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## Anatomy of a Failed Mortgage

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The front-page stories of sub-prime mortgages, predatory lending practices, title company defalcations, foreclosures, and troubled neighborhoods—coupled with failing banks—have sensitized both consumers and courts to the respective rights and responsibilities of all parties involved in real estate transactions. Although real property laws vary from state to state (and even by locale within a state), the processes for transfers of interests in land are uniform in nature. This is also true for the financial aspect of these transfers.

National lenders loan money across the country and face different sets of rules, depending on the jurisdiction, when it comes to foreclosing on their interests in real property. Those rules—fairly formulaic in the past—are evolving today; change is spurred on by attorneys seeking to help clients who become primary defendants in foreclosure actions.

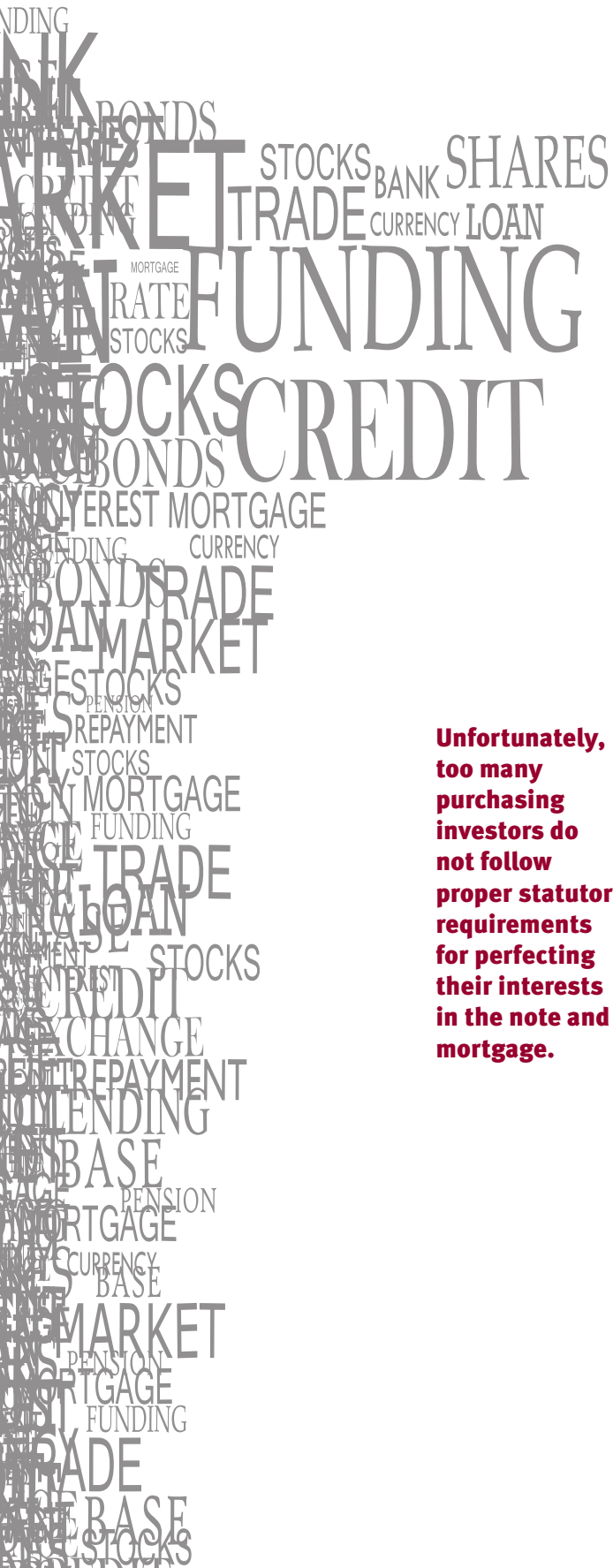
Courts are losing patience with many foreclosure plaintiffs who fail to pay attention to fundamental details that provide their right to foreclose in the first place. This article will explain some potential pitfalls in the foreclosure process. It will also identify some emerging trends for attorneys looking to practice real estate law.

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## Note, Note, Who Has the Note?

First of all, a foreclosing plaintiff must be able to prove justification for a foreclosure action. It is therefore the responsibility of the plaintiff's counsel to determine if proper documentation of the plaintiff's interest in the real property exists. When an investor purchases a mortgage loan, the selling lender—who ostensibly owns the paper—should assign its interest in the note and mortgage to the purchasing investor. The Statute of Frauds dictates the transfer of an interest in real estate be in writing. In most jurisdictions, notice of that assignment must be placed on record with the real estate record keeper in the county where the encumbered property is located.

Unfortunately, too many purchasing investors do not follow proper statutory requirements for perfecting their interests in the note and mortgage. Oftentimes this is because the purchasing investor has an option to force the selling lender to repurchase the paper. In that case, the purchasing investor may want to hold off placing notice in the public record of its ownership interest in case the resale option is invoked. Sometimes, not following proper statutory requirements is accidental. The paperwork—because of the high volume of notes and mortgages to be transferred—simply slips through the cracks.

The foreclosing attorney typically has no contact with, and consequently can find it difficult to ascertain, a note's true owner. The "servicer" is typically the contact entity for the foreclosing attorney. The servicer of the mortgage loan is charged with collecting monthly payments from the borrower. If the borrower defaults on his or her loan, the servicer—operating under a servicing agreement with the original lender or trustee—may begin foreclosure proceedings in the name of the purchasing investor.

The situation is further complicated when the owner of the note and mortgage is a trustee. The trustee holds title to the note and mortgage for the beneficiary and may hold title to several notes and mortgages for multiple beneficiaries under the same trust arrangement. Frequently, the trustee is unable to identify the beneficiary of any given asset in the trust.

It is common to find a foreclosure filed in the name of a plaintiff lender who is not the owner-of-record of the mortgage. In the past, some courts did not monitor this discrepancy. Due to the high number of foreclosures now clogging the system, an increase in the number of primary defendants retaining counsel, and a heightened sense of consumerism by the courts, some jurisdictions have begun to dismiss cases in which the plaintiff's standing is challenged by the defendant's counsel.

As plaintiff's counsel, the failure to properly monitor a client's ownership interest may lead to lengthy delays for the client in obtaining relief. It is imperative to confirm title evidence indicating the plaintiff has obtained ownership of the note and mortgage. The ownership should not consist of unrecorded or unprocurable assignments. The assignment must be sufficient to satisfy the jurisdiction's requirements for perfecting the interest in the lien.

## When is Subrogation Equitable?

Closing agents are charged with examining title evidence, ordering payoffs, preparing closing documents, overseeing the signing, disbursing funds, and recording. The surge of home equity loans in the 1980s led to the need to order two—and sometimes three—payoffs to clear a property from prior liens. At a prior closing, the home equity lender may have disbursed the entire proceeds of the loan to pay debts or provide the borrower with cash. Sometimes these lenders will provide a line of credit along with checks to allow the borrower to draw on the line as needed. As a result, closing agents must take extra steps to make sure all prior loans encumbering a property are not merely paid down but are paid off at closing, and the mortgages are released of record.

Our title claim practice recently has overwhelmingly consisted of cases in which a prior owner's line of credit loan was paid down, but not closed, and the prior owner has drawn further funds. This occurs most frequently when the subsequent lender files for foreclosure and, in the process of obtaining title evidence, discovers the prior home equity mortgage was never released.

When the foreclosure is filed and names the home equity lender as a defendant, the title insurer is notified of a potential claim. Everyone hopes the home equity lender will realize that failing to file its release of mortgage was just an oversight. More often than not, however, the home equity lender files an answer asserting priority over the plaintiff and asking the court to protect its interest. This is where equitable subrogation comes in to play.

The doctrine of equitable subrogation is defined loosely as a situation in which a third party (closing agent)—with the borrower's consent and agreement—pays a prior mortgage, thereby encumbering real property with funds from a new mortgagee. In this case, equitable subrogation allows the new mortgagee to step in to the shoes of the former mortgage holder. Although it sounds fairly straightforward, the doctrine of equitable subrogation is limited by all of the tenets of equity. The party claiming equitable subrogation must show it is appearing before the court with clean hands and without knowledge of circumstances that would have allowed it to take action to protect itself.



For instance, the payoff for a home equity loan may include a requirement that the mortgagors affirmatively state to the lender that they wish to close out the line. Some lenders require the mortgagors to sign a payoff letter to indicate their desire to have the line closed out. If the closing agent fails to get the mortgagors' signature on the payoff letter and opts, instead, to have the mortgagors sign a separate statement requesting the line be closed, then the line-of-credit lender may not close out the line. This can occur even when the closing agent instructs the lender not to accept the funds if it does not intend to release the mortgage. Courts have struggled on a case-by-case basis with variations of this pattern of facts. Many courts have concluded that what is necessary is a writing—not a signed payoff notice.

The situation can be complicated further when new mortgagees pay off a first mortgage and a second line of credit mortgage at closing. The court may allow equitable subrogation to apply for those amounts remitted to pay the first mortgage, but not the home equity mortgage. Some courts rule the prior line-of-credit mortgage should come second after the new mortgagee, as that position is no worse than what it bargained for in the first transaction.

Parties have tried to use equitable subrogation in other instances. One such situation exists if a title examiner fails to find a prior valid mortgage, and the lender is not paid at closing. Although the doctrine would seem inapplicable in this situation, a few courts have allowed equitable subrogation to apply because courts want to prevent fraud and provide relief from mistake. It is imperative in such instances the mortgagee show he or she had no actual knowledge of the mortgage. Constructive knowledge through public records may prove to be inconsequential. This defense would be very fact-specific and would involve an uphill battle.

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INTEREST MORTGAGE  
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BONDS TRADE  
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REPAYMENT  
STOCKS  
MORTGAGE  
FUNDING  
TRADE  
LOAN  
STOCKS  
CREDIT  
EXCHANGE  
REPAYMENT  
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FUNDING  
TRADE  
BASE  
STOCKS  
CREDIT

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There also have been attempts to apply the doctrine of equitable subrogation when the closing agent delays filing the new mortgage and, in the interim, another mortgage has been placed on record. In this case, courts are reluctant to apply the doctrine—asserting the closing agent has been negligent in his or her business practices by failing to record the new mortgage in a timely manner. Additionally, bankruptcy courts may set aside the mortgage due to the delay.

## Conclusion

The economic events of the past twenty years have created many new platforms and pitfalls for real estate attorneys. The number of failed mortgages has exacerbated the problem. Failing to be diligent in both researching issues and being watchful for problems can open the door to potential claims for attorneys practicing in real estate. An ounce of prevention can thwart a pound of claims!

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