HETLAND, SECURED REAL ESTATE TRANSACTIONS 73 (1974).

[43] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 3.5.

[44] *See, e.g.,* Chase Manhattan Bank v. Gems-By-Gordon, Inc., 649 F.2d 710 (9th Cir. 1981); Sorran Bank v. United States (*In re* Aumiller), 168 B.R. 811 (Bankr. D.C. 1994); Crystal City State Bank v. Goldstein (*In re* Slover), 71 B.R. 9 (Bankr. E.D. Mo. 1986); *In re* Friese, 28 B.R. 953 (Bankr. D. Conn. 1983); Weaver v. Tri City Credit Bureau, 557 P.2d 1072 (Ariz. Ct. App. 1976); Tahoe Nat'l Bank v. Phillips, 480 P.2d 320 (Cal. 1971);

foreclosed. Indeed, whether the creditor has any satisfactory remedy for breach of a negative covenant is unclear. Of course, the creditor may sue for damages if the borrower breached the covenant by conveying or encumbering the real estate. But if the original debt was recourse in nature, a suit for damages adds nothing significant to the creditor's action on the debt.[45] That a court would order specific performance of a negative covenant by literally preventing the borrower from transferring the land is highly unlikely because doing so would require the court to impose a direct and egregious disabling restraint on alienation.[46]

In light of the limited and dubious nature of the remedies available to a lender on a negative pledge, the wisest course is simply not to use them. They are subject to the charge of being too cute. An ordinary mortgage or deed of trust is almost certainly a better choice, regardless of the procedural limitations imposed upon them by local law.

VI. ASSIGNMENTS OF RENTS

An assignment of rents is really a security interest in rents, given to a mortgagee as additional collateral for a mortgage loan. It might better be

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Equitable Trust Co. v. Imbesi, 412 A.2d 96 (Md. 1980); Perpetual Fed. Sav. & Loan Ass'n v. Willingham, 370 S.E.2d 286 (S.C. Ct. App. 1988).

[45] Professor Gilmore stated it as follows:

> [t]he 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 property.

GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1017 (1965).

[46] The closest any court has come to granting specific performance of a negative covenant is the California Supreme Court's dictum in *Coast Bank v. Minderhout*, 392 P.2d 265, 268 (Cal. 1969), *overruled by Wellenkamp v. Bank of America*, 582 P.2d 970 (Cal. 1978):

> Whether the promise not to transfer or encumber the property would be directly [enforceable] by injunction, specific performance or an action for damages is another question. It is open to doubt whether such a promise would be a reasonable restraint when, as in this case, plaintiff had the additional protection of a security interest and the right to declare the entire debt due in the event of default. It is unnecessary, however, to decide this question now.

This is not a ringing endorsement of specific enforcement of the negative covenant.

described as a "mortgage on rents." Such collateral can be highly useful in loans on income-producing real estate, particularly in jurisdictions where foreclosure is slow and in cases in which the mortgagor files for bankruptcy to delay foreclosure. Under the Mortgages Restatement a mortgage on rents is enforceable[47] and may be included in a mortgage on the real estate or created by a separate document. Many practitioners who represent lenders prefer to use a separate document because it highlights the existence of the interest in rents and may persuade a court to be more favorable to enforcing it.

Under the Mortgages Restatement a mortgage on rents is effective upon its execution, delivery, and recording.[48] For purposes of the Bankruptcy Code, the act of executing, delivering, and recording a mortgage would seem to establish that the mortgage on rents is perfected, even though the mortgagee is not yet collecting the rents.[49] Thus, the Mortgages Restatement should help to rebut the misguided bankruptcy cases that have held that perfection does not occur until the mortgagee commences actual collection of rents.[50]

The Mortgages Restatement provides that the documents may specify the time when the mortgagee becomes entitled to begin collection of the

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[47] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 4.2(b).

[48] *See id.*

[49] *See* 11 U.S.C. § 552(b) (1994). Unfortunately, the precise meaning of this section is far from clear, for reasons well beyond the scope of this Article. Thus, whether Congress's amendment of this section has adequately resolved the problem described in the next footnote is uncertain. *See* Wilson 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, 120-21 (1997).

[50] *See, e.g.*, *In re* Association Center Ltd. Partnership, 87 B.R. 142 (Bankr. W.D. Wash. 1988); Santa Fe Fed. Sav. & Loan Assoc. v. Oak Glen R-Vee (*In re* Oak Glen R-Vee), 8 B.R. 213 (Bankr. C.D. Cal. 1981). In reaction to such cases, lenders' counsel, by the beginning of the 1990s, began to describe the assignments of rents as "absolute" in the mortgage documents, even though it was perfectly obvious that they were not absolute because the lender in fact had no right to begin intercepting the rents until a default occurred on the underlying mortgage debt. The bankruptcy courts generally accepted this fiction as if it had some real-world significance, and began holding that such clauses were indeed perfected when recorded, and thus survived the attacks of bankruptcy trustees. *See generally* Patrick A. Randolph, Jr., *When Should Bankruptcy Courts Recognize Lenders' Rents Interests?*, 23 U.C. DAVIS L. REV. 833 (1990) (discussing "when and how a lender can gain recognition of . . . rights [to receive rents] after a mortgagee declares bankruptcy").

rents.[51] Thus, the mortgagee may begin collection when the loan is made, when the mortgagor fails to meet certain financial tests (such as a debt service coverage ratio test), or when the mortgagor defaults. Of course, the mortgage on rents should clearly spell out the conditions on which collection by the mortgagee depends.

To commence collection of the rents, the Mortgages Restatement provides that the mortgagee must first establish that any conditions to its collection of rents have been satisfied.[52] The mortgagee must then give written notice to the mortgagor, to any person who has subsequently acquired the real estate, and to any holder of a mortgage on the real estate or its rents.[53] As a practical matter, in most cases notice to the tenants also will be necessary.

When a loan is made, careful lenders often obtain a set of letters signed by the mortgagor addressed to each of the tenants. These letters, which are sent to the tenants only if and when the mortgagee is ready and entitled to begin collection of the rents, advise the tenants that the mortgagee has the right to the rents and that they should thereafter be paid to the mortgagee.

VII. RECEIVERS

Various jurisdictions have developed tests for determining when a mortgagee is entitled to appointment of a receiver of the mortgaged real estate. However, Mortgages Restatement section 4.3(b) shortcuts these tests, providing that the mortgagee is always entitled to a receiver if (1) the loan is in default, and (2) the mortgage contains either a mortgage on rents or a provision authorizing appointment of a receiver.[54] Mortgagees should ensure that their mortgages on income-producing property always contain such language.

Whether a receiver can collect imputed rent in the form of an occupancy charge from a mortgagor who is in personal possession of the

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[51] *See* MORTGAGES RESTATEMENT, *supra* note 1, at § 4.2(c).
[52] *See id.* § 4.2(c)(1).
[53] *See id.* § 4.2(c)(2).
[54] *Id.* § 4.3(b).

real estate and is not paying rent is questionable. The Mortgages Restatement generally denies the receiver any right to imputed rents,[55] unless the mortgage so provides[56] and the mortgage debt is not the personal liability of the mortgagor. Hence, from the mortgagee's viewpoint, including mortgage language making the mortgagor responsible for imputed rent in the event of a default and appointment of a receiver is generally desirable.

VIII. WASTE

That a mortgagee may recover for waste committed by the mortgagor or by third parties has long been recognized.[57] The judicially accepted definition of waste has been gradually expanding and now goes well beyond the traditional concept of physical damage to the mortgaged premises. The Mortgages Restatement defines waste very broadly, including not only physical damage but also failure to repair and maintain the property and failure to pay prior property taxes and assessments.[58] In an innovative step, the Mortgages Restatement also provides that waste includes the mortgagor's material failure to comply with mortgage covenants respecting the property's "physical care, maintenance, construction, demolition, or insurance."[59] Hence, if the mortgagee has special concerns about the

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[55] *See id.* § 4.3(d). Several New York cases deny receivers the right to collect imputed rent from mortgagors. *See* Grusmark v. Echelman, 162 F. Supp. 49 (S.D.N.Y. 1958) (stating that 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 the mortgagor is in possession of mortgaged premises on which he or she is conducting a business); Holmes v. Gravenhorst, 188 N.E. 285 (N.Y. 1933).

[56] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 4.3(d)(1). *See also* Union Dime Sav. Bank v. 522 Deauville Assoc., 398 N.Y.S.2d 483 (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 rental value of the use and occupation of any portion of the premises occupied by the mortgagor after the appointment of a receiver.").

[57] *See* NELSON & WHITMAN, *supra* note 30, § 4.4-.11; David A. Leipziger, *The Mortgagee's Remedies for Waste*, 64 CAL. L. REV. 1086 (1976); Jeffrey S. Bay, Comment, *Remedies for Waste in Missouri*, 47 MO. L. REV. 288 (1982).

[58] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 4.6.

[59] *Id.* § 4.6(a)(4).

physical condition of the premises, the mortgage may impose covenants concerning them and define a breach of those covenants as waste. This technique can be useful because a broad range of remedies is available for waste, including remedies under the mortgage such as foreclosure, injunction of the waste, and recovery of damages.[60] Waste can be a particularly powerful tool for the mortgagee in the case of a non-recourse loan in which the mortgagor has no personal liability for the mortgage debt. Because waste is a species of tort, recovery for waste may be available even if an action on the debt itself would be barred.[61]

IX. RESTORATION OF MORTGAGED PROPERTY FOLLOWING CASUALTY LOSS OR EMINENT DOMAIN

Virtually every mortgage contains a covenant by the mortgagor to insure the property. In such cases, many judicial decisions treat the proceeds of an insurance claim as "substituted collateral" and allow the mortgagee to demand that the funds be paid toward retirement of the

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[60] *See id.* § 4.6(b). All of these remedies are limited to cases in which the mortgagee's security has been impaired by the waste. Hence, a mortgagee who makes a full credit bid at foreclosure will be denied any other recovery for waste because such a bid establishes that the mortgage debt has been fully paid. *See* Allstate Fin. Corp. v. Zimmerman, 272 F.2d 323 (5th Cir. 1950); Sloss-Sheffield Steel & Iron Co. v. Wilkes, 165 So. 764 (Ala. 1936); Cornelison v. Kornbluth, 542 P.2d 981 (Cal. 1975); Band Realty Co. v. North Brewster, Inc., 398 N.Y.S.2d 724 (App. Div. 1977); Monte Enters., Inc. v. Kavanaugh, 303 S.E.2d 194 (N.C. Ct. App. 1983).

[61] *See, e.g.*, Jaffe-Spindler Co. v. Genesco, Inc., 747 F.2d 253 (4th Cir. 1984) (holding that waste is a tort and therefore, 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); United States v. Haddon Haciendas Co., 541 F.2d 777 (9th Cir. 1976) (holding that waste is a tort); Prudential Ins. Co. v. Spencer's Kenosha Bowl, Inc., 404 N.W.2d 109 (Wis. Ct. App. 1987) (entitling the mortgagee to assert a waste claim against nonassuming grantee). However, whether a non-recourse mortgagor will be personally liable for waste depends on the specific language of the non-recourse clause and it is entirely possible that the clause will be worded broadly enough to preclude the mortgagee's recovery for waste. *See* Travelers Ins. Co. v. 633 Third Assocs., 973 F.2d 82 (2d Cir. 1992). This suggests that the parties are well-advised to negotiate carefully the terms of any "carve-outs" from the non-recourse clause.

mortgage debt.[62] Perhaps surprisingly, this result is often reached even when no express mortgage clause gives the mortgagee access to the insurance proceeds.[63] Decisions granting the mortgagee such access can have a harsh impact on the mortgagor, particularly if current interest rates are much higher than the rate on the mortgage loan or if the mortgagor's credit has deteriorated so that getting new financing to pay for restoration of the damage will be difficult or impossible. The Mortgages Restatement rejects this view and instead gives mortgagors the right, when the property is damaged by a casualty loss or eminent domain taking, to access the insurance proceeds or condemnation award for restoration of the premises if (1) the restoration is reasonably feasible, and (2) after restoration, the property will have value equal to or greater than its value when the mortgage was made.[64] This result is consistent with the provision for insurance proceeds in the FNMA/FHMLC Uniform 1-to-4-family residential mortgage form[65] and is closer to the expectations of most

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[62] The mortgagee may not get the entire proceeds. A minority of the cases limit the mortgagee to receipt of the amount necessary to avoid impairment of the mortgagee's security. Nearly all the cases adopting this view deal with eminent domain awards rather than insurance proceeds. *See* Swanson v. United States, 156 F.2d 442 (9th Cir. 1946); Milstein v. Security Pac. Nat'l Bank, 103 Cal. Rptr. 16 (Ct. App. 1972); First W. Fin. Corp. v. Vegas Continental, 692 P.2d 1279 (Nev. 1984); Buell Realty Note Collection Trust v. Central Oak Inv. Co., 483 S.W.2d 24 (Tex. App. 1972), *aff'd per curiam,* 486 S.W.2d 87 (Tex. 1972).

[63] *See, e.g.*, Pare v. Natale (*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); Loving v. Ponderosa Sys., Inc., 479 N.E.2d 531 (Ind. 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); 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 Servs., Inc. v. Poole, 738 S.W.2d 68 (Tex. App. 1987). *See generally* NELSON & WHITMAN, *supra* note 30, §§ 4.13-.14 (discussing the insurable interests and types of policies available to mortgagors and mortgagees).

The same approach is usually taken with respect to eminent domain awards. *See Swanson*, 156 F.2d 442; Carson Redev. Agency v. Adam, 186 Cal. Rptr. 615 (Ct. App. 1982); Department of Transp. v. New Century Eng'g & Dev. Corp., 454 N.E.2d 635 (Ill. 1983); Silverman v. State, 370 N.Y.S.2d 234 (App. Div. 1975); Wynnewood Bank v. State, 767 S.W.2d 491 (Tex. App. 1989).

[64] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 4.7.

[65] Clause 10, FNMA/FHLMC Uniform Mortgage—Deed of Trust Covenants—Single Family, reprinted in GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE & DEVELOPMENT (4th ed. 1992) at 1310.

borrowers.[66]

The Mortgages Restatement rule is, however, reversible by express language in the mortgage that waives the mortgagor's right to use the funds for restoration.[67] The Mortgages Restatement's comment warns that such a waiver might be unenforceable if the courts regard it as unconscionable or as contrary to the implied covenant of good faith and fair dealing.[68] These issues are most likely raised in the context of residential or consumer loans, but they might arise in a commercial real estate loan as well. A mortgagee who wants the mortgagor to waive the right to use the funds for restoration should therefore include mortgage language (1) highlighting the waiver, (2) reciting that the mortgagor fully understands that no right to use the funds for restoration will exist, and (3) reciting that the mortgagor regards this result as fair and not unconscionable. The mortgagee might also wish to call the mortgagor's attention to the waiver in a separate letter or other notice.

X. ASSUMPTIONS OF MORTGAGES

Mortgages Restatement sections 5.1 and 5.2 highlight the legal differences between a real estate purchaser who assumes a mortgage obligation and one who takes merely subject to the obligation. The differences can be highly significant,[69] but the parties often overlook or

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[66] The *Mortgages Restatement*'s position is supported by only a few cases. *See* Schoolcraft v. Ross, 146 Cal. Rptr. 57 (Ct. App. 1978) (allowing mortgagor to use insurance proceeds for restoration despite mortgage clause allowing mortgagee to pay them on the debt); Fergus v. Wilmarth, 7 N.E. 508 (Ill. 1886); Hatch v. Commerce Ins. Co., 249 N.W. 164, *opinion on rehearing*, 249 N.W. 824 (Iowa 1933) (holding vendee's insurance proceeds apply to construction of a new building); Starkman v. Sigmond, 446 A.2d 1249 (N.J. Super. Ct. Ch. Div. 1982) (holding insurance money payable to the mortgagors when the value of the land exceeds the balance of the mortgage).

[67] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 4.7(b) (allowing the proceeds to be used for restoration "[u]nless the mortgage effectively provides the contrary").

[68] *See id.* § 4.7 cmt. e.

[69] Purchasers who assume a mortgage obligation become personally and primarily liable on the debt, with the original mortgagor having liability as a surety. Purchasers who do not assume a mortgage obligation are not personally liable, but are merely subject to the risk of losing the real estate in foreclosure. In non-assumption transactions, the real estate becomes primarily liable, with the original mortgagor again becoming a surety. *See*

misunderstand these differences. The attorney handling a sale transaction for either the purchaser or seller should be certain that the deed, contract of sale, and any side agreements or other documents consistently and clearly state that the mortgage either will be assumed or will be taken subject to the obligation.[70]

A related issue arises when the lender enters into a modification of the arrangement with the real estate buyer after a transfer of real estate with a mortgage either assumed or taken subject to the obligation. Under traditional rules, most forms of modification completely discharge the original mortgagor's obligations under the debt and the mortgage.[71] The Mortgages Restatement takes a more moderate approach. In general, the Mortgages Restatement provides that such a modification discharges the mortgagor only to the extent that the mortgagor would otherwise be harmed by the modification.[72]

Nonetheless, lenders should know that modifying the obligation without joining the original mortgagor in the negotiations may allow the original mortgagor to walk away from the debt. For example, suppose a lender approves, under the authority of its due-on-sale clause, a transfer of the real estate to an assuming purchaser. If the lender subsequently makes an agreement with the purchaser to increase the interest rate, the lender's claim

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MORTGAGES RESTATEMENT, *supra* note 1, at §§ 5.1-5.2; NELSON & WHITMAN, *supra* note 30, §§ 5.1-5.8.

[70] The best practice is to put the purchaser's promise to pay the debt and perform the other mortgage covenants into a separate "assumption agreement," so that it will specifically be called to the purchaser's attention.

[71] *See* Chrysler First Bus. Credit Corp. v. Kawa, 914 P.2d 540 (Colo. Ct. App. 1996) (holding that the mortgagee's release of the mortgage security discharges the original mortgagor's liability); Moss v. McDonald, 772 P.2d 626 (Colo. Ct. App. 1988) (holding that the agreement between mortgagee and assuming purchaser, extending time for payment, discharges the original mortgagor's liability); First Fed. Sav. & Loan Ass'n v. Arena, 406 N.E.2d 1279 (Ind. Ct. App. 1980) (holding that an agreement between mortgagee and assuming purchaser, increasing the interest rate, discharges original mortgagor's liability); Brockton Sav. Bank v. Shapiro, 88 N.E.2d 344 (Mass. 1949) (holding that a mortgagee's release of assuming purchaser from personal liability discharges original mortgagor's liability). *See generally* NELSON & WHITMAN, *supra* note 30, §§ 5.18 -.20 (discussing the modification of rights after a transfer of interest).

[72] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 5.3. The *Mortgages Restatement*'s position is consistent with RESTATEMENT OF SURETYSHIP AND GUARANTY §§ 37-49 (1997) and U.C.C. § 3-605 (1990) (dealing with the discharge of accommodation parties to notes).

against the original mortgagor may be wholly or partially lost unless the mortgagor consents to the increase.[73] Hence, getting the mortgagor's consent is highly desirable. As a practical matter, obtaining the mortgagor's consent as a condition of the mortgagee's approval of the sale is the easiest option. Once the sale has been consummated, the mortgagor has little incentive to cooperate in giving consent.

Good drafting can eliminate this problem entirely for lenders. If the original mortgage contains language by which the mortgagor consents to all future modifications, releases, and the like between the mortgagee and a purchaser of the real estate, that consent will be binding on the mortgagor. Consequently, the mortgagor will not be discharged by any modification or release.[74] However, to be effective the clause must be carefully and broadly drafted. If the clause only mentions certain types of modifications or releases, the mortgagor may still be discharged if a different type of modification or release occurs.[75] To be complete, the clause should mention release or impairment of any of the real estate security, damage or waste to the security, release of any assuming purchaser, modification of the terms of payment, and extension of time for payment.

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[73] *See* Oellerich v. First Fed. Sav. & Loan Ass'n, 552 F.2d 1109 (5th Cir. 1977).

[74] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 5.3 cmt. g. *See also* Phillips v. Plymale, 381 S.E.2d 580 (Ga. Ct. App. 1989) (upholding the mortgagor's obligation because the mortgagor consented in sale contract); Kent v. Rhomberg, 6 N.E.2d 271 (Ill. App. Ct. 1937) (upholding liability when the mortgagor consented to an extension of time in the trust deed); Mutual Life Ins. Co. v. Rothschild, 160 N.Y.S. 164 (App. Div. 1916), *aff'd*, 123 N.E. 880 (N.Y. 1918) (holding that the mortgagor agreed in advance to extension agreements); Federal Land Bank v. Taggart, 508 N.E.2d 152 (Ohio 1987) (holding that the reservation to extend time in the contract binds the accommodation party). Such a consent clause is sometimes referred to as a "survival" or "waiver of defenses" clause.

[75] Courts often construe these clauses narrowly. This point is well illustrated by *First Federal Savings & Loan Ass'n v. Arena*, 406 N.E.2d 1279 (Ind. Ct. App. 1980), in which the mortgage clause provided that the mortgagor consented to any future agreement between the mortgagee and a purchaser that extended the time for payment of the debt. The mortgagee not only extended the purchaser's time for payment but also increased the interest rate on the loan. The court held the latter modification to be outside the scope of the original mortgage clause, and hence discharged the mortgagor completely.

XI. SECONDARY MARKET TRANSFERS OF MORTGAGES

A great majority of cases hold that when a mortgagee transfers the note or other evidence of the obligation, the mortgage automatically follows it.[76] Thus, no formal mortgage assignment is required. The Mortgages Restatement agrees,[77] holding that a transfer of the mortgage automatically transfers the obligation,[78] except when the UCC prevents that result (as it does with a negotiable note).[79]

This does not mean that a mortgage investor (a secondary-market purchaser) can safely take a transfer of the debt without getting an assignment of the mortgage. The reason is that the assignee has a strong interest in recording the assignment, which can be accomplished only if the assignee obtains a written assignment.[80]

Occasionally one sees a transaction in which a mortgage has been transferred to one party, while the obligation it secures is transferred to another. For example, the Federal Home Loan Mortgage Corporation's

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[76] *See, e.g.*, Unsecured Creditors' Comm. v. Showmint Worcester County Bank (*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. 1989); First Nat'l Bank v. Larson (*In re* Kennedy Mortgage Co.), 17 B.R. 957 (Bankr. D.N.J. 1982); Rodney v. Arizona Bank, 836 P.2d 434 (Ariz. Ct. App. 1992); Domarad v. Fisher & Burke, Inc., 76 Cal. Rptr. 529 (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).

[77] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 5.4(a).

[78] *See id.* § 5.4(b). The cases are divided on this point. *Compare* United States v. Freidus, 769 F. Supp. 1266 (S.D.N.Y. 1991) (holding that an assignment of a mortgage automatically transfers the note as well) *with* Pierce v. Tavormina (*In re* Hurricane Resort Co.), 30 B.R. 258 (Bankr. D. Fla. 1983) (holding that an assignment of a mortgage without the note is a nullity).

[79] U.C.C. § 3-202 (1987) is generally understood to make the right of enforcement of a negotiable promissory note transferrable only by delivery of the instrument itself. Hence, it would appear that an assignment of the mortgage without delivery of the negotiable note cannot transfer the right to enforce the note.

[80] If the assignee fails to record the assignment, it is entirely possible for the original mortgagor and mortgagee to enter into a collusive and fraudulent release of the mortgage, and then to purport to sell the real estate free and clear of the mortgage to a bona fide purchaser. The case law consistently holds that such a bona fide purchaser will take the property free of the assignee's rights under the unrecorded assignment. *See* Brenner v. Neu, 170 N.E.2d 897 (Ill. App. Ct. 1960); Kalen v. Gelderman, 278 N.W.2d 165 (S.D. 1938). Hence, careful mortgage assignees always record their assignments.

(FHLMC) procedures allow an apparent separation of the note and the mortgage. However, this is not problematic because the loan servicers are agents of FHLMC and are controlled by it. Specifically, the procedure states:

> When the mortgage loan is sold to Freddie Mac, the lender endorses the note "in blank" and delivers the note to Freddie Mac or our custodian. The note remains in our or our custodian's possession until the loan is paid off, foreclosed or repurchased by the mortgage loan servicer. The assignee of the note also prepares an assignment of the mortgage which is held by the custodian, but is not recorded until Freddie Mac instructs the custodian to do so. The assignee of the note usually is the servicer of the mortgage and remains the mortgagee of record until and unless Freddie Mac has the assignment recorded. This arrangement accommodates the mortgage servicer and Freddie Mac.[81]

The FNMA process is essentially identical.

Transferring a mortgage to one party and the obligation it secures to another rarely makes sense unless one of the transferees controls the other as in FHLMC's case.[82] The reason, as the Mortgages Restatement points out, is that a mortgage is enforceable only by or on behalf of a person who can enforce the obligation that the mortgage secures.[83] Parties who hold the mortgage, but who cannot enforce the note it secures, can never experience a default because nothing is owed to them. Hence, such mortgage holders can never foreclose the mortgage. In effect, splitting the mortgage from the note simply wastes the mortgage security without providing any benefit. A lawyer contemplating a transaction that will split the mortgage and the obligation, putting them in the hands of two unrelated parties, should consider carefully the wisdom of doing so; it is almost always a bad idea.

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[81] Letter from James A. Newell, Associate General Counsel, Federal Home Loan Mortgage Corporation, to the author (Oct. 2, 1996) (on file with the author). *See* FEDERAL NATIONAL MORTGAGE ASS'N, SELLING GUIDE, § 204 (1986).

[82] *See id.*

[83] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 5.4(c).

XII. PAYMENT AND PREPAYMENT

The common law, which is still widely followed, holds that a mortgagee has no duty to accept a prepayment unless the mortgage or note so provides.[84] This so-called "perfect tender in time" rule is contrary to most borrowers' expectations.[85] The Mortgages Restatement reverses the rule, providing that all mortgages are freely prepayable unless a specific agreement between the parties restricts or prohibits prepayment.[86] Thus, mortgagees who wish to limit the borrower's prepayment privilege must do so explicitly, ordinarily by a clause in the mortgage or promissory note. Lenders who previously left their mortgages silent with respect to prepayment are now well-advised to revise their forms to cover the matter expressly.

Express restrictions and fees upon prepayment of a mortgage obligation are generally enforceable under the Mortgages Restatement.[87] However, a prepayment resulting from an insured casualty loss or an eminent domain taking may not trigger a prepayment fee if the funds could feasibly have been used to restore the property, but for the existence of a mortgage clause waiving the mortgagor's right to use the funds for restoration. As noted above, such a clause may be enforceable,[88] but if the mortgagee enforces it, the resulting prepayment is completely involuntary from the mortgagor's viewpoint. Moreover, the mortgagee has no economic justification for demanding prepayment because permitting the funds to be used for restoration of the property causes the mortgagee no economic harm. Thus, the Mortgages Restatement asserts that the lender should not be permitted to charge a prepayment fee when an insured casualty loss or an eminent

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[84] *See* Brannon v. McGowan, 683 So. 2d 994 (Ala. 1996); 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); Patterson v. Tirollo, 581 A.2d 74 (N.H. 1990); Arthur v. Burkich, 520 N.Y.S.2d 638 (App. Div. 1987); Young v. Sodaro, 456 S.E.2d 31 (W.Va. 1995).

[85] *See* Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 CORNELL L. REV. 288 (1987); Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis,* 40 UCLA L. REV. 851 (1993).

[86] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 6.1.

[87] *See id.* § 6.2.

[88] *See supra* text accompanying note 61.

domain taking occurs, even if the mortgage documents provide for a fee.[89]

XIII. PRIORITY OF PURCHASE-MONEY MORTGAGES

The Mortgages Restatement agrees with traditional case law in giving purchase-money mortgages a presumed priority over other liens attaching to the property at the same time or in the same transaction.[90] Moreover, purchase-money mortgages given to vendors of the real estate are presumed to have priority over such mortgages given to third-party lenders.[91]

In a land purchase involving two purchase-money mortgages, one to the vendor and one to a third-party institutional lender, this rule can unexpectedly result in giving the vendor first priority even though the third-party lender anticipated having that status. Fulfilling the third-party lender's expectations is easy, assuming all parties agree, but it must be done explicitly. For example, an express subordination clause may be included in the mortgage to the vendor, or the vendor's mortgage may expressly describe itself as a second mortgage, junior to the third-party lender's mortgage.[92] Another alternative is to have the vendor execute a separate subordination agreement. Lawyers often assume that the desired priorities can be established simply by recording the third-party lender's mortgage first and then recording the vendor's mortgage, but this is a weak straw on which to rely.[93] An express, recorded statement of the desired priorities is

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[89] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 6.3. Whether a mortgagee can enforce a prepayment fee when the prepayment in question is derived from a casualty insurer's payoff or an eminent domain award is not yet clear. Very little authority is on point, but courts probably will sustain such fees if they are provided for clearly in the mortgage documents. *See* Village of Rosemont v. Maywood-Proviso State Bank, 501 N.E.2d 859, 862 (Ill. App. Ct. 1986); Melin v. TCF Fin. Corp., No. C6-94-2586, 1995 WL 265064, at *1-2 (Minn. Ct. App. May 9, 1995).

[90] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 7.2(b).

[91] *See id.* § 7.2(c).

[92] *See id.* § 7.2 cmt. d.

[93] Relying on the order of recording is weak because of the structure of the recording acts. Except in the few states in which pure "race" statutes exist, recording acts operate to change the common law priorities, and give priority to the subsequent purchaser (the third-party mortgagee in the scenario in the text) only when the subsequent purchaser does not have notice of the prior conveyance. However, in a contest between two purchase-money mortgagees, a vendor and a third-party lender, each mortgagee is typically fully aware of the

much more effective than simply relying on who recorded first.[94]

However, one could argue that, by expressly directing the closing attorney, title company, or other closing agent to record the third party lender's mortgage first, the parties have expressed a mutual intent to give the third party priority over the vendor. Courts often seem to accept this argument, but rarely with any cogent analysis. For that reason, a written expression of the parties' intent with respect to priority is a much better practice. Even courts that might otherwise accept the order of recording as evidence of the parties' intent also recognize that a clear (and preferably written) expression of intent will override the order of recording.[95]

Purchase-money mortgages, both to vendors and to third parties, have a presumed priority over other liens attaching at the same time, such as the liens of previously-obtained judgments against the purchaser of the real estate.[96] Although this protection is advantageous to purchase-money mortgagees, it is available only for loans that courts are willing to characterize as purchase-money in nature. The Mortgages Restatement includes construction loans within its description of purchase-money mortgages, provided that the construction mortgage is given as part of the same transaction in which title is acquired.[97] A construction lender might persuade a court to view its mortgage as a purchase-money mortgage by expressly reciting that the construction loan is regarded by the parties as a purchase-money mortgage. All construction lenders should take this simple step.

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other's role in the transaction. Nobody lacks notice, and consequently the recording acts change nothing. Hence, the order of recording is technically irrelevant. This point is recognized in *Friarsgate, Inc. v. First Fed. Sav. & Loan Ass'n*, 454 S.E.2d 901, 904 (S.C. Ct. App. 1995).

[94] *See* FDIC v. Republicbank, 883 F.2d 427, 429 (5th Cir. 1989); Colonial Villas, Inc. v. Title Ins. Co. of Minn., 703 P.2d 534, 536 (Ariz. Ct. App. 1985).

[95] *See* ; Monterey Devel. Corp. v. Lawyer's Title Ins. Co., 4 F.3d 605 (8th Cir. 1993); *FDIC*, 883 F.2d 427; *In re* Mihalko, 87 B.R. 357 (Bankr. E.D. Pa. 1988); Bankwest, Inc. v. United States, 102 B.R. 738 (D.S.D. 1989); Community Title Co. v. Crow, 728 S.W.2d 652, 654 (Mo. Ct. App. 1987).

[96] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 7.2(b).

[97] *See id.* § 7.2(a)(2).

XIV. REPLACEMENT AND MODIFICATION OF MORTGAGES

A mortgagee who replaces an old mortgage or note with a new one nearly always wishes to retain the priority status of the old mortgage. Indeed, loss of the original mortgage's priority can often be disastrous to the lender. The Mortgages Restatement,[98] like most case law, provides that the new mortgage retains the old mortgage's priority except to the extent that it incorporates changed terms materially prejudicial to holders of junior interests.[99] If the terms of the new mortgage differ from the old, the case technically involves both a replacement and a modification of the old mortgage. Modifications typically lose priority, as against intervening interests, to the extent that the modification is prejudicial to them. Prejudicial modifications include interest rate increases and increases in the outstanding principal balance.[100]

However, case law is not entirely consistent. The South Carolina Supreme Court held that a modified mortgage entirely lost its priority as against another lien which had been voluntarily subordinated to the mortgage in question, irrespective of the amount of prejudice that might have resulted from the modification.[101] The court reasoned that the subordination was made to the original mortgage, and no other.[102]

In contrast, a recent California case held that a modified mortgage had full priority over intervening liens, whether the modification was prejudicial to them or not.[103] The case simply seems wrong. Its implication is that no lender can ever safely take a second mortgage, because the first mortgage might later be modified in a manner that would entirely wipe out the borrower's remaining equity in the real estate.

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[98] *See id.* § 7.3.

[99] *See, e.g.,* Skaneateles Sav. Bank v. Herold, 376 N.Y.S.2d 286 (App. Div. 1975) *aff'd*, 359 N.E.2d 701 (N.Y. 1976).

[100] *See, e.g.*, Bank of Searcy v. Kroh, 114 S.W.2d 26 (Ark. 1938); Prudential Ins. Co. v. Nuemberger, 284 N.W. 266 (Neb. 1939); Fleet Bank v. County of Monroe Indus. Dev. Agency, 637 N.Y.S.2d 870 (App. Div. 1996); Shultis v. Woodstock Land Dev. Assoc., 594 N.Y.S.2d 890 (App. Div. 1993); Werner v. Automobile Fin. Co., 12 A.2d 31 (Pa. 1940); Mergener v. Fuhr, 208 N.W. 267 (Wis. 1926).

[101] *See* Citizens & Southern Nat'l Bank v. Smith, 284 S.E.2d 770 (S.C. 1981).

[102] *See id.*

[103] *See* Friery v. Sutter Buttes Sav. Bank, 72 Cal.Rptr.2d 32 (Ct. App. 1998).

A modification that simply extends the time for payment is generally not regarded as prejudicial to intervening interest holders because its likely effect is to benefit them by giving the borrower additional time to pay, and thus to reduce the probability of default on the senior mortgage debt.[104]

Unfortunately, lenders sometimes lose the benefits of the rule that the new mortgage retains the old mortgage's priority unless it incorporates terms materially prejudicial to junior interest holders, simply because they fail to clarify that the new mortgage is intended to replace the old one. A drafter of a replacement mortgage should always incorporate language clearly reciting that it replaces a specifically identified previous mortgage and that the parties intend to give the new mortgage the priority of the old one.

If the new mortgage changes the terms of the old one or if a mortgage obligation is simply modified to change its terms, a court may hold that priority is lost in favor of intervening liens to the extent that the changes are materially prejudicial to them. A mere extension of the maturity date is usually not held prejudicial, but increases in the interest rate, the principal amount, or the monthly payments may well be prejudicial.[105] The drafter of the modification can do little to resist this characterization by the courts, but no harm can be done in reciting that the parties do not consider the changes prejudicial to intervening interest-holders.

XV. AFTER-ACQUIRED PROPERTY CLAUSES

As between the parties, a mortgage can effectively cover the mortgagor's after-acquired property if it contains a suitable clause so providing. However, such clauses are problematic with respect to third parties who take interests, such as deeds, mortgages, or leases, in real estate

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[104] *See* Resolution Trust Corp. v. BVS Dev., Inc., 42 F.3d 1206 (9th Cir. 1994); *In re* Earl, 147 B.R. 60 (Bankr. N.D.N.Y. 1992); Lennar Northeast Partners v. Buice Revocable Living Trust, 57 Cal. Rptr. 2d 435 (Ct. App. 1996); Eurovest Ltd. v. 13290 Biscayne Island Terrace Corp., 559 So. 2d 1198 (Fla. Dist. Ct. App. 1990); Guleserian v. Fields, 218 N.E.2d 397 (Mass. 1966); Shultis v. Woodstock Land Dev. Assoc., 594 N.Y.S.2d 890 (App. Div. 1993).

[105] *See supra* notes 85-88.

that the mortgagor acquires after giving a mortgage with an after-acquired property clause. One problem is that the index in the recorder's office does not show what land may be affected in the future by prior recorded mortgages with after-acquired property clauses. Hence, a title searcher for a later grantee, mortgagee, or lessee can discover that the original mortgage was executed by the mortgagor, but cannot tell what land it affects. Thus, determining whether the mortgagor has actually taken title to the real estate so that the mortgage lien can attach to it becomes a tedious business of reading every conveyance to persons bearing that mortgagor's name. If the mortgagor is an active real estate speculator or investor, the task becomes monumental. The search becomes virtually impossible when the mortgage containing the after-acquired property clause is recorded in a different county or state, making the task analogous to searching for a needle in a haystack.

To circumvent these difficulties for future title examiners, the Mortgages Restatement provides that, as against any third party acquiring an interest in the after-acquired property, an after-acquired property clause is effective only after the mortgagee records a notice in the public records that specifically identifies the additional property and refers to the mortgage containing the after-acquired property clause.[106] Several recent cases support this approach.[107]

Under this rule, an after-acquired property clause has little value unless the mortgagee sets up a workable procedure for monitoring the mortgagor's future land acquisitions. When the mortgagor acquires any new parcel of land, the mortgagee must take immediate steps to record the required notice extending the lien of the original mortgage to the new property. If this is not done, any later transfer of the land by the mortgagor to a third party will take priority over the mortgage. Counsel whose clients rely on after-acquired property clauses must teach them to abide by this principle.

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[106] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 7.5(b).

[107] *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); Far West Sav. & Loan Ass'n v. McLaughlin, 246 Cal. Rptr. 872 (Ct. App. 1988); Security Pac. Fin. Corp. v. Taylor, 474 A.2d 1096 (N.J. Super. Ct. Ch. Div. 1984); Schuman v. Roger Baker & Assoc., 319 S.E.2d 308 (N.C. Ct. App. 1984).

XVI. LOANS TO PAY PRIOR MORTGAGES AND THE DOCTRINE OF SUBROGATION

Consider the lender who makes a mortgage loan to a borrower to refinance and pay off an existing mortgage loan. Such a lender, if well-advised, will obtain a title examination to ensure that no intervening liens exist and that the new mortgage will have the same priority as the original mortgage. However, a lender who engages in such refinancing will occasionally fail to get a title examination, or the examination may be conducted erroneously. As a result, the lender will be unaware of an intervening lien. In such cases, courts usually employ the doctrine of equitable subrogation to grant the new lender the priority of the original mortgage.[108] This result imposes no hardship on the intervening lienor, who remains in exactly the same position as if the refinancing had not occurred.

Traditional case law grants this right of subrogation only if the refinancing lender has no actual knowledge of the intervening lien.[109] This rule is oddly counterintuitive because it rewards those who do not procure a title examination. The Mortgages Restatement broadens the refinancing lender's subrogation right, granting it the original mortgage's priority if the lender reasonably expected to get that priority, even if the lender knew about the intervening lien.[110] Seeing any sensible objection to this result is difficult because denying subrogation simply gives the intervening lienor an expected windfall promotion in priority, usually at the expense of the refinancing lender's title insurance company. However, whether most courts will adopt the Mortgages Restatement's approach in this respect is

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[108] This is only one of numerous situations in which the principle of equitable subrogation may be applied. *See* NELSON & WHITMAN, *supra* note 30, §§ 10.1-10.8.

[109] *See* United States v. Baran, 996 F.2d 25 (2d Cir. 1993) (applying New York law); Han v. United States, 944 F.2d 526 (9th Cir. 1991) (applying California law); Herberman v. Bergstrom, 816 P.2d 244 (Ariz. Ct. App. 1991); Smith v. State Sav. & Loan Ass'n, 223 Cal. Rptr. 298 (Ct. App. 1985); Louisiana Nat'l Bank v. Belello, 577 So. 2d 1099 (La. Ct. App. 1991); United Carolina Bank v. Beesley, 663 A.2d 574 (Me. 1995); Metrobank for Sav. v. National Community Bank, 620 A.2d 433 (N.J. Super. Ct. App. Div. 1993); Rusher v. Bunker, 782 P.2d 170 (Or. Ct. App. 1989); Pee Dee State Bank v. Prosser, 367 S.E.2d 708 (S.C. Ct. App. 1988).

[110] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 7.6(b)(4).

uncertain. Only a minority of courts have yet done so.[111]

An attorney for a refinancing lender can strengthen the client's position in at least two ways. One method is to recite in the refinancing mortgage that the mortgagee is unaware of any intervening lien and expects to have the priority of the original mortgage. If the Mortgages Restatement is followed, this recitation should help to bring the refinancing lender within its coverage. An additional and better approach for the refinancing lender is to use the doctrine of "conventional" (*i.e.*, express contractual) subrogation by entering into an agreement with the borrower which provides that the refinancing mortgage is to be substituted for the original mortgage and to retain its priority. If a specific agreement is made, the courts no longer insist, as they often do as a prerequisite to equitable subrogation, that the refinancing lender have no knowledge of the intervening lien.[112]

If the refinancing lender is actually aware of an intervening lien, the most certain method of ensuring the refinancing loan's priority is not to rely on the doctrine of subrogation at all. Instead, the holder of the original mortgage should assign it and its associated promissory note to the refinancing lender in return for a full payment of the outstanding debt. Then the refinancing lender should obtain the borrower's signature on a replacement note and mortgage, using the principles of replacement mortgages discussed above.[113] This procedure virtually insures that the priority of the original mortgage will be preserved.

XVIII. SUBORDINATION

Mortgagees are occasionally willing voluntarily to subordinate the priority of their mortgage liens. Voluntarily subordinating priority

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[111] *See* Klotz v. Klotz, 440 N.W.2d 406 (Iowa Ct. App. 1989); Trus Joist Corp. v. National Union Fire Ins. Co., 462 A.2d 603 (N.J. Super. Ct. App. Div. 1983), *rev'd on other grounds*, Trus Joist Corp. v. Treetop Assoc., 477 A.2d 817 (N.J. 1984); Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex. App. 1994); Med Center Bank v. Fleetwood, 854 S.W.2d 278 (Tex. App. 1993).

[112] *See, e.g.*, Wolf v. Spariosu, 706 So.2d 881 (Fla. Dist. Ct. App. 1998).

[113] *See supra* text accompanying notes 83-88.

obviously increases a mortgagee's risk of ultimate loss, but business considerations may persuade the mortgagee that subordination makes sense. When the subordination is to an existing mortgage the terms of which are known, the subordinating party can make an intelligent decision whether the risk is acceptable.

However, a mortgagee is sometimes asked to subordinate to a non-existent mortgage. Because the terms of the new mortgage cannot be known with precision, this sort of prospective subordination is obviously more risky. In such cases, the Mortgages Restatement states that the subordination must describe "with reasonable specificity" the terms of the future mortgage which will have priority.[114] This rule is admittedly paternalistic; its objective is to prevent the subordinating mortgagee from unwisely accepting a risk of unknown and possibly devastating dimensions.

Prospective subordination seems to occur commonly in the case of a landowner who sells to a developer, taking back a purchase-money mortgage for part of the selling price, and agreeing to subordinate to a construction or land development loan to be obtained by the developer in the future. Surprisingly, often such subordinations are expressed in almost unimaginably vague language, such as: "Vendor agrees to subordinate to a construction loan." Plainly, this description does not satisfy the Mortgages Restatement's test of reasonable specificity. Perhaps the greatest risk to the subordinating land seller is that the construction or development loan funds will be disbursed by the lender without adequate supervision. Thus, the

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[114] MORTGAGES RESTATEMENT, *supra* note 1, § 7.7. The *Mortgages Restatement* draws its position principally from California cases on the subject. The earliest of those cases included *Stockwell v. Lindeman*, 40 Cal. Rptr. 555 (Ct. App. 1964), and *Handy v. Gordon*, 422 P.2d 329 (Cal. 1967), noted in B.H. Glenn, Annotation, *Specific Performance: 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). *See also* Roskamp Manley Assocs., Inc. v. Davin Dev. & Inv. Corp., 229 Cal. Rptr. 186 (Ct. App. 1986) (holding that a subordination agreement, in addition to continuing specific terms of the subordinating mortgage, must be fair and reasonable to the holder of the first mortgage). Other jurisdictions take a similar approach. *See, e.g.*, Stenehjem v. Kyn Jin Cho, 631 P.2d 482 (Alaska 1981); Troj v. Chesebro, 296 A.2d 685 (Conn. Super. Ct. 1972); Malani v. Clapp, 542 P.2d 1265 (Haw. 1975); Hux v. Raben, 219 N.E.2d 770 (Ill. App. Ct. 1966), *aff'd*, 230 N.E.2d 831 (Ill. 1967); Grooms v. Williams, 175 A.2d 575 (Md. 1961); American Fed. 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).

funds may be diverted by the developer to other uses rather than being applied toward improvements on the land.[115] The Mortgages Restatement's comment to section 7.7 suggests that, in this context, the subordination should, at a minimum, include the following information about the construction loan gaining priority:

1. identification of the lender or type of lender;
2. an upper limit on the amount of the debt;
3. an upper limit on the interest rate;
4. a statement that the loan must be used for improvements to the premises; and
5. a reasonable description of the improvements.[116]

A well-advised subordinating vendor will wish to include a number of additional conditions and provisions to protect against overreaching or sloppy loan administration by the construction lender and the developer. However, this list is at least sufficient to make the subordination enforceable. Agreeing to include these items in the subordination is in the developer's interest because the developer may otherwise have failed to obtain an enforceable subordination.

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[115] A California court recently upheld the validity of a subordination arrangement in which this set of events occurred. *See* Swiss Property Management Co. v. Southern Cal. IBEW-NECA Pension Plan, 70 Cal. Rptr. 2d 587 (Ct. App. 1998). However, the subordination agreement clearly warned the land seller that the lender would take no responsibility to ensure that the loan funds would be applied toward improvements on the land. It stated:

> Lender in making disbursements pursuant to any such agreement is under no obligation or duty to, nor has Lender represented that it will, see to the application of such proceeds by the person or persons to whom Lender disburses such proceeds and any application or use of such proceeds for purposes other than those provided for in such agreement or agreements shall not defeat the subordination herein made in whole or in part.

Id. at 590. The court concluded that, under this clear language, the land seller was not entitled to relief when the construction funds were diverted to other uses. That this agreement was signed by the land seller after the actual lender had been identified and the exact terms of the construction loan were known in detail is significant; hence, this was not a prospective subordination agreement of the sort discussed in the text. Lenders in other jurisdictions might consider employing similar language, although no assurance exists that other courts will grant as much latitude for the operation of freedom of contract.

[116] MORTGAGES RESTATEMENT, *supra* note 1, § 7.7 cmt. b.

XIX. WRAPAROUND MORTGAGES

In a wraparound mortgage, the property is already encumbered by a preexisting mortgage that typically bears a relatively low interest rate. The wraparound mortgagee obtains a mortgage and note from the borrower that is usually for an amount larger than the balance owed on the preexisting or underlying loan. The transaction is commenced with the understanding and promise that the wraparound lender will make all payments on the underlying mortgage debt as they come due. The only payments that the borrower makes are those due on the wraparound mortgage. The wraparound lender disburses funds to the borrower only in an amount equal to the difference between the wraparound loan and the underlying loan balances.[117]

Questions arise when a wraparound mortgage is foreclosed.[118] For instance, at least one court has held that the wraparound lender may foreclose for the full balance owed on the wraparound debt.[119] Another court decided that the wraparound lender may retain the foreclosure proceeds and apply them to the underlying loan payments as they become due.[120] Yet another court asserted that the wraparound lender has an implied duty to forego making a distribution to the wraparound mortgagor and to pay off the underlying loan from the foreclosure proceeds.[121]

The results of these cases are highly problematic. Allowing the

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[117] For further discussion of wraparound mortgages, see NELSON & WHITMAN, *supra* note 30, § 9.8; Sam M. Galowitz, *How to Use Wraparound Financing*, 5 REAL EST. L.J. 107 (1976); Sanford M. Guerin, *Selected Problems in Wrap-Around Financing: Suggested Approaches to Due-on-Sale Clauses and Purchaser's Depreciable Basis*, 14 U. MICH. J.L. REFORM. 401 (1981); Mary Ann Arditto, Note, *The Wrap Around Deed of Trust: An Answer to the Allegation of Usury*, 10 PAC. L.J. 923 (1979); Wayne A. Schrader, Comment, *The Wrap-Around Mortgage: A Critical Inquiry,* 21 UCLA L. REV. 1529 (1974); James L. Isham, Annotation, *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).

[118] *See generally* NELSON & WHITMAN, *supra* note 30, § 9.8 (discussing the foreclosure of wraparound mortgages).

[119] *See* FPCI RE-HAB 01 v. E & G Inv., Ltd., 255 Cal. Rptr. 157 (Ct. App. 1989).

[120] *See* Park N. Partners, Ltd. v. Park N. Assoc. (*In re* Park N. Partners, Ltd.), 72 B.R. 79 (Bankr. N.D. Ga. 1987).

[121] *See* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580 (Tex. 1989).

wraparound lender to retain the full foreclosure sale amount results in unjust enrichment because the lender immediately receives a sum which it is only required to pay to the underlying lender gradually in installments over the underlying loan's remaining life.[122] Requiring the wraparound lender to pay off the underlying loan immediately is a problem because that loan may not be prepayable, or may be prepayable only with a substantial penalty.[123]

The Mortgages Restatement takes a different view from the case law. It provides that the wraparound lender may foreclose only for an amount equal to the difference between the wraparound loan balance and the underlying loan balance.[124] Any surplus received in such a foreclosure must be treated like any other foreclosure surplus. It is paid first to retire any encumbrances junior to the wraparound loan, with the balance going to the real estate owner. This approach is attractive because it recognizes that the wraparound loan is, after all, a second mortgage, and that it has a practical worth equal only to the difference between the wraparound and underlying loan balances.

That this issue has arisen at all may be surprising because one might expect the proper method of foreclosure accounting be agreed upon by the parties and explicitly incorporated into every wraparound mortgage. However, the wraparound mortgages in the reported cases are almost universally silent on handling foreclosure proceeds, which is a remarkable lapse in drafting. The Mortgages Restatement provides a useful guide and a clear rationale for drafting such clauses in wraparound mortgages.

XX. MARSHALING

When a mortgage covers multiple parcels of land, the marshaling doctrine dictates the order in which a court will sell the parcels of land in foreclosure. Marshaling's objective is to prevent unnecessary injury to the holders of junior interests when foreclosure of a senior mortgage is necessary.

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[122] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 7.8, reporters' note.
[123] *See id.*
[124] *See id.* § 7.8.

The marshaling doctrine has two branches. Under the first, known as the "two funds" doctrine, parcels which are not encumbered by subordinate interests are ordinarily foreclosed before parcels with subordinate interests.[125] If the first-foreclosed parcels bring enough money to satisfy the mortgage debt, foreclosing on the remaining parcels and destroying the junior interests on them may be unnecessary. The second branch of the marshaling principle, known as the "inverse order of alienation" rule, provides that, if all of the parcels covered by the mortgage in question also have junior interests, those parcels with more recently created subordinate interests should be foreclosed first.[126] The basis of the rule is that the more recent grantee or mortgagee can anticipate, from an examination of the public records, that the earlier grantees or mortgagees expected under the two funds rule to have the common grantor's remaining land (now conveyed to the more recent grantee) sold in foreclosure before their parcels were sold.[127]

In theory, marshaling will never be ordered by a court when it will materially prejudice the interests of the foreclosing mortgagee.[128] However, mortgagees are sometimes understandably cynical about this rule. They may suspect or fear that although eventually they will be permitted to foreclose on all of their security, marshaling will delay and complicate the foreclosure process, resulting in loss of value of some of the security.[129] Hence, senior mortgagees often resist marshaling and avoid it if possible.

The question thus arises whether a junior interest holder can waive the right to marshaling. The Mortgages Restatement's comment suggests that marshaling protection can be waived, but the waiver may occur in two very different contexts.[130] The first and most obvious is a waiver clause in the mortgage of a junior mortgagee who might otherwise seek marshaling when the senior mortgage is foreclosed. Such a waiver clause will undoubtedly be enforced. The junior mortgagee that has, in effect, conceded in advance that it will not seek marshaling will not be permitted to change its mind.[131]

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[125] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.6 cmt. b.
[126] *See id.* § 8.6 cmt. c.
[127] *See id.*; NELSON & WHITMAN, *supra* note 30, §§ 10.9-10.10.
[128] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.6(b)(3).
[129] *See id.* § 8.6 cmt. f, illus. 11.
[130] *See id.* § 8.6 cmt. e.
[131] *See* Raynor v. Raynor, 193 S.E. 216 (N.C. 1937).

A senior mortgagee may obtain a marshaling waiver by exercising the leverage of a due-on-encumbrance clause.[132] Under such clauses, the senior mortgagee may tell the borrower, "I will permit you to obtain a second secured mortgage loan on some of the parcels on which I have the senior lien, but only if the second mortgage contains a waiver-of-marshaling clause." Senior lenders with mortgages on multiple parcels of land should at least consider requiring such a waiver when they are approached by their borrowers for approval of subordinate financing.

The second context in which a marshaling waiver might occur is less certain to be effective. A senior mortgagee may simply provide, in its own mortgage, that "no mortgage subordinate to this one may assert the privilege of marshaling."[133] Although the Mortgages Restatement's comment suggests that these clauses are effective,[134] very little authority exists that supports that view.[135] The comment points out that if the waiver clause is inserted in a recorded senior mortgage, it will be in the record chain of title to the property, and anyone thereafter taking a junior mortgage should be held to have notice of it.[136] The waiver clause may make the taking of a junior mortgage less attractive to lenders. However, they cannot complain if they later discover that marshaling is unavailable to them because they have been fairly warned by the state of the record title.[137]

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[132] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.6 cmt. e.

[133] *Id.*

[134] *See id.*

[135] *See* Thompson v. Thomas, 185 P. 427 (Cal. Ct. App. 1919); Platte Valley Bank v. Kracl, 174 N.W.2d 724 (Neb. 1970) (holding that marshaling is not applied if it hinders or imposes hardship, inconveniences collection of debt, or deprives the senior creditor of contractual rights).

[136] *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.6 cmt. e.

[137] The issue raised in the text can be stated even more broadly. In general, what kinds of clauses in a senior mortgage can deny to junior mortgagees rights and remedies they would otherwise have? One can argue that if a due-on-encumbrance clause, which effectively prohibits the borrower from obtaining junior financing without the senior lender's consent, is enforceable, then virtually any conceivable restriction on the junior lender's rights should be equally enforceable—assuming it is recorded against the mortgaged property. Whether this is true is largely unexplored in case law. For example, what effect would a senior mortgage clause have if it not only prohibited junior mortgagees from seeking marshaling, but also denied them the right to accelerate their debts or foreclose their mortgages without the senior lender's consent? No authority exists that addresses this kind of clause.

A careful drafter of a senior mortgage on multiple parcels is well-advised to use both of the techniques described above. Thus, the drafter should include a generic waiver-of-marshaling clause in the senior mortgage and insert a due-on-encumbrance clause, using the leverage of that clause to exact specific waivers of marshaling from all future junior mortgagees.

XXI. CONCLUSION

This Article has described only some of the many drafting lessons one might learn from a careful review of the new Mortgages Restatement. In a broad sense, the Mortgages Restatement is a strong reminder that mortgage law is not static, but constantly changing. Lawyers habitually using mortgage forms of earlier years without reviewing them carefully will do a disservice to their clients. Good lawyers should strive to remain current as the law develops, and to keep their documents current as well.