Principles of Real Estate
Chapter 9-Mortgage Theory

This chapter explores the basics of mortgage theory, and delves into the components of a promissory note, mortgage instrument, and deed of trust. It will also outline foreclosures.

Overview
Objectives

At the end of this chapter, the student will be able to:

- Demonstrate the difference between title theory and lien theory
- Describe the purpose, contents and impact of the promissory note
- Define hypothecation/pledging
- Differentiate between a mortgagor and a mortgagee
- Define typical contents and clauses
- Recognize satisfaction of a mortgage
- Describe the purpose of a deed of trust
- Name the parties and roles involved in a deed of trust
- List typical content and clauses in a deed of trust
- Compare a deed of trust to a mortgage document
- Describe the difference between a mortgage and deed of trust in respect to a foreclosure
- Define foreclosure redemption
- Explain "quick title"

Mortgage Theory

The concept of mortgage lending originated in England under Anglo-Saxon law. Originally, a borrower (mortgagor) who needed to finance the purchase of land was forced to convey title to the property to the lender (mortgagee) to ensure payment of the debt. If the obligation was not paid, the borrower automatically forfeited the land to the creditor, who was already the legal owner of the property.

Through the years, English courts began to acknowledge that a mortgage was only a security device and the borrower was the true owner of the real estate. Under this concept, real estate -- including fixtures and items attached to the land -- was given as security for the payment of a debt.

Upon gaining independence from England, the original 13 colonies adopted the English laws as their own basic body of law. From their inception, American courts of equity considered a mortgage as a voluntary lien on real estate given to secure the payment of a debt or the performance of an obligation.
Title and Lien Theory

Some states recognized -- and still recognize -- a lender as the owner of mortgaged land. This ownership is subject to defeat upon full payment of the debt or performance of the obligation.

In other states, if a borrower defaults, the lender is required to foreclose the lien, offer the property for sale, and apply the funds received from the sale to extinguish the obligation.

- States in which ownership is subject to defeat upon full payment of the debt or performance of the obligation are called title theory states. Under title theory, a lender has the right to possess and/or to rent the mortgaged property upon default by the mortgagor.
- States that interpret a mortgage purely as a lien on real property are called lien theory states. In such states, if a borrower defaults, the lender is required to foreclose the lien, offer the property for sale, and apply the funds received from the sale to extinguish the obligation.
Promissory Note

The promissory note, referred to simply as a note, is a contract between a borrower, the obligor, and a lender, the obligee. It establishes the amount of the debt, the terms of repayment and the interest rate.

A note serves as the written evidence of a debt and to be valid must:

- Be in writing
- Be between a borrower and a lender who both have contractual capacity
- State the borrower's promise to pay a certain sum of money
- Show the terms of payment
- Be signed by the borrower (principal)
- Be voluntarily delivered by the borrower and accepted by the lender

If the note is secured by a mortgage or trust deed, it must say so. Otherwise, it is solely a personal obligation of the borrower. Although interest is not required to make the note valid, most loans do carry an interest charge; when they do, the rate of interest must be stated in the note.

In some states it is necessary for the borrower's signature on the note to be acknowledged and/or witnessed.

When the borrower signs a note, he becomes personally liable for the debt. If more than one borrower signs, each becomes jointly and severally liable. In other words, not only are the borrowers liable together, but each is responsible for the entire debt, not just a proportionate share of it.

Promissory Note-Negotiable Instrument

A promissory note is considered a negotiable instrument because the right to collect the payments may be transferred by endorsement or actual delivery of the instrument to a third party.

- To be negotiable, a promissory note must be a written promise to pay a certain sum of money, either on demand or at a predetermined
time. When the note provides that the sum is payable to the order of the person specifically named in the instrument, a transfer of the negotiable instrument is completed by an endorsement.

Some notes are payable to the bearer, the one who actually has possession of it. Such notes are transferred simply by delivery. A person who, in good faith and without notice of defect, pays valuable consideration to receive a note before it is due is known as a **holder in due course**. Unless the note has been marked paid and returned to the maker, he has no legal basis to refuse payment to a holder in due course.

**Promissory Note-Clauses**

The typical clauses contained within a mortgage note include:

- **Exculpatory Clause**
- **Acceleration Clause**
- **Prepayment Clause**

**Promissory Note-Exculpatory Clause**

An **exculpatory clause** is inserted in a mortgage note when the lender accepts the property as sole security for the debt, thereby waiving his right to a deficiency judgment.

This provision **eliminates the borrower’s personal guarantee of satisfying the debt regardless of what the proceeds are at a foreclosure sale.**

**Promissory Note-Acceleration Clause**

The **acceleration clause** allows the lender to demand that the entire loan balance be immediately paid in full should the borrower fail to make timely payments or comply with the other covenants in the mortgage contract and promissory note.

- If the borrower cannot pay off the loan, the mortgage is foreclosed and the property sold at public auction with the sale proceeds being applied to the debt.
- Most mortgage contracts provide a grace period during which the borrower can cure the default. Lenders usually prefer to accept
payments or restructure the terms of a loan rather than exercise their right to foreclose the mortgage.

- Without the acceleration clause, the lender could only sue for each payment as it became due.

**Promissory Note-Prepayment Clause**

A prepayment clause either allows a loan to be paid in part or in full prior to the maturity date. The prepayment can come with or without a penalty.

When a loan is amortized over a long term, the total interest paid by the borrower can be a larger amount of money than the principal of the loan. If an amortized loan is paid off ahead of its full term, the lender will collect less interest from the borrower. For this reason, some mortgage and trust deed notes require the borrower to pay a prepayment penalty against the unearned portion of the interest for any payments made ahead of schedule.

- A loan may not be prepaid without a prepayment clause allowing for it.
- The prepayment privilege is also called a right of anticipation.

**Mortgage Instrument**

The mortgage is a separate agreement from the promissory note.

Whereas the note is evidence of a debt and a promise to pay, the mortgage provides security (collateral) that the lender can sell if the note is not paid. The technical term for this is hypothecation.

- Hypothecation means the borrower retains the right to possess and use the property while it serves as collateral.
- In contrast, pledging means to give up possession of the property to the lender while it serves as collateral.

An example of pledging is the loan made by a pawn shop. The shop holds the collateral until the loan is repaid. The term "pledge" is often incorrectly used to describe a hypothecation.
The mortgage is a contract and must, therefore, meet the minimum requirements of any contract in order to be valid.

- The agreement must clearly identify the property to be held as collateral as well as the lender (mortgagee) and the borrower (mortgagor); however, the note and mortgage are signed only by the borrower.
- The mortgage document must clearly indicate that it is security for a debt by referring to the promissory note. Specific provisions which set forth the lender's rights and the borrower's obligations arising from the debt may appear in either the mortgage or the note, or possibly both.

**Clauses**

Although provisions differ somewhat depending on state law, local custom, and the needs of the parties, mortgage contracts typically contain the following:

- Defeasance Clause
- Alienation Clause
- Escalation Clause
- Condemnation Clause
- Subordination Clause

**Defeasance Clause**

A defeasance clause in the mortgage allows the borrower to "defeat" the mortgage by paying off the debt. The mortgage is thereby cancelled, divesting the lender of any interest and restoring the borrower to his full rights of ownership.

**Alienation Clause**

An alienation clause, also known as a due-on-sale clause, allows the lender to demand the entire loan balance due if title to the property is transferred (alienated) or, in some cases, upon change of possession.

In effect, this provision gives the lender the option of:
- Approving any buyer who wants to assume a loan
- Calling the note immediately due and payable

This provision is designed to give the lender the opportunity to eliminate a loan with a low rate of interest. **The alienation clause is considered to be a lender's best protection in times of rising interest rates.**

**Escalation Clause**

Although the agreed upon interest rate is stated in the note, it may be changed at some time in the future if the mortgage contract or note contains an **escalation or escalator clause.**

Some lenders reserve the right to escalate the interest rate if the property is not used by the borrower as his primary residence, but the escalation or escalator clause generally will apply upon assumption of the loan.

**Condemnation Clause** The **condemnation clause** states that if all or any part of the property is taken through eminent domain, any money so received is to be used to satisfy the note.

**Subordination Clause**

A security instrument may or may not contain a **subordination clause.** A subordination clause is a **clause in which the holder of a mortgage permits a subsequent mortgage to take priority.** Subordination is waiving prior rights in favor of another.

- This clause provides that if a prior mortgage is paid off or renewed, the junior mortgage will continue in its subordinate position and will not automatically become a higher or first mortgage.
- A subordination clause is usually standard in a junior mortgage, since the junior mortgagee gets a higher interest rate and is often not concerned about the inferior mortgage position.

**Subordination Agreement**

A **subordination agreement** is an agreement whereby a **holder of a prior superior mortgage agrees to subordinate or give up his or her priority**
position to an existing or anticipated future lien.

- **Subordination agreements are frequently used in development projects** where the seller of the land to be developed takes back a *purchase-money mortgage* (owner financing) and agrees to subordinate the mortgage to a construction loan, thereby enabling the developer/purchaser to obtain a first mortgage loan to improve the property.
- Many interim lenders refuse to lend any money in the absence of a subordination agreement in all prior loans or other agreements.

**Mortgage Instrument-Covenants**

The borrower agrees to keep certain covenants upon signing the mortgage. They include:

- Covenant to Pay Indebtedness
- Covenant to Pay Taxes
- Covenant to Pay Insurance
- Covenant of Good Repair
- Covenant Against Removal
- Covenant to Acknowledge Indebtedness
- Covenant to Pay Legal Expenses

**Covenant to Pay Indebtedness**

*Covenant to Pay Indebtedness* is the borrower's promises to pay the amount owed according to the terms of the note.

**Covenant to Pay Taxes**

Through the *Covenant to Pay Taxes*, the borrower agrees to pay real estate taxes and special assessments in a timely manner.

This promise is especially important to the lender because unpaid taxes become a first lien on the property and, therefore, superior to the lender's mortgage.
Covenant to Pay Insurance

The **Covenant to Pay Insurance** requires the borrower to maintain adequate insurance coverage against damage or destruction of the mortgaged property. The amount of coverage should not be less than the outstanding loan balance.

If the borrower fails to pay the taxes and insurance premium on time, the lender may elect to make the payments and add that amount to the mortgage loan balance. To avoid the potential problem of a borrower not paying taxes and insurance when due, many lenders only offer budget mortgages. Each month the borrower pays one-twelfth on the annual property tax and insurance premium in addition to principal and interest.

Covenant of Good Repair

The **Covenant of Good Repair** requires the borrower to maintain the mortgaged property in good condition at all times.

Covenant Against Removal

Covenant Against Removal entails the borrower promising not to remove or destroy any of the property's improvements without the lender's permission. This covenant is especially important to the lender if personal property is also pledged as security for the debt.

Covenant to Acknowledge Indebtedness

**Covenant to Acknowledge Indebtedness:** At the lender's request, the borrower agrees to execute an estoppel certificate, also known as a certificate of no defense, acknowledging the current mortgage loan balance.

This procedure is important to the lender if the mortgage is sold to a third party (investor). The borrower's acknowledgment of a specific loan balance prevents him from later claiming that he owes an amount different from what he had stated.

Covenant to Pay Legal Expenses

**Covenant to Pay Legal Expenses:** In the event of default, the borrower agrees to pay all legal expenses incurred by the lender in his attempt to collect the outstanding indebtedness.
By far, most mortgage loans are paid in full either on or ahead of schedule. When the loan is paid, the standard practice is for the lender to return the promissory note to the borrower along with a document called a satisfaction of mortgage (or a release of mortgage).

- Issued by the lender, a satisfaction of mortgage states that the promissory note or bond has been paid in full and the accompanying mortgage may be discharged from the public records.

It is extremely important that this document is promptly recorded by the public recorder in the same county where the mortgage is recorded. Otherwise, the records will continue to indicate that the property is mortgaged. When a satisfaction or release is recorded, a recording office employee makes a note of its book and page location on the margin of the recorded mortgage. This is done to assist title searchers and is called a marginal release.

- Occasionally, the situation arises during which the borrower wants the lender to release a portion of the mortgaged property from the mortgage after part of the loan has been repaid. This is known as asking for a partial release.
Deed of Trust

The basic purpose of a deed of trust, also referred to as a trust deed, is the same as a mortgage. Real property is used as security for a debt; if the debt is not repaid, the property is sold and the proceeds are applied to the balance owed.

When a debt is secured by a mortgage, the borrower delivers his promissory note and mortgage to the lender, who keeps them until the debt is paid.

But when a note is secured by a deed of trust, three parties are involved:

- The borrower (the trustor)
- The lender (the beneficiary)
- A neutral third party (the trustee).

The lender makes a loan to the borrower, and the borrower gives the lender a promissory note and the deed of trust is given to the trustee. In the deed of trust document, the borrower conveys title to the trustee, to be held in trust until the note is paid in full.

The deed of trust must be signed and is recorded in the county where the property is located and then is given to the lender. Anyone searching the title records would find the deed of trust conveying title to the trustee. This would alert the title searcher to the existence of a debt against the property.

Naked Title

The title that the borrower grants to the trustee is sometimes referred to as a naked title or bare title. This is because the borrower still retains the usual rights of an owner such as the right to occupy and use the property and the right to sell it. The title held by the trustee is limited only to what is necessary to carry out the terms of the trust. In fact, as long as the note is not in default, the trustee's title lies dormant. The lender does not receive title, but only a right that allows the lender to request the trustee to act.
Payment

When the note is repaid in full under a regular mortgage, the lender cancels the note and returns it to the borrower together with a mortgage satisfaction or release. Upon recordation, the mortgage satisfaction or release informs the world at large that the mortgage is nullified and no longer encumbers the property.

Under the deed of trust arrangement:

- The lender sends to the trustee the note, the deed of trust, and a request for reconveyance.
- The trustee cancels the note and issues to the borrower a reconveyance or a release deed in accordance with the reconveyance clause in the deed of trust that reconveys title back to the borrower.
- The borrower records this document to inform the world that the trustee no longer has title. At the recorder's office, a marginal note is made on the record copy of the original deed of trust to show it has been discharged.

Default

If a borrower defaults under a deed of trust, the lender delivers the deed of trust to the trustee with instructions to sell the property and pay the balance due on the note. The trustee can do this because of two important features found in the deed of trust.

- First, by virtue of signing the deed of trust, the borrower has already conveyed title to the trustee.
- Second, the power of sale clause found in a deed of trust is designed to give the trustee the authority to sell the property without having to go through a court-ordered foreclosure proceeding.

In nearly all states, a title, trust or escrow company or the trust department of a bank may act as a trustee. An individual can be named as a trustee in most jurisdictions. However, this can present a problem if the person dies before reconveyance is made. Therefore, a corporate trustee is preferred.
because its life span is not limited by the human life span.

In a few jurisdictions, Colorado for example, the role of trustee is performed by a government official known as a public trustee. Whether public or private, the trustee is expected to be neutral and fair to both the borrower and the lender. To accomplish this, the trustee carefully abides by the agreements found in the deed of trust.

Foreclosure

Default is the borrower’s failure to comply with all provisions in the mortgage contract and the promissory note. Noncompliance generally occurs because the borrower is delinquent or behind on his payments. The lender’s remedy for a borrower’s default is foreclosure.

Foreclosure is a legal procedure whereby the mortgaged property is either sold to a third party or transferred to the lender in order to satisfy the debt. Most lenders are not anxious to foreclose their mortgages because the process is expensive and generally results in bad public relations. Whenever possible, lenders prefer to arrange a new payment program for the borrower rather than enforcing their rights of foreclosure.
Foreclosure-Types of Foreclosure

Lenders who have no other alternative to recover their money except by foreclosure may use one of three foreclosure methods, depending on state law. They are:

- Judicial Foreclosure
- Non-Judicial Foreclosure
- Strict Foreclosure

Judicial Foreclosure

In order to initiate judicial foreclosure, the lender must file a lawsuit against the borrower, petitioning the court to sell the mortgaged property at public auction and to apply the sale proceeds to the debt. When the foreclosure suit is filed with the court, a notice of lis pendens is also filed to inform the public that a legal action is pending against the borrower. Interested parties searching the title are officially put on notice of an unsettled lawsuit that may affect the title to the property.

All parties who have a legal interest in the property are identified by a title search. They are notified by the court of the foreclosure proceedings so that they may appear at the sale in order to protect their interest in the property. Notice of the sale is published in the local newspaper in order to obtain the best possible price through competitive bidding.

Redemption

At any time before the property goes on sale, the borrower may redeem his property by paying off the debt. This privilege is known as the equity of redemption or equitable redemption.

If the borrower does not exercise this right and the best bid is less than the outstanding loan amount, the lender will usually enter a bid of his own, up to the amount of the debt. Title is conveyed to the successful bidder.

- Where the state recognizes a statutory right of redemption, the borrower may redeem his property after the sale within a period of
time set by law, usually six to 24 months. Because of the borrower’s right to redeem the property after the sale, the purchaser is issued a **certificate of sale**. During the redemption period, the court may appoint a **receiver** to protect and manage the property. If during this time the property is not redeemed, the purchaser (successful bidder) will receive a deed conveying title to him.

**Deficiency Judgment**

**Sale proceeds in excess of the debt are turned over to the** borrower. If the proceeds are insufficient to pay the debt, the lender may file for a **deficiency judgment** on the note because of the borrower’s personal liability. This procedure allows the lender to proceed against the borrower’s unsecured assets.

*A few states do not allow the lender to reach beyond the mortgaged property to satisfy the debt.*

**Non-judicial Foreclosure**

Many states allow the lender to foreclose a mortgage without filing a lawsuit. If the mortgage (trust deed) contains a **power of sale clause**, the lender or trustee is authorized to sell the property and apply the proceeds to the debt, provided notice of the sale is properly advertised in the local newspaper. Because of this feature, **non-judicial foreclosure is also known as sale by advertisement**.

Lenders often prefer this method because it simplifies the foreclosure process and is less expensive than filing a lawsuit. One criticism of the method, however, is that junior mortgagees are not personally notified of the pending sale. **The advertisement in the local newspaper serves as their legal notice of the intent to sell the property.** If the highest bid is not enough to cover a junior mortgage, the lien holder must be present to enter a bid in order to protect his interest.

*In some states the power of sale eliminates the borrower’s period of statutory redemption and allows him only equitable rights of redemption. Lenders would still have to go to court to obtain a deficiency judgment in power of sale states.*
Although most foreclosures are handled through either the judicial process or by the mortgagee's power of sale, a few states will allow the lender to take title without a foreclosure sale. This procedure is called strict foreclosure.

To initiate strict foreclosure, the lender asks the court to establish a certain period of time during which the delinquent borrower must satisfy the indebtedness. If the debt is not paid during the time allowed, legal title is awarded to the lender without the borrower retaining any rights of redemption.

If the lender agrees, the borrower may avoid the embarrassment of a public sale and convey title by deed in lieu of foreclosure. For the lender, the advantage of this procedure may be to avoid the expense and time of foreclosure or to avoid waiting out a period of redemption. The disadvantage is that the mortgagee must take title to the property subject to
all junior liens.

Also, the courts may set aside the conveyance if the borrower later proves that he was pressured by the lender to give up title. Because of the possibility of a court reversal, a lender who accepts a deed in lieu of foreclosure will generally obtain an independent appraisal of the property. The estimate of value is used as a basis to establish the amount owed the borrower if the property is worth more than the loan balance.

**Comparing a Mortgage and a Deed of Trust**
In Review

- State governments can recognize either lien theory or title theory.
- The promissory note is a contract between a borrower and a lender.
- A promissory note must be in writing, be between a borrower and a lender who both have contractual capacity, state the borrower's promise to pay a certain sum of money, show the terms of payment, be signed by the borrower (principal), be voluntarily delivered by the borrower and accepted by the lender.
- Exculpatory, acceleration, and prepayment clauses are commonly found within a mortgage note.
- The mortgage is a separate agreement from the promissory note; the note is evidence of a debt and a promise to pay, while the mortgage provides security that the lender can sell if the note is not paid.
- Mortgage contracts commonly include: a defeasance clause, an alienation clause, an escalation clause, a condemnation clause, and a subordination clause.
- Borrowers agree to keep certain covenants upon signing the mortgage.
- Foreclosure is a legal procedure whereby the mortgaged property is either sold to a third party or transferred to the lender in order to satisfy the debt.
- The types of foreclosure include: judicial, non-judicial, and strict.