# Mortgages

## Introduction: What is a Mortgage?

A mortgage is an interest in land. It is not a possessory interest: the owner of a mortgage has no right to use the property, the way the owner of the fee or an easement owner would. Instead, mortgages exist to secure loans. A secured loan is backed, or secured, by a specific asset such as a house or a car, which the lender can seize in case of default. An unsecured loan is not secured by any specific asset – for example, credit card debt and student loans are unsecured. The borrower owes the money, and the lender can go after the borrower’s unsecured assets in case of default, but if those assets are too small, the unsecured lender is out of luck. Secured loans are generally considered less risky than unsecured loans, for obvious reasons, and should bear lower interest rates (absent some foolery on the part of the lender or government intervention into the market, both of which do happen).

Most mortgages are residential mortgages. Usually, homebuyers in the U.S. can’t afford to pay the entire purchase price of a house at the time they buy it. Instead, they take out a loan – a mortgage – to pay the bulk of the purchase price. They will sign a promissory note (the note) that creates personal liability for the borrowers if they fail to pay, and also sets out the terms of the mortgage such as the repayment period and the interest rate. They will also sign a mortgage, a written instrument that grants the lender an interest in their newly purchased land. Usually, this transaction occurs at the time the buyers buy the land, though mortgages can also be refinanced or taken out on already-owned property.

The homebuyers are the *mortgagors*. The lender is the *mortgagee*. Over time, the buyers pay off the loan. As they pay off the loan, they build “equity” in their homes. Equity is the difference between what a home is worth and what the homeowners owe on their mortgage.[[1]](#footnote-1) As a result of deliberate policy choices, the model residential mortgage in the U.S. is for no more than 80% of the value of the house at time of purchase; has a fixed interest rate; and amortizes over a period of years, usually twenty or thirty. Amortization means that the payments are the same throughout the period of the mortgage: at the beginning, most of the payments go to interest on the loan, while over time more and more of the payments go to reduce the loan principal.

The mortgagors can transfer the land at will. However, any transfer will not free the land from the mortgage (nor will a transfer free them from their contractual promise to pay the debt); the mortgage *runs with the land*. Thus, a sensible transferee will not be willing to pay full value for the land – the fair market value of the land is reduced by the amount of the mortgage. A transferee can either take “subject to the mortgage,” which means that the original mortgagors still owe the debt and the transferee is at risk if they don’t pay, or “assuming the mortgage,” which means that the new owner agrees to pay the mortgage directly. When the purchaser assumes the mortgage, the seller still has a duty to pay the mortgage if the buyer doesn’t, but the seller can pursue the buyer for reimbursement if that happens. However, this all risks some big messes; to avoid problems associated with transfers, many mortgages have “due on sale” clauses, which means that the full amount of the mortgage comes due (“accelerates”) when the mortgagor sells the property. One important feature of a due on sale clause is that it enables lenders to reprice loans: if the interest rate has risen since the initial mortgage loan, the buyer can’t just assume the existing loan and receive a lower interest rate than would otherwise be available to him.

Suppose Joan Watson wants to sell her house to Sherlock Holmes. She still owes $400,000 on her house; Holmes will be buying it for $500,000. But she doesn’t have $400,000 in the bank to pay off her mortgage, which has a due on sale clause. How can she accomplish the sale? The answer is that a series of transactions take place together. The day of the sale, Holmes will give Watson a check for $500,000 (most of which will likely come from Holmes’ own new mortgage on the property). Watson will then pay her lender $400,000 and keep $100,000. As you can see, there will be some time at which both Holmes and Watson are relying on the value of the underlying property – Holmes to get his mortgage and Watson to pay hers off. For this reason, real estate transactions regularly involve the use of multiple third parties, including escrow agents, to facilitate and guarantee the sale.

If the mortgagors default on the mortgage by failing to pay the appropriate amounts at the appropriate times, the mortgagee can foreclose. Foreclosure can be time-consuming and expensive, so in some circumstances the mortgagee may accept a “deed in lieu of foreclosure,” by which the mortgagor surrenders the property to the mortgagee and the mortgagee accepts the deed. However, deeds in lieu of foreclosure are relatively rare; most of the time, if a default is not cured and the loan is not modified, the result will be a foreclosure.

Either by a private sale (nonjudicial foreclosure) or under judicial supervision (judicial foreclosure), the mortgagee can have the property sold and apply the proceeds of the sale to the amount due on the note. The foreclosure is so called because it forecloses the mortgagee’s ability to get the property back by paying off the mortgage debt; after the foreclosure, it is too late to become current.[[2]](#footnote-2)

In a number of states, it is possible to avoid judicial foreclosure – which takes more time and money than nonjudicial foreclosure – through the use of a “deed of trust,” which is recognized in most jurisdictions. Under a deed of trust, the borrower conveys title to the property to a person to hold in trust to secure the debt. If the borrower defaults, the trustee has the power of sale without needing to go to court. However, almost all states that allow this procedure do impose some procedural safeguards, such as notice and public sale. Other than the ability to avoid judicial foreclosure, you can expect a deed of trust to be treated like a mortgage.

In addition, there are two different types of secured loans: recourse and nonrecourse loans. For a nonrecourse loan, the only way the lender can get its money back in case of default is by seizing the asset, and if there’s not enough money to satisfy the debt from the asset, too bad for the lender. The lender has no “recourse” against any of the borrower’s other assets. A recourse loan is different: in case of default, the lender can seize and sell the asset, and if there’s not enough money to satisfy the debt, the lender is now an unsecured creditor for the remaining balance (the deficiency) and can go after any of the borrower’s other assets, such as her bank account. Foreclosure wipes out the lender’s interest in the land, which means that the land can then be resold free of the lender’s interest. However, with a recourse loan, foreclosure will not wipe out the borrower’s debt, if it is greater than the foreclosure sale amount.

Obviously, lenders ordinarily prefer recourse loans, but will grant nonrecourse loans in various circumstances.[[3]](#footnote-3) Many businesses can get nonrecourse loans based on their assets. Some states bar deficiency judgments for residential mortgages, which makes them nonrecourse loans. Other states bar deficiency judgments unless there is a judicial foreclosure, with its greater expense and greater procedural protections for the borrower. Still others limit the amount of any deficiency judgment to the difference between the principal balance and the property’s fair market value at the time of foreclosure – this limit recognizes that foreclosed properties often sell for below market value for a variety of reasons, including buyers’ uncertainty about the true condition of the property and the limited number of potential buyers who bid at foreclosure sales. (Historically, the mortgagee is often the only bidder at a foreclosure sale. Why would this be true?)

Even states that allow deficiency judgments generally recognize an exception: if the sale price shocks the conscience, then a deficiency judgment may not be allowed. More generally, even in the absence of a potential deficiency judgment, the foreclosing entity has a limited duty of good faith to the mortgagor in seeking an acceptable price at the sale. However, mere inadequacy of price will not invalidate a sale in the absence of fraud, unfairness, or procedural problems that deterred bidding. As a result, very low sale prices are sometimes accepted by courts. *Compare* Moeller v. Lien, 30 Cal. Rptr. 2d 777 (Ct. App. 1994) (sale at 25% of market value was acceptable where sale was to bona fide purchaser and there was no irregularity in the sale procedure), *with* Murphy v. Fin. Dev. Corp., 495 A.2d 1245 (N.H. 1985) (finding that mortgagee violated duty to mortgagor when (1) sale was rescheduled and poorly advertised, (2) sale price was so low that it wiped out substantial equity for homeowners, and (3) mortgagee quickly resold property at substantially higher price).

One final introductory point: it is possible to take out a second and even a third mortgage. The first mortgage has “priority” over the second mortgage: it will be paid first at foreclosure. Only if there is money remaining after the first mortgage is paid off will the holder of the second mortgage be paid. As a result of the greater risk involved in second mortgages, they generally bear higher interest rates than first mortgages.

## Crystals and Mud in Property Law

We have skimped on the history of mortgage law, which is a long struggle between creditors and debtors. Mostly, legislatures and courts act to protect debtors, who are usually seen as the more vulnerable parties, from sharp dealing by creditors. As rules stretch to be more equitable and less hard-edged, pressure grows to create *new* clear rules, which then grow their own exceptions and qualifications.

Carol Rose describes the legal seesawing in the following excerpt, which has important lessons for property law generally:

Carol M. Rose, *Crystals And Mud In Property Law*

40 Stan. L. Rev. 577 (1988) (excerpts reprinted by permission)

Property law, and especially the common law of property, has always been heavily laden with hard-edged doctrines that tell everyone exactly where they stand. Default on paying your loan installments? Too bad, you lose the thing you bought and your past payments as well. Forget to record your deed? Sorry, the next buyer can purchase free of your claim, and you are out on the street. Sell that house with the leak in the basement? Lucky you, you can unload the place without having to tell the buyer about such things at all.

In a sense, hard-edged rules like these – rules that I call ‘crystals’ – are what property is all about. If, as Jeremy Bentham said long ago, property is ‘nothing but a basis of expectation,’ then crystal rules are the very stuff of property: their great advantage, or so it is commonly thought, is that they signal to all of us, in a clear and distinct language, precisely what our obligations are and how we may take care of our interests. Thus, I should inspect the property, record my deed, and make my payments if I don’t want to lose my home to unexpected physical, legal, or financial impairments. I know where I stand and so does everyone else, and we can all strike bargains with each other if we want to stand somewhere else.

Economic thinkers have been telling us for at least two centuries that the more important a given kind of thing becomes for us, the more likely we are to have these hard-edged rules to manage it. We draw these ever-sharper lines around our entitlements so that we know who has what, and so that we can trade instead of getting into the confusions and disputes that would only escalate as the goods in question became scarcer and more highly valued.

At the root of these economic analyses lies the perception that it costs something to establish clear entitlements to things, and we won’t bother to undertake the task of removing goods from an ownerless ‘commons’ unless it is worth it to us to do so. What makes it worth it? Increasing scarcity of the resource, and the attendant conflicts over it. To use the example given by Harold Demsetz, one of the most notable of the modern economists telling this story, when the European demand for fur hats increased demand for (and scarcity of) fur-bearing animals among Indian hunters, the Indians developed a system of property entitlements to the animal habitat. Economic historians of the American West tell a similar story about the development of property rights in various minerals and natural resources. Easy-going, anything-goes patterns of appropriation at the outset came under pressure as competition for resources increased, and were finally superseded by much more sharply defined systems of entitlement. In effect, as our competition for a resource raises the costs of conflict about it, those conflict costs begin to outweigh the costs of taking it out of the commons and establishing clear property entitlements. We establish a system of clear entitlements so that we can barter and trade for what we want instead of fighting.

The trouble with this ‘scarcity story’ is that things don’t seem to work this way, or at least not all the time. Sometimes we seem to substitute fuzzy, ambiguous rules of decision for what seem to be perfectly clear, open and shut, demarcations of entitlements. I call this occurrence the substitution of ‘mud’ rules for ‘crystal’ ones.

Thus, … over time, the straightforward common law crystalline rules have been muddied repeatedly by exceptions and equitable second-guessing, to the point that the various claimants under real estate contracts, mortgages, or recorded deeds don’t know quite what their rights and obligations really are. And the same pattern has occurred in other areas too. …

Quite aside from the wealth transfer that may accompany a change in the rules, then, the change may sharply alter the *clarity* of the relationship between the parties. But a move to the uncertainty of mud seems disruptive to the very practice of a private property/contractual exchange society. Thus, it is hardly surprising that we individually and collectively attempt to clear up the mud with new crystal rules – as when private parties contract out of ambiguous warranties, or when legislatures pass new versions of crystalline record systems – only to be overruled later, when courts once again reinstate mud in a different form.…

Early common law mortgages were very crystalline indeed. They had the look of pawnshop transactions and were at least sometimes structured as conveyances: I borrow money from you, and at the same time I convey my land to you as security for my loan. If all goes well, I pay back my debt on the agreed ‘law day,’ and you reconvey my land back to me. But if all does not go well and I cannot pay on the appointed day, then, no matter how heartrending my excuse, I lose my land to you and, presumably, any of the previous payments I might have made. As the fifteenth century commentator Littleton airily explained, the name ‘mortgage’ derived from the rule that, if the debtor ‘doth not pay, then the land which he puts in pledge … is gone from him for ever, and so dead.’

This system had the advantage of great clarity, but it sometimes must have seemed very hard on mortgage debtors to the advantage of scoundrelly creditors. Littleton’s advice about the importance of specifying the precise place and time for repayment, for example, conjures up images of a wily creditor hiding in the woods on the repayment day to frustrate repayment; presumably, the unfound creditor could keep the property. But by the seventeenth century, the intervention of courts of equity had changed things. By the eighteenth and nineteenth centuries, the equity courts were regularly giving debtors as many as three or four ‘enlargements’ of the time in which they might pay and redeem the property before the final ‘foreclosure,’ even when the excuse was lame. One judge explained that an equity court might well grant more time even after the ‘final’ order of ‘foreclosure absolute,’ depending on the particular circumstances.

The muddiness of this emerging judicial remedy argued against its attractiveness. Chief Justice Hale complained in 1672 that, ‘[b]y the growth of Equity on Equity, the Heart of the Common Law is eaten out, and legal Settlements are destroyed; . . . as far as the Line is given, Man will go; and if an hundred Years are given, Man will go so far, and we know not whither we shall go.’ Instead of a precise and clear allocation of entitlements between the parties, the ‘equity of redemption’ and its unpredictable foreclosure opened up vexing questions and uncertainties: How much time should the debtor have for repayment before the equitable arguments shifted to favor the creditor? What sort of excuses did the debtor need? Did it matter that the property, instead of dropping in the lap of the creditor, was sold at a foreclosure sale?

But as the courts moved towards muddiness, private parties attempted to bargain their way out of these costly uncertainties and to reinstate a crystalline pattern whereby lenders could get the property immediately upon default without the costs of foreclosure. How about a separate deal with the borrower, for example, whereby he agrees to convey an equitable interest to the lender in case of default? Nothing doing, said the courts, including the United States Supreme Court, which in 1878 stated flatly that a mortgagor could not initially bargain away his ‘equity of redemption.’ Well, then, how about an arrangement whereby it looks as if the lender already owns the land, and the ‘borrower’ only gets title if he lives up to his agreement to pay for it by a certain time? This seemed more promising: In the 1890s California courts thought it perfectly correct to hold the buyer to his word in such an arrangement, and to give him neither an extension nor a refund of past payments. By the 1960s, however, they were changing their minds about these ‘installment land contracts.’ After all, these deals really had exactly the same effect as the old-style mortgages – the defaulting buyer could lose everything if he missed a payment, even the very last payment. Human vice and error seemed to put the crystal rule in jeopardy: In a series of cases culminating with a default by a ‘willful but repentant’ little old lady who had stopped paying when she mistakenly thought that she was being cheated, the California Supreme Court decided to treat these land contracts as mortgages in disguise. It gave the borrower ‘relief from forfeiture’ – a time to reinstate the installment contract or get back her past payments.

With mortgages first and mortgage substitutes later, we see a back-and-forth pattern: crisp definition of entitlements, made fuzzy by accretions of judicial decisions, crisped up again by the parties’ contractual arrangements, and once again made fuzzy by the courts. Here we see private parties apparently following the ‘scarcity story’ in their private law arrangements: when things matter, the parties define their respective entitlements with ever sharper precision. Yet the courts seem at times unwilling to follow this story or to permit these crystalline definitions, most particularly when the rules hurt one party very badly. The cycle thus alternates between crystal and mud.

Questions

1) Do you prefer Crystals or Mud? If you prefer Crystals, is there a way to prevent judges (and others) from creating mud? If you prefer mud, is there a way to prevent lenders (and others) from creating crystals?

2) Betty Finn buys a house for $450,000. She puts down $90,000 and takes out a mortgage for $250,000 from Heather Chandler, and a second mortgage for $110,000 from Veronica Sawyer. When Betty defaults, the house is sold for $500,000 at foreclosure. Assuming the amounts due on the mortgages haven’t changed at all, how should the proceeds be distributed? What would the answer be if the house brought $350,000 at foreclosure?

3) Prof. Rasmussen owns two parcels, 1 & 2 Eastfield Rd. Bank1 has mortgage on 1 Eastfield Rd for 500K, Bank 2 has mortgage on 2 Eastfield Rd. for 500K. Prof. Rasmussen defaults on the loan to Bank 1. Instead of foreclosing on 1 Eastfield Rd., Bank1 gets a judgment lien, which, according to statute in the jurisdiction, gives it a lien on all of Prof. Rasmussen’s property. Creditor 1 then foreclosed on both its mortgage and the judgment lien. The sale of 1 Eastfield raised 400K and the sale of 2 Eastfied raised 700K. How much does each creditor get? How much does Prof. Rasmussen get?

4) Prof. Barnett owns 1 Crest Rd, which he financed with a mortgage for 1m from WaMu that was never recorded. Prof. Barnett sold the property for 2m to Prof. Rose and moved to Peru. Prof. Barnett then stopped paying monthly payments on the mortgage. WaMu then petitioned the court to foreclose on 1 Crest Rd. Can it do so?

1. This terminology has a historical basis in the “equity of redemption,” which was a means by which early chancellors protected early mortgagors from abuses by lenders. Over time, the equitable procedures created by courts gave way to legislation establishing rules for how foreclosures could occur. [↑](#footnote-ref-1)
2. At common law, the equity of redemption allowed the mortgagor to redeem the property from the mortgagee. This equity of redemption was extinguished by foreclosure sale. In about half of the states, there is also a statutory right to redeem the property from the *purchaser* at a foreclosure sale for a certain period of time. This right is rarely used, because most people would already have paid, if they could, before the sale. [↑](#footnote-ref-2)
3. In fact, the basic idea of a corporation is a way of limiting a lender’s recourse: before the corporate form, if a business owner went bust, creditors could go after the owner’s personal assets until they were gone. The corporation allows shareholders/owners to limit their liability to the extent of the corporation’s assets. If a person owned shares of Lehman Brothers, its creditors could make her shares worthless, but they couldn’t make her pay Lehman Brothers’ debts. [↑](#footnote-ref-3)