Foreclosing the Wraparound Mortgage: Practical Considerations And the Emergence of Texas Case Law

By Abe S. Goren and Larry E. Meyer

Part I

I. Introduction

Despite the record number of Texas real property foreclosures within the last several years and the multitude of seminars and articles published on the broad topic of foreclosure, little information has been disseminated to Texas practitioners on the practical considerations involved in foreclosing the wraparound mortgage. There has also been a paucity of Texas case law directly addressing wraparound foreclosure issues.' This article explores several legal issues involved in the foreclosure of a wraparound mortgage and comments upon two recent Texas Court of Appeals decisions, both of which are now on appeal to the Texas Supreme Court.

II. Basics of the Wraparound Mortgage

A. Definition of Wraparound Mortgage

A wraparound mortgage is a financing arrangement in which the purchaser of real property makes an installment note (the "wraparound note"), the principal amount of which "wraps around" or includes the principal balance of an underlying indebtedness (the "underlying note").[2] The unpaid principal balance of the underlying note is often referred to as the "included debt." The "true debt" (also referred to as "real debt") is the actual amount of money advanced or credit extended by the wraparound note holder ("holder") to the wraparound note maker ("maker") in connection with the execution of the wraparound note. Stated more simply, the "true debt" is the difference between the outstanding balance of the wraparound note and the outstanding balance of the underlying note.[3] The purchaser of the real property is the maker, and the seller of the real property is the holder. The title to the real property is accepted by the purchaser subject to the lien(s) securing the underlying note, and the maker expressly does not assume the indebtedness evidenced by the underlying note. The lien(s) securing the payment of the wraparound note are subordinate and inferior to the lien(s) securing the payment of the underlying note. Generally, the wraparound note provides that the holder shall, subject to the performance of the maker under the wraparound note, pay to the underlying note holder the corresponding current installment of principal and interest due on the underlying note.[4] In most instances, in the event of default by the holder on the underlying note, the maker is allowed to cure the default and to correspondingly reduce his obligation under the wraparound note.[5]

B. Objectives of a Wraparound Mortgage

Sellers structure transactions using wraparound financing for a variety of reasons. The most significant reasons include: (1) increasing the effective rates of return on the seller's investment or equity, (2) avoiding acceleration of the underlying note upon sale of the property to the purchaser under a "due on sale" clause, and (3) being able to take an advantageous position for federal income tax purposes in reporting a seller's gain on the installment sale method.[6] These objectives generally cannot be achieved by the purchaser's simply assuming or accepting title to real property subject to, an underlying note.

C. Hypothetical Situation Involving A Wraparound Mortgage

For purposes of the following discussion, assume the following hypothetical situation. In connection with the acquisition of Blackacre for $1,500,000, the purchaser (the maker) executes a wraparound note in the original principal sum of $1,500,000 payable to the order of the seller (the holder). By the express terms of the wraparound note its principal balance includes or "wraps around" an underlying note that has an outstanding principal balance of $1,000,000 executed by the holder and payable to the first lienholder. The maker must pay $1,500,000 to the holder, but the holder has a corresponding obligation to pay $1,000,000 to the underlying note holder. The wraparound note represents a true debt of only $500,000 payable by the maker to the holder. The maker immediately defaults on the payment of the wraparound note. The holder requests legal advice about how to foreclose upon Blackacre, which secures the payment of the wraparound note.

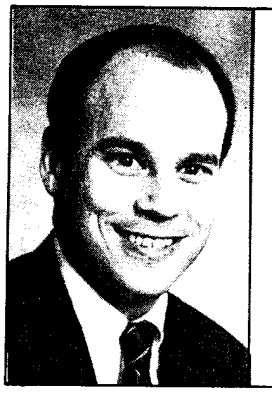
III. Issues Relating to Foreclosing The Wraparound Mortgage

Conducting a foreclosure sale under a wraparound deed of trust involves serious unsettled questions of law, and there is a paucity of case law about wraparound mortgages in all states.[7] The unsettled nature of the law in this area was noted by a North

Carolina appellate court:

Affidavits and depositions of skilled lawyers for both parties reflect that the so-called "wraparound" mortgage is an area of real property law not well understood by property lawyers in North Carolina, and further, that the foreclosure of such a mortgage is fraught vvith questions and uncertainty.8

Several distinct but related issues must be considered when foreclosing real property secured by a wraparound mortgage. These issues include: (1) the determination by the holder of an appropriate bid amount in the event that the holder wishes to purchase the real property at the foreclosure sale, (2) the amount that may be bid by the holder as a credit against the vvraparound note, and (3) the calculation of the resulting deficiency against or surplus in favor of the maker following the foreclosure sale.



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C. Protecting the Holder When the Holder Is Personally Obligated on the Underlying Note

A holder would have a concern if the property is sold at foreclosure and purchased subject to the underlying note by a third party and the holder remained personally liable on the underlying note. To protect the holder from a possible default on the underlying note by the new owner of the property, one practitioner suggests that the holder consider retaining a lien to secure the new owner's performance of the underlying indebtedness and the liens securing it in conjunction with the foreclosure sale.'2 This will provide the holder with the means to regain title to the property in the event of a default by the new owner. A prudent practitioner should add language to the original wraparound deed of trust expressly permitting the use of a deed of trust to secure performance benefiting the holder upon a foreclosure of a wraparound mortgage. 13

D. Amount That May be Bid by the Holder As a Credit Against the Wraparound Note

Deeds of trust typically require successful foreclosure sale purchasers to pay cash. A holder bidding at a foreclosure sale, however, can apply his successful purchase bid as a credit against the wraparound note.l4 Because the holder will bid at the foreclosure sale against potential third party purchasers, the amount and application of that credit is of critical importance. If the first approach is applied, the holder has a decisive advantage over third party bidders because he could be allowed a credit bid of up to the full amount of the wraparound note (51,500,000). A prospective third party purchaser would only bid an amount equal to or less than the value of the property minus the underlying note ($500,000) because he would acquire title subject to the outstanding balance of the underlying note ($1,000,000). Alternatively, if the second approach is applied, prospective third party purchasers can bid on an even basis against the holder because the holder's credit is limited to the amount of the true debt (6500,000) and any amount bid in excess of the true debt is paid in cash to inferior lienholders, if any, or, if none, as a surplus to the maker.

Part II

IV. The Emergence of Texas Case Law

Until recently, no Texas case law addressed foreclosure of wraparound mortgages, but two recent court of appeals cases directly confront these issues. These are *Consolidated Capital Special Trust v. Summers,* 737 S.W.2d 327 (Text App. — Houston [14th Dist.] 1987, writ granted) and *Lee v. O'Leary* 742 S.W.2d 28, (Text App.—Amarillo 1987) *aff'd in part sub nom. Lee v. Key West Towers, Inc.* No. C-6820, slip op. (Text 1987) (per curiam), *reh g granted. Consolidated* and *Lee* were both appealed and were argued before the Texas Supreme Court on March 30, 1988. No decision has been issued on either case as of the date of this article.

A. Consolidated

Consolidated is the first reported case in Texas that directly discusses the issues relating to foreclosure of a wraparound mortgage. The central issues concerned: (1) the application of sales proceeds received by a trustee following a foreclosure sale under a wraparound deed of trust; (2) the reduction of, or offset against, the wraparound note by the total amount of thie included underlying debt; and (3) the amount of the resulting deficiency against, or excess proceeds payable to, the owner of

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A. Calculating the Def~ciency/Surplus After Foreclosure

Two polar approaches have emerged with respect to calculating the deficiency against or surplus in favor of the maker following the foreclosure sale. The two approaches have dramatically different consequences for the maker and the holder, because the existence of the underlying note is virtually ignored under one approach, while fully recognized in the other. The approaches vary in their differing calculations of the maker's liability under the wraparound note. In considering these two approaches the following additional hypothetical facts will be assumed (1) the maker defaults, (2) foreclosure occurs, (3) Blackacre's value remains $1,500,000, (4) the amount of the successful foreclosure bid is $soo,ooo, and (5) Blackacre remains encumbered by the 51,000,000 underlying note.

1. **Bid vs. Outstanding Balance of Wraparound Note** The first approach provides for a credit against the wraparound note of *only* the amount bid for the property at the foreclosure sale to determine the deficiency against or surplus for the wraparound note maker.9 (Hypothetical: 51,500,000 twraparound note] — 500,000 [bid amount] = 51,000,000 [deficiencyl). This approach looks rigidly to the form rather than to the substance of the transaction and results in an enormous windfall for the holder.

The following consequences result when applying this approach to the hypothetical facts. The maximum amount that a third party could reasonably be expected to bid would be 5500,000. If a third party is the successful bidder at the foreclosure sale, he would be obligated to service the underlying note. The holder would receive all of the 5500,000 cash bid in at the foreclosure sale *and* could sue the maker for a deficiency of $1,000,000, (the outstanding balance of the wraparound note less the amount bid by the third party at the foreclosure sale). Therefore, the holder would recover 51,500,000 from the maker, when the "true debt" was only $500,000.

A similar result occurs if the holder successfully bids 5500,000 at the foreclosure sale of Blackacre and that amount is credited against the wraparound note. Under this scenario, the holder would regain title to Blackacre and could sue the maker for a deficiency of $1,000,000 on the wraparound note.

Both of these results seem contrary to the true intent of the parties to the wraparound transaction because the holder is allowed to sue the maker for 51,000,000 and either: (1) regain title to the property (with an assumed equity of 5500,000) when he is the successful bidder, or (2) obtain all of his equity in the property in cash. In either event, the holder is 51,000,000 better off in the event of default than in the event of full performance by the maker. It stretches credulity to assert that the maker intended for this windfall to result.

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2. Bid vs. True Debt In calculating the deficiency against or surplus for the maker, the second approach provides for a credit against the wraparound note of the amount bid for the property at the foreclosure sale *and* the outstanding balance of the underlying note. Stated another way, this approach provides for a credit of the amount bid at the foreclosure sale against the true debt.

Applying the second approach to the hypothetical facts, the true debt would be $soo,ooo (51,500,000, the outstanding balance of the wraparound note, less 51,000,000, the outstanding balance of the underlying note). Accordingly, the deficiency or surplus would be the true debt of $500,000 less the amount bid at the foreclosure sale. This approach looks to the economic reality and substance of the transaction rather than to the rigid form of the transaction.

Applying the second approach to the hypothetical facts results in dramatically different consequences to both the holder and the maker. If a third party is the successful bidder and bids $500,000 at the foreclosure sale, a third party would make payments upon or service the underlying note. The holder also would receive all of the 5500,000 cash bid in at the foreclosure sale of Blackacre by the third party, equalling the holder's equity in Blackacre. The maker would receive no portion of the cash bid in at the foreclosure sale because Blackacre did not appreciate during the maker's ownership, and therefore, the amount bid in at the foreclosure sale did not exceed the true debt. Most significantly, the holder would *not* have a deficiency suit against the maker because no deficiency would exist.

A similar result occurs if the holder successfully bids 5500, 000 at the foreclosure sale of Blackacre. Under these facts, the holder would regain title to Blackacre and would receive $500,000 (all of the amount bid in at the foreclosure sale of Blackacre) as a credit against the wraparound note. This credit equals the true debt or the holder's equity in Blackacre on the date of the sale of Blackacre to the maker and the total benefit of the holder's bargain. The maker would receive no portion of the cash bid in for the property at the foreclosure sale because the bid amount did not exceed the true debt. Again, the holder would not have a deficiency claim against the maker.

B. Determination of Proper Bid Amount by Holder

The holder is usually the successful bidder at the foreclosure sale. Often, he is the only bidder. Accordingly, his attorney must be careful in advising him of an appropriate bid amount. At least one attorney has been sued for malpractice by a holder after advising the holder to bid an amount in excess of the true debt, when the maker later claimed that the foreclosure sale created a surplus.10

Provided the foreclosure sale is conducted legally and properly, the mere fact that the property was sold for considerably less than its fair market value will not render the sale invalid.11 However, the holder's bid amount may create an unintended surplus claimable by the maker, depending upon which of the two approaches is applicable. If the jurisdiction follows the first

approach, which ignores the outstanding balance of the underlying note, the amount bid by the holder at the foreclosure sale under the hypothetical facts could equal an amount up to the outstanding balance of the wraparound note ($1,500,000) without creating a surplus. However, if the jurisdiction follows the second approach, which bases the calculation of the deficiency/ surplus upon the difference between the true debt and the amount bid, then the amount bid by the holder at the foreclosure sale under the same facts could not exceed the true debt (5500,000) without creating a surplus claimable by the maker. Accordingly, a conservative holder who wishes to avoid the creation of an unintended surplus should bid less than the amount of the true debt.

the property which was sold at the foreclosure sale under the wraparound deed of trust.

Consolidated involved a foreclosure sale of property encumbered by five liens under five separate deeds of trust, which secured five separate promissory notes. EVA, the holder of the wraparound fifth lien note, which was secured by the wraparound deed of trust pursuant to which foreclosures occurred, purchased the property at the foreclosure sale 'subject to" the four underlying notes and liens. The four underlying liens are described as "Prior Liens," and the outstanding balances of the notes secured by those liens were included in the fifth lien vvraparound note. It was undisputed that the fifth lien was to secure a wraparound note that specifically wrapped around the underlying notes secured by the four pre-existing liens encumbering the property.

EVA, the highest bidder at the foreclosure sale, purchased the property for 52,750,000. The total indebtedness of the fifth lien (which wrapped the outstanding balances of the four pre-existing notes) was stipulated at 56,206,952. The *Conslidated* court began its deficiency calculations by reducing the total indebtedness of the fifth lien by the amount of the successful bid at the foreclosure sale *and by tl~,e total amount of the included r~nderlying deot.* The only issue was whether the fourth lien in indebtedness, which was paid off by the trustee, should be included as a part of the underlying debt. The *Consolidated* court held as a matter of law that the owner of the foreclosure sale, and that the total outstanding balance of all four included underlying notes was offset against the amount of the wraparound fifth lien note for deficiency (or surplus) calculation purposes.

B. Lee

In *Lee,* the holder sued the maker on the wraparound note after a default in payment. The case involved a series of wraparound transactions. The appellate court's pertinent decisions were that: (1) the maker was not responsible for the balance due on prior debt (underlying note) and (2) the proper method of calculating the sums due to the holder from the maker was to subtract "the balance due on the prior debts ... from the balance due on the [wraparound note]."ls

By opinion dated Dec. 9, 1987, the Texas Supreme Court refused to grant a writ in *Lee,* finding no reversible error. However, the Court subsequently granted rehearing in *Lee,* consolidated *Lee* with *Consolidated* for argument, and heard argument in both cases on March 30, 1988. As of the date of this article, neither case has been decided.

V. Conclusion

Consolidated and *Lee* indicate that Texas courts currently compute deficiencies after foreclosure under wraparound mortgages using the bid versus true debt approach. The persuasive logic behind these decisions leads irrevocably to the conclusion that, when computing the amount of deficiency after foreclosure under a wraparound indebtedness, the amount of the underlying debt must be offset against the amounts owing under the wraparound note in order to arrive at the "true debt" owing by the maker to the holder. Further, the bidding holder at a foreclosure sale should bid only an amount equal to or less than the true debt in order to avoid an arguable claim of surplus by the maker.

The Texas Supreme Court in *Consolidated* and *Lee* will be the first high court in any state to definitively choose one approach or the other. Thus, these decisions can be expected to have broad impact outside Texas, as well as within this state.

LAWYER TO LAWYER

1. W. Baggett, "Forec?osure: Special Problem Areas" Twentieth Annual Mortgage Lending Institute 111(1986).
2. *Id.* at 110.
3. B. Bentley, "The Wrap-Around Mortgage: Analyzing and Documenting" Advanced Real Estate Lavv Course Materials 60 (1986) (hereinafter cited as Bentley).
4. *Trafulger b?r Ltd. v. Westminster Assoc. Etd.,* 715 S.W.2d 745, 746 (Text App.—Austin 1986, no writ); Schrader, "The WrapAround Mortgage A Critical Inquiry," 21 UCLA L. Rev.
5. *Id.* at 1531.
6. *See e.g. Tarrant sa? -v Lucky Horr~es,lnc.,* 390 S.W.2d 473 (Text 1965); *Daugherty v. Monritt Assoc..* 293 Md 339, 444 A.2d 1030 (1982); *Conso)idated Capital Special Tn~st v. Summers,* 737 S.W.2d 327 (Text App. — Houston [14th Dist.] 1987, writ granted) *Quality Inns Int'l -v. Booth,* 292 S.E.2d 755,58 N.C. App. 1 (N.C. Ct. App. 1982); *J.M. Realty Inv. Corp. v. Stern,* 296 So.2d 588 (Flat Dist. Ct. App. 1974).
7. *Q:`ality Inns Int'l,* 292 S.E.2d at 762.
8. *See Quality Inns Int'l,* 292 S.E.2d at 755.
9. *Id.* at 762.
10. *Tarrant Sav.,* 390 S.W.2d at 475. Exceptions are set forth in *Lee v. Sabine Bank,* 708 S.W.2d 582 (Text App,—Beaumont 1986, writ ref'd n.r.e.) and in bankruptcy law.
11. Bent]ey at 60.
12. *Id.*
13. *Thomason -~. Pacific Mut. Life Ins. Co.,* 74 S.W.2d 162, 164 (Text Civ. App.—El Paso 1984, writ ref'd).
14. *Lee v. O'Leary,* 742 S.W.2d 28, 31 (Text App.—Amarillo
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