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UNWRAPPING THE WRAPAROUND MORTGAGE FORECLOSURE PROCESS

A wraparound mortgage[1] is a special type of junior or second mortgage.[2] A wraparound is subordinate to an existing first mortgage or other prior lien that remains unsatisfied.[3] The wraparound differs from a conventional second mortgage in that the principal or face amount of the wraparound "wraps around" and includes the underlying indebtedness of the first mortgage.[4] The face amount of the wraparound, therefore, consists of the underlying indebtedness of the first mortgage and the amount of the additional funds or credit that the lender extends under the wraparound.[5] The lender charges interest, at a rate higher than that charged on the underlying indebtedness, on the face amount of the wraparound to create a yield greater than the yield that an ordinary junior mortgage would produce.[6] When the lender adds the amount of underlying indebtedness to the amount of funds extended under the wraparound and charges interest on the resulting sum, the lender collects sufficient payments to service the underlying debt.[7] The most distinctive feature of the wrap-

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1. Commentators and practitioners do not agree on the spelling ("wraparound," "wrap around," or "wrap-around") or name ("wraparound," "all-inclusive," "overriding" mortgage or deed of trust) of this financing device. *See* Galowitz, *How to Use Wraparound Financing*, 5 REAL EST. L.J. 107, 137 (1976) (noting that commentators and practitioners disagree on spelling and name of wraparounds). This Note will refer to the terms "wraparound mortgage," "wraparound note," and "wraparound deed of trust" as a "wraparound."

2. *See* Bentley, *The Wrap-Around Mortgage: Analyzing and Documenting*, Advanced Real Estate Law Course Materials X-3 (1986) (available from State Bar of Texas) (explaining that wraparounds are essentially junior mortgages); Gunning, *The Wrap-Around Mortgage . . . Friend or U.F.O.?*, 2 REAL EST. REV. 35, 36 (1972) (stating that wraparounds are second mortgages); Zumpano & Marsh, *Creative Financing Arrangements: Risks and Liabilities*, 12 REAL EST. L.J. 151, 156 (1983) (noting that wraparounds are subordinate mortgages because wraparounds "wrap around" existing indebtedness); *infra* note 4 and accompanying text (describing difference between wraparound and conventional second mortgage). *But see* HAW. REV. STAT. § 478.8(e)(1) (1985) (defining wraparounds as first liens for purposes of usury statute).

3. *See* Bentley, *supra* note 2, at X-1 (stating that first mortgage and other prior liens remain outstanding at inception of wraparound); Gunning, *supra* note 2, at 36 (same).

4. *See* Gunning, *supra* note 2, at 36 (comparing wraparound financing to conventional mortgage financing).

5. *See id.* (explaining mechanics of wraparounds).

6. *See id.* (describing mechanics of wraparounds).

7. *See* R. KRATOVIL & R. WERNER, REAL ESTATE LAW 378 (9th ed. 1988) (explaining that, because wraparound mortgagee charges interest on aggregated debts, wraparound mortgagee collects payments sufficient to pay prior mortgage); Bentley, *supra* note 2, at X-1 (explaining that wraparound mortgagee uses payments received from wraparound mortgagor to pay underlying debt); *infra* notes 16-26 and accompanying text (illustrating that, although wraparound mortgagor does not assume first mortgage indebtedness, wraparound mortgagee includes first mortgage debt in wraparound debt and services underlying debt by charging interest on sum of underlying indebtedness and funds advanced under wraparound).

around is that the lender, the wraparound mortgagee, and the borrower, the wraparound mortgagor, typically agree that the wraparound mortgagee will pay the underlying indebtedness from the funds received from the wraparound mortgagor.[8] The parties to the wraparound also usually agree that the wraparound mortgagor will take the property "subject to" the underlying indebtedness and, therefore, not assume liability for the underlying indebtedness.[9]

The two principal types of wraparounds are the purchase money wraparound and the refinancing wraparound.[10] The purchase money wraparound facilitates the purchase of real property.[11] The parties to a sale of real property use a purchase money wraparound when interest rates are higher at the time of sale than the interest rate of the underlying mortgage on the property.[12] Because the buyer may not wish to or cannot obtain financing at the prevailing market interest rate, the seller provides the buyer with the financing for the transaction.[13] In return for financing the transaction, the seller receives a promissory note and either a deed of trust or a purchase money mortgage from the buyer.[14] By providing the buyer

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8. *See* Baggett, *Foreclosure: Special Problem Areas*, Twentieth Annual Mortgage Lending Institute 3 (1986) (available from University of Texas Law Library) (describing and illustrating common express agreements found in wraparounds); Bentley, *supra* note 2, at X-15 (same); Gunning, *supra* note 2, at 37 (describing common express agreements between wraparound mortgagor and wraparound mortgagee); Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 UCLA L. REV. 1529, 1529-30 (1974) [hereinafter Comment, *Critical Inquiry*] (discussing characteristics of wraparound agreements).

9. *See* Gunning, *supra* note 2, at 37 (noting that wraparound borrower expressly agrees not to assume payment of underlying indebtedness).

10. *See* Hool v. Rydholm, 467 So. 2d 1038, 1039 (Fla. Dist. Ct. App. 1985) (recognizing purchase money and refinancing wraparounds as two categories of wraparounds); Note, *Wrap-Around Financing: A Technique for Skirting the Usury Laws?* 1972 DUKE L.J. 785, 789 [hereinafter Note, *Wrap-Around Financing*] (identifying purchase money and refinancing wraparounds as two types of wraparounds); Note, *The Wrap-Around Deed of Trust: An Answer to the Allegation of Usury*, 10 PAC. L.J. 923, 927-29 (1979) [hereinafter Note, *The Wrap-Around Deed of Trust*] (same); Comment, *Critical Inquiry*, *supra* note 8, at 1530 (same). The purchase money wraparound and the refinancing wraparound may encompass more than one prior lien. *See* Bentley, *supra* note 2, at X-2 (noting that parties may wrap around outstanding obligations, including other wraparounds). In cases in which more that one wraparound exists, each subsequent wraparound becomes a lower priority lien to all previous mortgages. *Id.*

11. *See* Comment, *Critical Inquiry*, *supra* note 8, at 1531 (explaining that purchase money wraparound is taken in exchange for conveyance of land).

12. *See* Gunning, *supra* note 2, at 36 (explaining use of purchase money wraparounds).

13. *See id.* (discussing circumstances in which seller provides wraparound financing to buyer).

14. *See* Bentley, *supra* note 2, at X-6 (describing instruments that parties use in wraparound transactions); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 927 (explaining that borrower signs promissory note, which acknowledges debt and promises payment, in addition to executing deed of trust or mortgage that serves as security for repayment). Although a mortgage and a deed of trust operate differently in the financing of the sale of property, the differences are not important for the purposes of this Note. The arguments this Note advances are equally applicable in jurisdictions that employ a trust deed rather than a mortgage

with purchase money wraparound financing, the seller capitalizes on both the sale of the property and the low interest rate on the underlying mortgage.[15]

The following example illustrates a purchase money wraparound transaction.[16] Landowner *(L)* wants to sell his equity in Blackacre for $200,000. *L* owes $50,000 on a first mortgage loan at an eight percent interest rate. The prevailing market interest rate is twelve percent. Purchaser *(P)* is unable to obtain institutional financing. *L*, as seller, will finance the transaction by taking a wraparound from *P* for $250,000 at a ten percent interest rate. The face amount of the wraparound ($250,000) includes the underlying indebtedness ($50,000) plus the amount of the credit *L* extended to *P* ($200,000). *P* delivers a wraparound to *L*. The wraparound includes *L*'s covenant to pay the first mortgage holder from the payments that *L* receives from *P*. *P*'s annual interest payment on the $250,000 note at ten percent interest is $25,000. Thus, *L* could pay the $4,000 of annual interest on the first mortgage and also realize interest income of $21,000.[17]

Unlike a purchase money wraparound, a refinancing wraparound does not occur in conjunction with the sale of real property.[18] The debtor,

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instrument. For purposes of clarity, this Note assumes that a wraparound deed of trust is the instrument that secures the wraparound promissory note.

15. *See* Prince George's County v. McMahon, 59 Md. App. 682, 686, 477 A.2d 1218, 1220 (1984) (explaining that, because wraparound interest rate is computed on sum of first mortgage and any additional funds advanced, wraparound seller receives higher effective loan rate); Bentley, *supra* note 2, at X-6 (explaining seller's advantages in wraparound transactions).

16. Examples throughout this Note assume simple interest.

17. The following computations illustrate the amortization of the purchase money wraparound example:

Existing first mortgage (underlying loan):	
Original Amount of loan	$100,000.00
Interest rate	8.00%
Term	20 years
Annual Debt Service (principal and interest)	$ 12,370.44
Wraparound loan:	
Amount of loan	$250,000.00
Interest rate	10.00%
Term	10 years
Annual Debt Service (principal and interest)	$ 46,960.89
Net Return to seller:	
Amount received from wraparound	$ 46,960.89
Amount paid on first mortgage	(12,370.44)
Net income to seller	$ 34,590.45
Net return	17.30%

18. *See* Hool v. Rydholm, 467 So. 2d 1038, 1039-40 (Fla. Dist. Ct. App. 1985) (stating that borrower and lender do not use refinancing wraparounds with sales of property). As with a purchase money wraparound, a promissory note and a deed of trust or mortgage accompany the refinancing wraparound. *See* Bentley, *supra* note 2, at X-6 (identifying documents used in refinancing wraparound transactions); Gunning, *supra* note 2, at 36 (explaining refinancing wraparounds). Gunning lists four common situations in which parties employ refinancing

instead, wants to borrow an amount equal to his equity in a piece of property.[19] The debtor signs a note equal to the amount of the funds that the lender advances plus the amount of the underlying debt on the property.[20] The refinancing loan thus "wraps around" the prior debts, and the lender receives a junior lien that is subordinate to any prior mortgages on the property.[21] Although the lender advances only the difference between the face amount of the wraparound and the unpaid balance of the underlying debt, the borrower must pay interest on the full face amount of the wraparound, which includes the senior indebtedness.[22] In a refinancing transaction the lender, not the borrower, takes advantage of the lower interest rate on the senior debt.[23]

Using the parties discussed in the previous example, the following example explains a refinancing wraparound. *L* owns Whiteacre subject to a $100,000 first mortgage bearing an eight percent interest rate. Whiteacre's fair market value is $300,000. To obtain a $100,000 personal loan, *L* wants to refinance Whiteacre by securing the loan on his equity. A third party wraparound lender *(TP)* will advance *L* $100,000 if *L* gives *TP* a wraparound in the amount of $200,000 (underlying indebtedness of $100,000 plus the advance of $100,000) at ten percent interest.[24] *L* pays *TP* $20,000 interest per year ($200,000 face amount of wraparound at ten percent interest), and *TP* in turn agrees to pay the first mortgagee $8,000 interest per year ($100,000 first mortgage balance at eight per cent interest). Although *TP* agrees to pay off the first mortgage, *TP* does not assume the obligation on the first mortgage.[25] Thus, *TP* takes advantage of *L*'s

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wraparounds: first, when the mortgagor desires additional financing but the mortgagee refuses to provide the refinancing or the cost of conventional secondary financing is prohibitive; second, when the mortgagor desires additional financing and the first mortgage prohibits prepayment or charges a substantial penalty for prepayment; third, when the existing first mortgage is satisfactory in amount but the mortgagor desires to obtain debt-service relief to improve his return on equity; and fourth, when a commitment for permanent financing is inadequate and conventional secondary financing is too expensive or burdensome. *Id.*

19. *See* Bentley, *supra* note 2, at X-4 (describing debtor's objectives in refinancing wraparound transactions).

20. *See id.* (explaining mechanics of refinancing wraparounds); Note, *Wrap-Around Financing*, *supra* note 10, at 787 (same); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 929 (same).

21. *See* Bentley, *supra* note 2, at X-4 (explaining mechanics of refinancing wraparounds).

22. *See id.* (describing borrower's obligation in refinancing wraparound transaction).

23. *See id.* at X-5 (explaining how lender benefits in refinancing wraparound transactions because of lower interest rate on first mortgage); *cf. supra* notes 16-17 and accompanying text (illustrating borrower's advantageous use of lower interest rate on first mortgage).

24. *See The Wrap-Around Deed of Trust*, *supra* note 10, at 929 n.10 (explaining refinancing wraparounds). If the refinancing wraparound borrower borrows additional funds from the same lender that holds the first mortgage or deed of trust on the property, then the transaction is viewed as a rescission of the old contract and the formation of a new contract as a first mortgage or deed of trust. *See id.* (explaining effect of using same lender who holds first mortgage or deed of trust to refinance property).

25. *See* Bentley, *supra* note 2, at X-4 to X-5 (explaining that refinancing wraparound

lower interest rate on the first mortgage, $100,000 at eight percent, by receiving debt service payments on $200,000 at ten percent interest. Although *TP* must pay $8,000 interest to the first mortgage holder, *TP* receives $20,000 per year from *L*, and *TP* thus realizes $12,000 of interest income per year on the $100,000 advanced to *L*.[26]

By engaging in a wraparound transaction, a lender can protect his inferior lien position by monitoring the borrower's performance on the underlying loans, can profit from the difference in interest between the

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lender and wraparound borrower agree that wraparound lender will pay on first mortgage but that wraparound lender does not assume first mortgage obligation); Gunning, *supra* note 2, at 37 (same); Randolph, *Home Finance in the Shadow World: Unsolved Usury Problems Affecting Adjustable Rate and Wraparound Mortgages in Missouri*, 51 UMKC L. REV. 41, 65 (noting that refinancing wraparound lender usually agrees to make payments on first mortgage as payments fall due and as refinancing wraparound lender receives payments from the wraparound borrower). Gunning notes that some wraparound documents contain language tantamount to an assumption of the first mortgage by the refinancing wraparound lender. *See* Gunning, *supra* note 2, at 37 (explaining refinancing wraparounds). According to Gunning, however, wraparound documents can and do dispell the legal effects of an assumption because the documents condition the wraparound lender's obligation to pay the first mortgage holder on the wraparound lender's actual receipt of the debt service on the refinancing wraparound from the wraparound borrower. *See id.* (same).

26. The following computations illustrate amortization of the refinancing wraparound example:

Existing first mortgage (underlying loan):	
Original Amount of loan	$100,000.00
Interest rate	8.00%
Term	20 years
Annual Debt Service (principal and interest)	$ 12,370.44
Wraparound loan:	
Amount of loan	$200,000.00
Interest rate	10.00%
Term	10 years
Annual Debt Service (principal and interest)	$ 38,823.62
Net Loan Amount:	
Amount of Wraparound	$200,000.00
Outstanding balance on first mortgage	($100,000.00)
Amount Advanced	$100,000.00
Net Return to lender on Wraparound:	
Amount Advanced	$100,000.00
Term	10 years
Annual Debt Service (principal and interest) received	$ 38,823.62
Annual Debt Service (principal and interest) paid	($ 12,370.44)
Net Income	$ 26,453.18
Net return	26.45%

The lender increases the interest yield by advancing only $100,000 but receiving interest calculated on the face amount of the wraparound ($200,000). Many possible variations in the structure of wraparound transactions exist. *See* Bentley, *supra* note 2, at X-39 (explaining that wraparound may be "interest only" for several years, while senior debt amortizes principal; that wraparound may contain periodic "mini-balloon" payments to correspond to underlying balloon payments; and that wraparound may cover underlying payments by charging lower interest rate on sufficiently higher face amount).

wraparound and the underlying indebtedness, can realize a continuously increasing equity interest in the property, and possibly can defer taxes by treating the wraparound transaction as an installment sale.[27] Disadvantages include excessive paperwork involved with servicing the debt obligations underlying a wraparound, the usury implications from the profits of any interest spread on a wraparound,[28] and a "procedural quagmire"[29] upon the foreclosure of a wraparound.[30]

The advantages of a wraparound transaction for the wraparound borrower include the convenience of paying interest on one note instead of two, the securing of financing that otherwise might not be available to the borrower, the appeal of a low interest rate on the underlying indebtedness, and an overall interest rate at less than the market rate of interest.[31] The wraparound purchaser, however, may encounter a wraparound mortgagee who defaults on the underlying indebtedness without informing the purchaser of the default, who does not allow the purchaser to deal with prior lienholders, and who charges a high interest rate on the wraparound that offsets the low interest rate on the underlying indebtedness.[32]

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27. *See* Investors Funding Corp. v. Bloor, 547 F.2d 13, 15 (2d Cir. 1976) (explaining how lender benefits from wraparound financing and noting that, because monthly rate of amortization is faster on first mortgage than on wraparound, lender receives continually increasing equity interest in property); Levin v. Garfinkle, 499 F.Supp. 1344, 1350 (E.D. Pa. 1980), *aff'd* 667 F.2d 381 (3d Cir. 1981) (explaining that wraparound holder controls debt service on property because borrower makes payments reflecting entire indebtedness of property directly to wraparound holder and wraparound holder in turn pays senior lienholders); Prince George's County v. McMahon, 59 Md. App. 682, 687, 477 A.2d 1218, 1220 (1984) (explaining that wraparound lender expects to obtain best effective yield with least amount of cash investment because interest on wraparound is computed on sum of first mortgage and any additional funds advanced); Bentley, *supra* note 2, at X-2 (explaining advantages to lenders of wraparound financing).

28. *See infra* notes 103-44 and accompanying text (discussing usury implications of wraparounds). The difference between the face amount of the wraparound and the accompanying interest rate and the underlying indebtedness and the accompanying interest rate is referred to as the spread. *See* Randolph, *supra* note 25, at 66 n.99 (defining spread as difference between underlying indebtedness and face amount of wraparound); Waters, *What It's Like To Be A Junior Lienholder*, Eleventh Annual Advanced Real Estate Law Course D-17 to D-18 (available from State Bar of Texas) (defining spread as difference between amount wraparound lender actually advances and face amount of wraparound).

29. *See* Bayshore Garden Apartments, Ltd. v. Real Estate Apartments, Ltd., 541 So. 2d 158, 159 (Fla. Dist. Ct. App. 1989) (noting that foreclosure of wraparounds is "procedural quagmire").

30. *See* Bentley, *supra* note 2, at X-2 (describing disadvantages of wraparounds that lenders encounter).

31. *See id.* at X-3 (explaining advantages of wraparound transactions for borrowers); Gunning, *supra* note 2, at 36 (same); Department of Revenue v. Brookwood Assocs., 324 So. 2d 184, 185 (Fla. Dist. Ct. App. 1975) (explaining that wraparound enables borrower to make single payments on property's total indebtedness because lender transmits amount due under first mortgage to first mortgage holder).

32. *See* Bentley, *supra* note 2, at X-3 (noting disadvantages to wraparound borrowers of wraparound transactions). *See generally* Stroh-Mc Invs. v. Bowens, 725 P.2d 33, 34 (Colo. Ct. App. 1986) (involving wraparound mortgagee who defaulted on underlying indebtedness and failed to inform wraparound borrower of default).

Commentators have addressed the implications of wraparound financing in relation to usury claims, due-on-sale clauses, and taxes.[33] One subject that is "fraught with questions and uncertainty"[34] is the foreclosure of wraparounds. Courts generally have failed to consider the foreclosure of wraparounds.[35] How courts will compute the debt on a wraparound is the all-important issue in wraparound foreclosures because other significant wraparound foreclosure issues, such as usury and the application of excess foreclosure proceeds, depend upon computation of debt.[36]

Until recently, the topic of wraparound foreclosures received sparse judicial attention.[37] In *Summers v. Consolidated Capital Special Trust*,[38] however, the Texas Supreme Court adopted a method to compute whether a deficiency or a surplus exists after the foreclosure of a wraparound.[39] In *Summers* English Village Apartments (EVA) sold property to Robert Sill (Sill) in return for a purchase money wraparound.[40] The underlying indebtedness totaled $3,250,000.[41] EVA extended $1,450,000 in credit to

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33. *See generally* Comment, *Critical Inquiry*, *supra* note 8 (discussing wraparounds in context of usury, due-on-sale clauses, and taxes); Note, *Wrap-around Financing*, *supra* note 10 (discussing usury implication of wraparounds); Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP., PROB. & TR. J. 315 (1969) (same); Note, *The Wrap-Around Deed of Trust*, *supra* note 10 (same); Schwarz, *The Wrap-Around Mortgage: Cold Comfort in the Winter of the Due-On-Sale Clause*, 4 ANN. REV. BANKING L. 429 (1985) (discussing wraparounds in context of due-on-sale clauses); Kanter & Banoff, *Should Real Estate Be Sold Via Wrap-Around Mortgages?*, 70 J. TAX'N 255 (1989) (discussing tax implications of wraparounds); Fowler & Wyndelts, *Installment Sales: Wraparound Mortgage Regulation Invalidated by the Tax Court*, 15 J. REAL ESTATE TAX'N 203 (1988) (same).

34. *See* Quality Inns Int'l. v. Booth, 292 S.E.2d 755, 762 (N.C. App. 1982) (describing wraparound foreclosures as "fraught with uncertainty").

35. *But see infra* note 37 (listing few courts that have addressed wraparound foreclosures).

36. *Compare* Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327 (Tex. Ct. App. 1987) (using true debt method to compute wraparound debt) *with* Summers v. Consolidated Capital Special Trust, 783 S.W. 2d 580 (Tex. 1989) (adopting outstanding balance method to compute wraparound debt); *compare* Lee v. O'Leary, 742 S.W.2d 28 (Tex. Ct. App. 1987) (using true debt method to compute wraparound debt) *with* Lee v. Key West Towers, Inc., 783 S.W.2d 586 (Tex. 1989) (adopting outstanding balance method of wraparound debt computation).

37. *See* FPCI RE-HAB 01 v. E & G Invs., 207 Cal. App. 3d 1018, 1023, 255 Cal. Rptr. 157, 160 (1989) (noting that proper method of foreclosure of wraparounds is unclear); Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 838, 229 Cal. Rptr. 509, 512 (1986) (stating that proper method of wraparound foreclosure is unclear and that foreclosure is most difficult problem of wraparounds); Bayshore Garden Apartments, Ltd. v. Real Estate Apartments, Ltd., 541 So. 2d 158, 159 (Fla. Dist. Ct. App. 1989) (recognizing that no statute or judicial rule addresses proper manner of foreclosing wraparounds); J.M. Realty Inv. Corp. v. Stern, 296 So. 2d 588, 589 (Fla. Dist. Ct. App. 1974) (interpreting terms of wraparound to hold defaulting mortgagor liable for face amount of wraparound mortgage); *infra* note 79 (discussing *J.M. Realty*).

38. 783 S.W.2d 580 (Tex. 1989).

39. Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 582 (Tex. 1989).

40. *Id.* at 581.

41. *Id.* In *Summers* the underlying indebtedness that the Sill note wrapped around consisted of four prior liens. *Id.*; *see infra* note 54 (listing four prior liens in *Summers*).

Sill, causing the face amount of the wraparound to equal $4,700,000.[42] The Sill wraparound executed in favor of EVA was made subordinate to all prior liens.[43] Sill later used a refinancing wraparound to obtain additional funds from Consolidated Capital Special Trust (Consolidated).[44] Sill executed a wraparound in favor of Consolidated bearing a face amount of $6,289,000.[45] Consolidated was a subordinate lienholder to EVA because Consolidated's wraparound was subsequent to EVA's wraparound.[46]

Sill defaulted on the Consolidated wraparound.[47] Six months later, Consolidated foreclosed on the wraparound and acquired the property that EVA had sold to Sill.[48] When the Sill debt to EVA became due, Consolidated, as Sill's assignee, failed to pay; consequently, Summers, the trustee named in the Sill wraparound to EVA, initiated foreclosure proceedings.[49] At the foreclosure sale, EVA acquired the property with a $2,750,000 credit bid.[50] Consolidated subsequently sued EVA, claiming that EVA's bid of $2,750,000 exceeded Consolidated's debt to EVA and that EVA, therefore, owed Consolidated the surplus of EVA's bid minus Consolidated's debt to EVA.[51] The trial court rejected Consolidated's argument, found that a deficiency existed after the foreclosure sale, and granted EVA's motion for summary judgment.[52]

On Consolidated's appeal the Texas Court of Appeals determined that the language of the Sill wraparound required that the trustee apply the proceeds from the foreclosure sale to the indebtedness secured by the Sill

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42. *Summers*, 783 S.W.2d at 581.

43. *Id.*

44. *Id.* Although Sill used a refinancing wraparound to obtain additional funds from Consolidated, the wraparound at issue was Sill's purchase money wraparound to EVA. *Id.*

45. *Id.*

46. *See generally supra* note 10 and accompanying text (discussing lien priority of wraparounds when more than one wraparound exists).

47. Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 581 (Tex. 1989).

48. *Id.*

49. *Id.*

50. *Id.* In *Summers* the trustee credited EVA's bid of $2,750,000 against the amount owed on the Sill note. *Id.* In other words, EVA did not pay any cash money for the property at the foreclosure sale because EVA used a "credit bid" to purchase the property. *See generally* Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 834, 229 Cal. Rptr. 509, 511 (1986) (explaining that full credit bid operates as total satisfaction of lien); Thomason v. Pacific Mut. Life Ins. Co., 74 S.W.2d 162, 164 (Tex. Ct. App. 1934) (explaining that mortgagee may bid and purchase property at foreclosure sale and apply proceeds as credit against mortgagor's debt to mortgagee); R. KRATOVIL & R. WERNER, *supra* note 7, at 395 (explaining that mortgagee is allowed to bid up to amount of mortgage debt without producing cash because purpose of foreclosure sale is to raise money to pay mortgagee).

51. *See Summers*, 783 S.W.2d at 581 (discussing Consolidated's claim against EVA).

52. *See id.* at 582 (stating that trial court denied Consolidated's claim and granted EVA's motion for summary judgment); *see also* Hodges v. Star Lumber & Hardware Co., 544 S.W.2d 185, 185-86 (Tex. Ct. App. 1976) (explaining that deficiency exists when foreclosure sale proceeds are less than amount that mortgagor owes foreclosing mortgagee); R. KRATOVIL & R. WERNER, *supra* note 7, at 390 (same); C. JACOBUS, REAL ESTATE LAW 215 (1986) (same).

wraparound and to pay the balance, if any, to the owner of the property.[53] The court of appeals emphasized that the notice of the foreclosure sale and the trustee's deed to the purchaser at the foreclosure sale stated that the property would be sold "subject to" the senior liens described in the Sill wraparound.[54] By construing the foreclosure sale as "subject to" the senior liens, the court excluded the senior liens from the debt "secured by" the Sill wraparound.[55] The court of appeals, consequently, held that the trustee should credit the foreclosure sale proceeds against that portion of the wraparound which exceeded the underlying indebtedness.[56] The court instructed the trustee to pay any sums that remained after this credit to the debtor, Consolidated.[57] Accordingly, the court of appeals granted

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53. *Summers*, 783 S.W.2d at 581. In *Summers* the pertinent provision of the Sill deed of trust read:

> [T]he Trustee shall first pay all expenses . . ., and shall next apply such proceeds toward the payment of the *indebtedness secured hereby* (principal, interest [and] attorney's fees, if any), the remaining balance, if any, shall be paid to Grantors [Sill], their heirs and assigns [Consolidated].

Id. (emphasis in original).

54. *Consolidated*, 737 S.W.2d at 329. The priority of the liens encumbering the property were:

Lien	Mortgagee	Original Principal Sum	Due
1	John Hancock	$ 2,450,000	6/01/98
2	Gaslight Square (Wrapped Lien 1)	2,775,000	10/25/89
3	Manchester Group (Wrapped Liens 1 and 2)	3,250,000	8/15/89
4	RAIA	500,000	10/01/83
5	EVA	4,700,000	10/01/83

Id.

55. *See* Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327, 332 (Tex. Ct. App. 1987) (noting that EVA purchased property at foreclosure sale expressly subject to prior liens described in wraparound). The *Consolidated* court reasoned that, because EVA and Sill used "subject to" to indicate that all prior liens would encumber the property if the property were sold, EVA and Sill must not have intended to include the prior liens in the computation of debt secured by the deed of trust. *Id.* at 331-32. *See* Daugharthy v. Monritt Assocs., 444 A.2d 1030, 1032-33 (Md. App. 1982) (explaining that sale of property "subject to" existing mortgage does not make purchaser responsible for payment of existing mortgage); C. JACOBUS, *supra* note 52, at 226 (explaining that sale of property "subject to" prior liens does not personally obligate purchaser to pay existing mortgage).

56. *Consolidated*, 737 S.W.2d at 332.

57. *Id.* The court of appeals in *Consolidated* illustrated the debt computation as follows:

TOTAL DEBT (principal, interest and fees) OF FIFTH LIEN (wraps first four liens)		$ 6,206,952
AMOUNT OF "PRIOR LIENS DEBT" (to which foreclosure was subject)		
-Third lien (wraps first two liens)	$ 3,017,581	
-RAIA note (fourth lien)	976,685	
		(3,994,266)
AMOUNT OWED TO EVA ON		2,212,686
AMOUNT BID AT FORECLOSURE		2,750,000
LESS AMOUNT OWED		(2,212,686)
EXCESS PROCEEDS		537,314

Id. at 330.

summary judgment for Consolidated.[58]

By requiring the trustee to credit the foreclosure sale proceeds against the difference between the underlying indebtedness and the face amount of the Sill wraparound, the Texas Court of Appeals adopted the true debt method of debt computation.[59] The true debt method of debt computation focuses on the amount of funds the wraparound lender actually advances to the wraparound mortgagor and ignores the face amount stated in the wraparound.[60] Proponents of the true debt method argue that the true debt method considers the economic reality and substance of a wraparound transaction rather than the rigid form of the transaction.[61] One commentator asserts that the economic reality of a wraparound transaction is that the wraparound lender will disburse to the wraparound borrower the full face amount of the wraparound only when the wraparound borrower defaults on the first interest payment and the wraparound lender elects immediately to pay off the first mortgage.[62] The true debt method further posits that the wraparound mortgagor is not responsible for any underlying indebtedness included in the wraparound because the wraparound mortgagor does not accept responsibility for any underlying indebtedness when the mortgagor purchases the property.[63] The underlying indebtedness, instead, remains the responsibility of the wraparound mortgagee.[64] Under the true debt method the wraparound mortgagor is liable only for the actual amount of funds that the wraparound mortgagee advances.[65]

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58. *Id.*

59. *See* Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327, 332 (Tex. Ct. App. 1987) (adopting, implicitly, true debt method of debt computation).

60. *See* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 1988 TEX. B.J. 1051, 1052 (Nov.) (defining true debt as difference between balance of wraparound and balance of underlying indebtedness); Gunning, *supra* note 2, at 37, 45 (stating that true measure of debt secured by wraparound is net investment of wraparound lender and that net investment is difference between balance of wraparound and balance of underlying indebtedness). Gunning terms the true debt as the wraparound mortgagee's net investment. *Id.* at 37. Gunning also suggests that the face amount of the wraparound is irrelevant in determining the amount of indebtedness secured by the wraparound. *Id.* at 45. Gunning argues that the face amount of the wraparound is relevant only in computing the wraparound lender's effective rate of interest. *Id.*

61. *See* Goren & Meyer, *supra* note 60, at 1052 (discussing true debt method for calculating deficiency or surplus after foreclosure of wraparound).

62. *See* Gunning, *supra* note 2, at 45 (explaining that only if wraparound lender pays off first mortgage does wraparound lender actually advance face amount of wraparound to wraparound borrower); Bentley, *supra* note 2, at X-11, X-60 (noting that many attorneys view wraparound balance as wraparound lender's equity in wraparound, that is, difference between underlying indebtedness and face amount of wraparound). Bentley suggests that the face amount of a wraparound should be relevant to the computation of wraparound debt when the first mortgage holder accelerates the underlying debt or when the wraparound mortgagee satisfies the underlying debt. *Id.*

63. *See* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 582 (Tex. 1989) (explaining true debt method of computing wraparound debt).

64. *Id.*

65. *Id.*

On Summers and EVA's appeal of the decision of the Texas Court of Appeals, the Texas Supreme Court considered whether the appellate court correctly used the true debt method.[66] Upon analyzing the true debt method, the *Summers* court concluded that the true debt method provided an unnecessary windfall to Consolidated for defaulting on the EVA wraparound because the foreclosure relieved Consolidated from any further obligation to EVA[67] and awarded Consolidated more than $500,000 for defaulting on the wraparound.[68] Dissatisfied with the consequences of applying the true debt method, the *Summers* court analyzed the outstanding balance method, which treats the unpaid balance of a wraparound as the pertinent debt figure.[69] The *Summers* court distinguished the wraparound mortgagor's personal liability on the underlying indebtedness from the wraparound mortgagor's obligation to pay for the property, as the wraparound mortgagee and the wraparound mortgagor had agreed.[70] The Texas Supreme Court reasoned that Consolidated's failure to become liable on the underlying indebtedness did not affect Consolidated's obligation to pay EVA the entire amount of the wraparound.[71]

The *Summers* court recognized that a wraparound mortgagee's failure to apply excess proceeds from a foreclosure sale to the underlying debt could result in a third party purchaser at a wraparound foreclosure sale having to pay twice to obtain clear title to the property.[72] The court specifically determined that a third party purchaser would have to pay cash at the foreclosure sale and then have to satisfy the underlying indebtedness to obtain clear title to the property and avoid subsequent foreclosure of the property.[73] To avoid forcing a third party purchaser to pay twice to obtain clear title to the property,[74] the *Summers* court implied a covenant, applicable to all wraparounds, that required that the trustee apply any excess proceeds from a foreclosure to the underlying indebtedness.[75] If any proceeds remain after the trustee applies the proceeds to the

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66. *Id.*

67. *Id.*; *see supra* note 50 (explaining that full credit bid operates to satisfy defaulting mortgagor's obligation to mortgagee).

68. *Summers*, 783 S.W.2d at 582; *see supra* note 57 and accompanying text (illustrating Texas Court of Appeals' computation of Consolidated's excess proceeds).

69. *Summers*, 783 S.W.2d at 582-83.

70. *See id.* at 582 (noting that court of appeals confused wraparound mortgagor's liability on underlying indebtedness with wraparound mortgagor's obligation to pay face amount of wraparound).

71. *See id.* (applying distinction between wraparound mortgagor's liability on underlying indebtedness and wraparound mortgagor's obligation to pay wraparound).

72. *Id.* at 583.

73. *See id.* (recognizing that outstanding balance method may require third party purchaser to pay senior liens twice to obtain clear title to property).

74. *See infra* notes 75, 80-82 and accompanying text (discussing possibility of third party purchaser paying twice to obtain clear title if foreclosing wraparound mortgagee failed to apply excess proceeds to underlying indebtedness).

75. Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 583 (Tex. 1989).

underlying indebtedness, the court directed that the trustee distribute the remaining funds to the defaulting mortgagor.[76] The *Summers* court found that the express terms of the agreement between Sill and EVA, to which Consolidated, as Sill's assignee, was subject, stated that Consolidated was liable upon foreclosure for the entire face amount of the wraparound.[77] Accordingly, the court ruled against Consolidated, holding that a deficiency existed because the foreclosure sale proceeds, when credited against the outstanding balance of the wraparound, were less than the amount Consolidated owed EVA.[78]

The *Summers* court declared that a covenant requiring the trustee to apply any excess foreclosure sale proceeds to the underlying indebtedness would be implied in every wraparound agreement in Texas. *Id.*

76. *Id.* If a deed of trust secures the wraparound, the trustee is responsible for conducting the foreclosure sale and applying the proceeds of the foreclosure sale. *See id.* (instructing trustee how to apply foreclosure sale proceeds).

77. *Id.* at 582.

78. *Id.*; *see infra* notes 79-98 and accompanying text (analyzing Texas Supreme Court's adoption of outstanding balance method of debt computation in *Summers*). In a companion case to *Summers*, *Lee v. Key West Towers, Inc.*, the Texas Supreme Court again considered how to apply the proceeds from the foreclosure sale of a wraparound. Lee v. Key West Towers, 783 S.W.2d 586, 586 (Tex. 1989). *Lee* involved a complex series of wraparound transactions. Lee v. O'Leary, 742 S.W.2d 28, 30 (Tex. Ct. App. 1987), *rev'd sub nom.* Lee v. Key West Towers, Inc., 783 S.W.2d 586 (Tex. 1989). In *Lee* the last wraparound mortgagor, Key West Towers, Inc. (Key West), sold the property to Northern Hospitality, Inc. (Northern). *Lee v. O'Leary*, 742 S.W.2d 28, 30 (Tex. Ct. App. 1987). Northern failed to make payments to Key West, causing Key West to default on its wraparound to Lee. *Id.* Key West's default caused a chain of defaults and ultimately the holder of the first mortgage foreclosed and acquired the property for $700,000. *Id.* at 30-31. The face amount of Key West's wraparound to Lee (the Lee wraparound) was $1,125,000. *Id.* at 30.

Lee sued Key West on the Lee wraparound. *Id.* at 31. The trial court used the true debt method and awarded Lee a deficiency judgment of approximately $74,000. *Id.* The trial court subtracted the unpaid balance on the underlying indebtedness, $974,382.12, from the unpaid balance on the Lee wraparound, $1,038,495.86, to arrive at the true debt of $73,702.70. *Id.* The court computed the figures as follows:

UNPAID BALANCE OF LEE WRAPAROUND	$ 1,038,495.86
UNPAID BALANCE OF UNDERLYING INDEBTEDNESS	(974,382.12)
AMOUNT OWED TO LEE	64,113.74
PLUS PRE-TRIAL INTEREST	9,588.96
TOTAL AMOUNT OWED TO LEE	73,702.70

Id. Lee argued that the amount bid at the foreclosure sale, instead of the unpaid balance of the underlying indebtedness, was the correct figure to credit against the amount owed on the wraparound. *Id.* Lee computed the following figures:

UNPAID BALANCE OF LEE WRAPAROUND	$ 1,038,495.86
AMOUNT BID AT FORECLOSURE	700,000.00
AMOUNT OWED TO LEE	338,495.86
PLUS PRE TRIAL INTEREST	9,588.96
TOTAL AMOUNT DUE LEE	348,084.82

Id.

The court of appeals in *Lee* subtracted the balance due on the prior liens from the balance due on the Lee wraparound because the Lee wraparound was made "subject to" the prior debts and because Key West expressly did not assume responsibility for the underlying

Although the Texas Supreme Court adopted the outstanding balance method in *Summers v. Consolidated Capital Special Trust*, the outstanding balance method, when applied to wraparound foreclosures, is flawed.[79]

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debts. *Id.* at 32. On appeal the Texas Supreme Court relied on *Summers* and held that the court should credit the foreclosure bid against the outstanding balance of the note. Lee v. Key West Towers, Inc., 783 S.W.2d 586, 588 (Tex. 1989), *rev'g sub nom.* Lee v. O'Leary, 742 S.W.2d 28 (Tex. Ct. App. 1987). Accordingly, the Texas Supreme Court reversed the court of appeals' decision and remanded the case for a determination of the deficiency. *Id.* According to the second computation above, the deficiency is $348,084.82.

79. *See* Baggett, *supra* note 8, at 113 (criticizing outstanding balance method of debt computation). The outstanding balance method is similar to the face amount version of the loan amount theory used when testing a loan for usury. *See infra* notes 112-15 and accompanying text (discussing face amount version of loan amount theory). The alternative method for computing the debt of a wraparound is the true debt method. *See supra* notes 53-65 and accompanying text (explaining true debt method of debt computation).

The Third District Court of Appeals of Florida adopted the outstanding balance approach in *J.M. Realty Investment Corporation v. Stern*, 296 So. 2d 588 (Fla. Dist. Ct. App. 1974). In *J.M. Realty* the court considered whether the wraparound mortgagor's default entitled the wraparound mortgagee to foreclose on the entire balance due under the wraparound, including the amount due on the first mortgage. *J.M. Realty*, 296 So. 2d at 589. The defendant, J.M. Realty, purchased property for $220,000, paying $35,000 cash and executing a purchase money wraparound in favor of Stern for $181,954, which included $150,000 of underlying indebtedness. *Id.* at 588. The *J.M. Realty* court explained that, although the purchase price ($220,000) minus the cash down payment ($35,000) equalled $185,000, credits for prepaid rents, security deposits, and taxes amounted to $3,046.23. *Id.* n.1. The court thus determined that the wraparound amount was $181,953.77 ($185,000 - $3,046.23). *Id.* at 588. After J.M. Realty defaulted on the wraparound, Stern foreclosed on the wraparound. *Id.* at 589. The trial court determined that J.M. Realty owed $185,851 on the wraparound. *Id.* The amount that J.M. Realty owed Stern upon foreclosure was greater than the stated wraparound amount because the amount foreclosed upon included accrued interest, court costs, and attorneys' fees. *Id.*

The trial court rejected J.M. Realty's arguments that the amount owed should not include the principal on the first mortgage and that Stern, as a junior lienholder, could not accelerate the junior mortgage without the senior lienholder's permission. *Id.* On appeal the district court, without detailed analysis, concluded that the terms of the wraparound required J.M. Realty to pay the face amount of the wraparound, not the difference between the balance on the wraparound and the balance on the underlying indebtedness. *Id.* The district court, consequently, affirmed the trial court's order which stated that the amount of wraparound indebtedness included the underlying indebtedness. *Id.* The district court in *J.M. Realty* also directed that the trustee at a foreclosure sale apply any proceeds received from a third party purchaser first to the underlying indebtedness. *Id.*

The California appellate court adopted the reasoning of *J.M. Realty* in Armsey v. Channel Associates, 184 Cal. App. 3d 833, 838-39, 229 Cal. Rptr. 509, 512-13 (1986). In *Armsey* the court considered the methods of computing wraparound debt to determine whether an indebtedness remained after foreclosure. *Id.* at 835-36, 229 Cal. Rptr. at 510-11. Channel, the defendant in *Armsey*, purchased property for $700,000, paying $100,000 cash and executing a purchase money wraparound for $600,000. *Id.* at 835, 229 Cal. Rptr. at 510. After a fire destroyed the improvements on the property, Channel defaulted on the wraparound. *Id.* Armsey foreclosed and purchased the property with a credit bid of $456,562.73. *Id.* At the time of foreclosure the balance of the wraparound totaled $621,000, which included $158,818.56 in underlying indebtedness. *Id.* After acquiring the property at the foreclosure sale, Armsey filed a declaratory action to determine whether Armsey, the wraparound mortgagee, or Channel, the wraparound mortgagor, was entitled to the fire insurance proceeds. *Id.*

Rejecting Channel's argument that the underlying indebtedness should be credited against

For instance, under the outstanding balance method, a third party purchaser at foreclosure must satisfy the underlying indebtedness twice to obtain clear title to the property. First, the third party purchaser must bid in excess of the credit available to the wraparound mortgagee.[80] The third party purchaser who takes the property subject to the underlying indebtedness then must satisfy the underlying indebtedness to avoid subsequent foreclosure.[81] Based on the *Summers* facts, a third party purchaser would have to pay cash in excess of $10,000,000 to obtain clear title to the property.[82]

Foreclosing mortgagees usually purchase the property at foreclosure by using a "credit bid," a non-cash bid that is credited against the defaulting mortgagor's indebtedness to the mortgagee.[83] When a foreclo-

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the unpaid balance of the wraparound, the court distinguished a wraparound mortgagee's equity in property from a wraparound mortgagor's indebtedness on the property. *Id.* at 837-38, 229 Cal. Rptr. at 512. The court recognized that, if Armsey, the wraparound mortgagee, sold the property for cash, Armsey would not retain the entire sale proceeds because of his obligation to pay the senior liens. *Id.* If such a sale for cash took place, Armsey would realize only the value of his equity, the difference between the balance of the wraparound and the balance of the underlying indebtedness. *See id.* (explaining wraparound mortgagee's equity in property); Comment, *Critical Inquiry*, *supra* note 8, at 1538 (recognizing that sale of encumbered property requires seller to use portion of sale proceeds to discharge liens encumbering property and thus only realize value of seller's equity in property).

In contrast to the wraparound mortgagee's equity in property, the *Armsey* court determined that a wraparound lender receives a security interest in the full face amount of a wraparound because the wraparound includes the deferred portion of the purchase price and the unpaid balance of the underlying indebtedness. *Armsey*, 184 Cal. App. 3d at 837-38, 229 Cal. Rptr. at 512. The *Armsey* court concluded that a wraparound mortgagor's indebtedness includes the total amount of the underlying liens, even though the wraparound mortgagee remains obligated on the underlying liens and the wraparound mortgagor's obligation is only to the wraparound mortgagee. *Id.* Embracing the reasoning of *J.M. Realty*, the court refused to credit the underlying indebtedness to the unpaid balance of the wraparound, stating that the court would not rewrite the parties' agreement. *Id.* at 839, 229 Cal. Rptr. at 513.

80. *See infra* notes 81-91 and accompanying text (explaining use and effect of wraparound mortgagee's credit bid on third party purchasers). Under the outstanding balance method, the wraparound mortgagee can bid the entire balance of the wraparound as a credit against the wraparound mortgagor's obligation to the wraparound mortgagee. *See id.* (same).

81. *See* Baggett, *supra* note 8, at 113 (explaining effect of outstanding balance on third party who purchases property at foreclosure).

82. *See supra* note 57 (discussing wraparound and foreclosure bid figures in *Summers*). On the facts of the *Summers* case, a third party purchaser would have to pay the outstanding balance of the wraparound ($6,206,952) plus the underlying indebtedness of the senior liens ($3,994,266), an amount totaling $10,201,218. *See* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 581 (Tex. 1989) (stating wraparound balance and underlying indebtedness balance in *Summers*).

83. *See* Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 836, 229 Cal. Rptr. 509, 511 (1986) (explaining that full credit bid is bid by lienholder at foreclosure in amount equal to unpaid mortgage debt and that full credit bid operates as total satisfaction of obligation); *supra* note 50 (explaining effect of mortgagee's credit bid); R. KRATOVIL & R. WERNER, *supra* note 7, att 395 (stating that mortgagee is often only bidder at foreclosure and that mortgagee is allowed to bid up to amount of mortgage debt without producing cash); Bentley, *supra* note 8, at X-60 (stating that mortgage holder is usually successful bidder at foreclosure sale); Goren & Meyer, *supra* note 60, at 1052 (same).

sure sale only involves a defaulted junior lien, such as a wraparound, the property is sold subject to the underlying or senior indebtedness.[84] A purchaser of property subject to an underlying indebtedness must make payments on the prior existing indebtedness to avoid a subsequent foreclosure even though the purchaser is not personally liable on the underlying indebtedness.[85] The outstanding balance method of debt computation, consequently, negatively impacts potential purchasers, other than wraparound mortgagees, who cannot use credit bids at wraparound foreclosure sales.[86] To lessen this negative impact, courts should limit the wraparound mortgagee's credit bid to the difference between the wraparound balance and the underlying indebtedness and require that the wraparound mortgagee pay cash for any bid exceeding that difference.[87]

If the wraparound mortgagee bids an amount in excess of the difference between the underlying indebtedness balance and the wraparound balance, the law pertaining to junior lien foreclosures supports a cash bid requirement. After the foreclosure of a wraparound, a type of junior lien, the prior senior liens still encumber the property.[88] Although a wraparound mortgagee who bids at a foreclosure sale is not adversely affected by any remaining senior liens because the mortgagee remains obligated on the senior liens, a third party purchaser is disadvantaged because the third party purchaser receives property that is encumbered by those liens.[89] To avoid disadvantaging third party purchasers, third party purchasers should be able to calculate bids in light of any unpaid underlying indebtedness.[90]

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84. *See* C. JACOBUS, *supra* note 52, at 216 (stating that, in foreclosure sale of junior lien, property is sold subject to superior interests).

85. *See id.* at 226 (explaining effect of taking property subject to superior interests).

86. *See supra* note 82 and accompanying text (illustrating effect of outstanding balance method on purchasers who cannot use credit bids).

87. *See* Baggett, *supra* note 8, at 114 (suggesting that, if wraparound foreclosure sale is subject to underlying indebtedness, wraparound mortgagee should have to pay cash for any bid greater than difference between balance of wraparound and balance of underlying obligation); Becker & Bingham, *Current Issues in Foreclosures*, Advanced Real Estate Law Course H-35 (1987) (available from State Bar of Texas) (same); Galowitz, *supra* note 1, at 127 (same).

88. *See, e.g.*, United States v. Sage, 566 F.2d 1114, 1114-15 (9th Cir. 1977) (stating that foreclosure of junior lien does not affect pre-existing senior liens); Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 585 (Tex. 1989) (Mauzy, J., dissenting) (noting that foreclosure of senior lien extinguishes all inferior liens but does not affect any more senior liens); Baggett, *supra* note 8, at 114 (stating that foreclosure of inferior mortgage should not affect prior mortgage); Waters, *supra* note 28, at D-7 (concluding that foreclosure of junior lien transfers title subject to senior liens).

89. *See* Baggett, *supra* note 8, at 113 (criticizing chilling effect of outstanding balance method on participation of third party purchasers at foreclosure sales); *supra* notes 80-86 and accompanying text (suggesting that outstanding balance method requires third party purchaser to pay twice to obtain clear title to property).

90. *See* Baggett, *supra* note 8, at 114 (suggesting that "best solution" to bid computation issue is to restrict wraparound mortgagee's credit bid to difference between wraparound balance and underlying indebtedness balance and to allow third party purchaser to calculate bid in light of underlying indebtedness).

In other words, third-party purchasers would calculate bids by subtracting the underlying indebtedness on the property from the fair market value of the property.[91]

In addition to the outstanding balance method's adverse effect on third party bidders at foreclosure sales, the wraparound documents may not support the application of the outstanding balance method. For example, the *Summers* court, in applying the outstanding balance method, reasoned that the clear terms of the wraparound expressed the intent of the parties that Consolidated was obligated to pay the full balance of the wraparound.[92] The Sill wraparound in favor of EVA that Sill assigned to Consolidated, however, contained additional language that suggested that Sill and EVA intended the indebtedness to be the difference between the wraparound balance and the balance of the underlying indebtedness.[93] The provisions in the wraparound documents, stating that Consolidated assumed no liability to pay the underlying indebtedness and that Consolidated took the property subject to the underlying indebtedness, indicate that the trustee should credit the underlying indebtedness against the unpaid balance of the wraparound.[94]

Yet another flaw of the outstanding balance method is its potential to provide a windfall to a wraparound mortgagee.[95] The outstanding balance method allows the wraparound mortgagee to regain title to the property and sue the wraparound mortgagor for any deficiency, or trans-

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91. Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 585 (Tex. 1989) (Mauzy, J., dissenting). Justice Mauzy, in his dissenting opinion in *Summers*, suggested an approach that allows third party purchasers to calculate bids by subtracting the amount owed on the underlying indebtedness from the fair market value of the property. *Id.* Justice Mauzy argued that such an approach is consistent with the intentions of the parties expressed in the *Summers* deed of trust, which required the trustee to conduct the foreclosure sale subject to the underlying indebtedness and excluded the wraparound mortgagor from personal liability on the underlying indebtedness. *Id.*

92. *See id.* at 582 (discussing Consolidated's obligation to pay pursuant to express terms of wraparound). The wraparound in *Summers* referred to the original principal balance of $4,700,000 plus accrued interest as the indebtedness secured by the deed of trust. *Id.* at 581.

93. *Id.* at 582 n.2. The deed of trust in *Summers* provided:

> The Grantors have accepted the conveyance of the . . . property *subject to* the Prior Notes and to the Prior Liens, to the extent and only to the extent set forth in the Deed, and *Grantors have in no way assumed* or agreed to pay or to become personally liable for any of the indebtedness evidenced by the Prior Notes.

Id. (emphasis added).

94. *See id.* at 585-86 (Mauzy, J., dissenting) (arguing that, because Note, Deed of Trust, and Notice of Trustee's Sale in *Summers* contained express provisions that wraparound mortgagor assumed no liability to pay underlying debt and that purchase was subject to the underlying indebtedness, indebtedness secured by deed of trust did not include underlying indebtedness). *But see supra*, notes 70-77 and accompanying text (explaining that *Summers* majority viewed wraparound documents as clearly stating amount of indebtedness and distinguishing between mortgagee's equity in property and mortgagor's obligation to pay for property according to terms of wraparound).

95. *See* Goren & Meyer, *supra* note 60, at 1052 (criticizing outstanding balance method).

form the mortgagee's equity in the property into cash.[96] According to some commentators, the wraparound mortgagee thus benefits more when a wraparound mortgagor defaults than when the wraparound mortgagor fully performs under the wraparound.[97] The typical mortgagor certainly will not intend that the mortgagee benefits when the mortgagor defaults.[98]

In addition to determining how to avoid claims of generating surplus proceeds, such as Consolidated's claim against EVA in *Summers*, wraparound mortgagees contemplating foreclosure of a wraparound mortgage should consider three possible effects of a foreclosure.[99] First, the foreclosing mortgagee should consider the possible usurious nature of accelerating the maturity of a wraparound.[100] Second, the foreclosing mortgagee

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96. *See id.* (same).

97. *See id.* (same). An amicus curiae brief to *Lee v. O'Leary*, 742 S.W.2d 28 (Tex. Ct. App. 1987) proposes that a wraparound mortgagee realizes a larger gain when the wraparound mortgagor defaults under the outstanding balance approach. *See* Brief of Amicus Curiae First American Title Insurance Company, Lee v. O'Leary, 742 S.W.2d 28 (Tex. Ct. App. 1987) (No. 07-85-0350-CV). The amicus brief offers the following example: Assume *P*, the wraparound mortgagor, acquired property by executing a wraparound of $4,500,000 in favor of *L*, the wraparound mortgagee. Brief of Amicus Curiae First American Title Insurance Company at 4, Lee v. O'Leary, 742 S.W.2d 28 (Tex. Ct. App. 1987) (No. 07-85-0350-CV). The wraparound includes underlying indebtedness of $4,350,000 and *L* advances $150,000 in credit to *P*. *Id.* *P* defaults on the wraparound and *L* forecloses. *Id.* at 5. At the foreclosure sale *L* acquires the property with a $50,000 credit bid. *Id.* The outstanding balance method, as applied by the *Summers* court, causes the following results:

1. If the parties fully perform as agreed, the wraparound mortgagee realizes a net gain of $150,000 (the face amount of the wraparound mortgage ($4,500,000) less the underlying indebtedness ($4,350,000)). *Id.* at 7.

2. If the mortgagor defaults and the wraparound mortgagee successfully acquires the property with a $50,000 credit bid, then the wraparound mortgagee recovers $4,450,000 (the difference between the face amount of the wraparound mortgage ($4,500,000) and the bid amount ($50,000)), without any corresponding offset of the underlying debt. *Id.*

3. Comparing the results of #1 and #2, the wraparound mortgagee is $4,300,000 better off ($4,450,000 recovery under #2 less $150,000 net gain under #1) if the wraparound mortgagor defaults than if the parties fully perform under the wraparound. *Id.* at 8.

98. *See* Goren & Meyer, *supra* note 60, at 1052 (noting that it is unbelievable that mortgagor would intend for mortgagee to benefit in event of default). *But see* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 582 (Tex. 1989) (interpreting that intent of parties to wraparound was to obligate wraparound mortgagor to pay full outstanding balance of wraparound); Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 839, 229 Cal. Rptr. 509, 513 (1986) (holding that wraparound mortgagor is responsible for entire balance of wraparound and stating that court would not rewrite parties agreement); J.M. Realty Corp. v. Stern, 296 So. 2d 588, 589 (Fla. Dist. Ct. App. 1974) (interpreting wraparound to hold wraparound mortgagor liable for balance of wraparound). In *J.M. Realty* the court refused to modify the express terms of the wraparound and stated that the court was powerless to relieve the wraparound mortgagor from the hardships of an improvident bargain. *Id.*

99. *See* Baggett, *supra* note 8, at 111 (suggesting three issues that wraparound instruments should address); Waters, *supra* note 28, at D-10 (identifying three prominent issues concerning wraparound foreclosure).

100. *See* Waters, *supra* note 28, at D-10 (advising that wraparound mortgagees should consider possible usurious effect of accelerating amount due under wraparound). Usury

who bids at the foreclosure sale should consider the potential impact of a wraparound mortgagor's filing of a bankruptcy petition simultaneously with the foreclosure sale.[101] Third, in the event that the foreclosure sale generates proceeds in excess of the wraparound mortgagor's debt to the wraparound mortgagee, the foreclosing mortgagee should consider how to apply any excess proceeds of the foreclosure sale.[102]

Because the wraparound lender advances only part of the principal of a wraparound in return for interest payments on the full face amount of the wraparound, the wraparound lender receives a high yield, or rate of return, that may violate a usury statute.[103] Two theories assert, however, that a purchase money wraparound is exempt from the usury laws or, alternatively, that the transaction is nonusurious. The first theory, the sale exemption theory, distinguishes a loan or forbearance from a sale of real property in which the parties use a purchase money wraparound.[104] The distinction between a loan or forbearance and a sale of real property is significant because most usury statutes apply only if a loan or forbearance exists.[105] Thus, if a debt such as a purchase money wraparound arose out of a sale of property, many courts hold that the usury laws do not apply because no loan or forbearance occurred.[106] Legislators justify exempting sales of real property from the usury laws because, unlike a loan or forbearance, a sale does not normally involve a needy borrower and an avaricious lender.[107]

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statutes vary among jurisdictions. *See* VA. CODE ANN. § 6.1-330.73 (1988) (exempting seller of property from usury law); *compare* ARIZ. REV. STAT. ANN. § 44-1201 (1987) (setting maximum interest rate at ten percent unless different rate is contracted for in writing) *with* MINN. STAT. ANN. § 334.01 (West 1981) (making unlawful charging or receiving interest above eight percent); *see also infra* notes 103-44 and accompanying text (discussing usury implications of wraparounds).

101. *See* Waters, *supra* note 28, at D-18 (suggesting possible grounds for bankruptcy trustee to avoid wraparound foreclosure sale); *infra* notes 145-49 and accompanying text (discussing impact of Bankruptcy Code on wraparound foreclosures).

102. *See* Waters, *supra* note 28, at D-13 (discussing application of foreclosure proceeds); *infra* notes 153-62 and accompanying text (same).

103. *See* Lowell, *A Current Analysis of the Usury Laws—A National View*, 8 SAN DIEGO L. REV. 193, 195 (1971) (noting that wraparound mortgagee's high yield on wraparound may violate state usury laws). According to Lowell, three elements are common among usury statutes: (1) a loan or forbearance; (2) wrongful intent; and (3) the exaction of usurious interest. *Id.*; Prince George's County v. McMahon, 59 Md. App. 682, 686, 477 A.2d 1218, 1220 (1984) (explaining that wraparound lender receives effective rate of interest higher than stated interest rate because wraparound interest rate is computed on sum of first mortgage and additional funds advanced).

104. *See* Randolph, *supra* note 25, at 66-67 (identifying sale exemption theory's rationale).

105. *See* Lowell, *supra* note 103, at 220 (stating that usury laws patterned after Statute of Anne typically require loan or forbearance for statute to apply); Randolph, *supra* note 25, at 67 n.102 (explaining that usury laws do not apply to sales of property because usury laws view mortgagor as "free-to-choose" buyer instead of "necessitous borrower").

106. *See* Lowell, *supra* note 103, at 220 (stating that many courts find that usury laws do not apply if debt arises from purchase and sale rather that loan or forbearance).

107. *See id.* at 223-24 (noting that equal bargaining power is basis of excluding credit

The second theory, the loan amount theory, focuses on the amount of the loan.[108] One version of the loan amount theory asserts that only the actual cash advanced constitutes the principal amount of the wraparound.[109] This actual cash advanced version ignores the face amount of the wraparound because the lender did not advance the full amount of the underlying indebtedness, an amount included in the face amount of the wraparound, to the borrower.[110] For example, if the underlying indebtedness of a wraparound is $200,000 and the face amount of the wraparound equalled $250,000, the actual cash advanced approach treats the principal of the wraparound as $50,000 (face amount of wraparound less underlying indebtedness). Depending on the applicable usury law, the actual cash advanced version of the loan amount theory would label the loan as usurious if the lender charged or received interest at a usurious rate because the lender's total return from the wraparound is computed on a base smaller than the face amount of the wraparound.[111]

The second version of the loan amount theory, the face amount version, asserts that the full face amount of the wraparound constitutes the principal amount of the wraparound.[112] The face amount version assumes that the property at issue is worth at least the face amount of

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sale of real property from usury laws). Lowell explains that usury laws do not encompass sales of real property because the parties to such sales normally have equal power to negotiate the terms of the sale, including price and interest rate. *Id.*

108. *See* Randolph *supra* note 25, at 68 (discussing loan amount theory); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 935 (same).

109. *See* Randolph, *supra* note 25, at 68 (noting that actual cash advanced version of loan amount theory computes wraparound principal (debt) on basis of actual cash advanced).

110. *See id.* (noting that rationale for actual cash advanced version of loan amount theory addresses amount of cash debtor actually receives, not amount on which debtor makes interest payments); *supra* notes 5-25 and accompanying text (discussing mechanics of wraparounds).

111. *See* Randolph, *supra* note 25, at 68 (explaining actual cash advanced version of loan amount theory). Randolph demonstrates how the actual cash advanced version of the loan amount theory computes interest on a wraparound transaction in the following example: Assume that B buys a home for $100,000, paying $10,000 in cash and executing a wraparound for $90,000 at a 15% interest rate. *Id.* at 66. Further, assume that B takes the property subject to S's existing 8% mortgage with an unpaid balance of $50,000. *Id.* Applying the actual cash advanced version of the loan amount theory, the wraparound lender, S, receives an effective annual rate of return of 23.75%, computed by adding the interest charged (15%) on the actual cash advanced under the wraparound ($90,000 - $50,000 = $40,000) to the difference between the interest rate S receives, 15%, and the interest rate the wraparound lender pays on the first mortgage, 8% ((.15 - .08) x $50,000). *Id.* Thus, S receives $9,500 in interest on the $40,000 S actually advanced ($6,000 interest on the $40,000 actually advanced and $3,500 interest from the difference between S's interest payment on the first mortgage and the amount S receives from the wraparound borrower), yielding an annual effective return of 23.75% ($9,500 divided by $40,000). *Id.* Under a usury statute that prohibits the lender from receiving interest above 15%, the wraparound is usurious because, even though the instrument states a nonusurious interest rate of 15%, the lender actually receives interest at a rate higher than that allowed by the statute.

112. *See id.* at 68-69 (explaining face amount version of loan amount theory); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 937-40 (same).

the wraparound.[113] The face amount approach treats the wraparound lender as advancing both cash and credit for the unpaid balance of the underlying indebtedness and the borrower as receiving the full economic benefit of the face amount of the wraparound.[114] Courts, consequently, do not view purchase money wraparounds as usurious under the face amount version of the loan amount theory because the total return from the wraparound is computed on the face amount of the wraparound and not the amount of funds the lender actually advances.[115]

The Texas Civil Court of Appeals addressed both the sale exemption and loan amount theories in *Greenland Vistas, Inc. v. Plantation Place Associates.*[116] The *Greenland Vistas* court specifically considered whether, upon Plantation Place's default on a wraparound, the demand of Greenland Vistas for the face amount of the wraparound was usurious.[117] In *Greenland Vistas* Plantation Place bought an apartment complex from Greenland Vistas, paying a portion of the purchase price in cash and executing a purchase money wraparound for the remainder of the sale price.[118] The face amount of the wraparound, $2,707,434, included $2,074,830 of underlying indebtedness.[119] Greenland Vistas thus advanced

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113. *See* Randolph, *supra* note 25, at 69 (noting that face amount version of loan amount theory assumes that property's value equals or exceeds face amount of wraparound); Note, *Wrap-Around Financing*, *supra* note 10, at 802 (same); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 937-38 (same); Comment, *Critical Inquiry*, *supra* note 8, at 1534-39 (same).

114. *See* Randolph, *supra* note 25, at 69 (noting that face amount version of loan amount theory focuses inappropriately on benefit to borrower and not on return to lender); Comment, *Critical Inquiry*, *supra* note 8, at 1537-38 (identifying and criticizing face amount version of loan amount theory for unrealistically equating borrower's receipt of incidents of ownership and title to property with lender's receipt of cash in amount equal to property's value); Note, *The Wrap-Around Deed of Trust*, *supra* note 10, at 937-38 (explaining that face amount version of loan amount theory assumes that borrower receives full amount of principal at outset of purchase money wraparound transaction because borrower has full use of property that is worth face amount of wraparound); Note, *Wrap-Around Financing*, *supra* note 10, at 802 (explaining that purchase money wraparound transaction may not be usurious because borrower receives property with value at least equal to face amount of wraparound).

115. *See supra* note 17 (illustrating results of computing interest on base larger than amount of funds lender actually advances). An example of computing interest on a face amount greater than funds actually advanced is as follows: Assume that B buys a home for $100,000, paying $10,000 in cash an executing a wraparound for $90,000 at 15% interest. Assume also that B takes the property subject to S's existing 8% mortgage with an unpaid balance of $50,000. Applying the face amount version of the loan amount theory, the wraparound lender, S, receives an effective annual rate of return of 15%, computed by dividing the interest received from the wraparound ($13,500) by the face amount of the wraparound ($90,000); *supra* note 111 (assuming figures to illustrate actual cash advanced version of loan amount theory).

116. 746 S.W.2d 923 (Tex. Ct. App. 1988).

117. Greenland Vistas, Inc. v. Plantation Place Assocs., 746 S.W.2d 923, 925 (Tex. Ct. App. 1988).

118. *Id.* at 924.

119. *Id.*

$632,604 to Plantation Place.[120] When Plantation Place defaulted on the wraparound, Greenland Vistas accelerated the wraparound and demanded that Plantation Place pay the unpaid balance, plus interest, of the wraparound.[121] Plantation Place sued Greenland Vistas for charging a usurious rate of interest.[122]

The *Greenland Vistas* court construed the Texas usury statute[123] to provide that a lender could violate the statute only by contracting for, charging, or receiving interest in excess of the lawful limit.[124] Because Plantation Place did not allege that Greenland Vistas contracted for a usurious interest amount, the court examined only whether Greenland Vistas' demand for payment constituted either charging or receiving interest above the lawful limit.[125] According to the *Greenland Vistas* court, the transaction at issue was a sale of real property, not a loan or forbearance.[126] The court examined the contract between the parties and found that Greenland Vistas was obligated to pay the senior liens on the property out of the proceeds from Plantation Place's payments on the purchase money wraparound.[127] The court of appeals further determined that Plantation Place could pay the wraparound in full and obtain the property free of any underlying indebtedness and that Greenland Vistas could satisfy the underlying indebtedness if Plantation Place defaulted on the wraparound.[128]

In making these determinations, the *Greenland Vistas* court reasoned that the wraparound instruments prohibited Greenland Vistas from retain-

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120. *Id.* In *Greenland Vistas* one computes the amount of cash Greenland Vistas actually advanced, $632,604, by subtracting the unpaid balance of the underlying indebtedness ($2,074,830) from the face amount of the wraparound ($2,707,434). *Id.*

121. *Id.* In *Greenland Vistas*, Greenland Vistas demanded from Plantation Place a total of $2,944,655. *Id.*

122. *Id.* at 925.

123. TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (Vernon 1987).

124. *See Greenland Vistas*, 746 S.W.2d at 925 (construing Texas usury statute).

125. *Id.*

126. *Id.* The *Greenland Vistas* court noted that, in exchange for the wraparound, Plantation Place, the purchaser, received a deed to the property. *Id.* at 926. The court determined that Plantation Place, therefore, received the full benefit of the property and the face amount of the note. *Id.* Although the *Greenland Vistas* court did not emphasize the fact that the transaction was a sale of real property, one commentator asserts that the court was distinguishing *Greenland Vistas* from other Texas cases that determined whether a transaction was usurious by first subtracting any amounts of which the debtor did not have the benefit from the face amount of the note at issue. *See* Waters, *supra* note 28, at D-11 (explaining significance of *Greenland Vistas* court's noting that purchase money wraparound transaction was sale of real property instead of loan or forbearance). Waters explains that Texas law requires a court that tests a loan for usury to consider only the portion of the principal balance of the loan of which the borrower receives the full benefit. *Id.* Waters notes further that the court's goal is to find the "true principal" of the loan, an amount which may be less than the face amount of the note. *Id.*; *supra* notes 104-07 and accompanying text (explaining sale exemption theory).

127. *Greenland Vistas* 746 S.W.2d at 926.

128. *Id.*

ing the full amount of the payment demanded.[129] Greenland Vistas, instead, could retain only the difference between the payments received from Plantation Place and the payments required on the underlying indebtedness.[130] By holding that Greenland Vistas was entitled to only the difference between the payments due on the wraparound and the payments due on the underlying indebtedness, the appellate court appeared to adopt the actual cash advanced version of the loan amount theory and the true debt method of wraparound debt computation.[131] The court, however, went on to hold that the outstanding balance of the wraparound comprised the actual balance of the wraparound because Plantation Place received the full benefit of the property and, therefore, the full benefit of the principal amount of the wraparound.[132] The court of appeals refused to limit the balance of the wraparound to Plantation Place's equity in the property.[133] The *Greenland Vistas* court thus held that Greenland Vistas properly demanded the principal balance of the wraparound, which included the underlying indebtedness.[134]

In contrast to purchase money wraparound transactions, refinancing wraparound transactions are more likely to violate usury laws because the total return from the wraparound is computed on a smaller principal base, the amount of credit or cash actually advanced.[135] In one instance, the

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129. *Id.* The *Greenland Vistas* court concluded that Greenland Vistas could not retain the full amount of the payment demanded because of the language in the wraparound instruments. *Id.* at 927. The instruments, a promissory note and a deed of trust, required Greenland Vistas to pay the senior lienholders after Greenland Vistas received Plantation Place's payments. *Id.* at 926. Such language, according to the court, revealed that the parties intended for Greenland Vistas to pay the underlying indebtedness out of Plantation Place's monthly payments. *Id.* at 926-27.

130. *Id.* at 927.

131. *See supra* notes 59-65 and accompanying text (discussing true debt method of wraparound debt computation); *supra* notes 109-11 and accompanying text (discussing actual cash advanced version of loan amount theory).

132. *Greenland Vistas*, 746 S.W.2d at 927. The *Greenland Vistas* court implicitly adopted the outstanding balance method of computing debt owed under a wraparound by accepting the face amount version of the loan amount theory, which computes the principal balance of the wraparound debt on the full face amount of the wraparound. *See supra* notes 112-15 and accompanying text (discussing face amount version of loan amount theory); *supra* notes 69-78 and accompanying text (discussing outstanding balance method of computing wraparound debt). The court's holding, however, is incongruous because the court held Plantation Place liable for the outstanding balance of the wraparound (outstanding balance method of debt computation), yet limited Greenland Vista's right to retain the proceeds from foreclosure to the amount of actual cash advanced (true debt method of debt computation). *Greenland Vistas*, 746 S.W.2d at 927.

133. *Greenland Vistas*, 746 S.W.2d at 927. The *Greenland Vistas* court defined Plantation Place's equity in the wraparound as the difference between the balance due on the wraparound and the sums due on the underlying indebtedness. *Id.*

134. *Id.*

135. *See* Hool v. Rydholm, 467 So. 2d 1038, 1039 (Fla. Dist. Ct. App. 1985) (noting that courts often label refinancing wraparounds as usurious because courts treat only amount advanced in addition to first mortgage as principal of wraparound on which to calculate

Michigan Court of Appeals determined that a refinancing wraparound was usurious under Michigan law. In *Mitchell v. Trustees of United States Mutual Real Estate Investment Trust*,[136] the plaintiffs, the Mitchells, borrowed $10,200 from United States Mutual and executed a $77,600 wraparound in favor of United States Mutual.[137] The wraparound, which charged an eleven percent interest rate, encompassed the underlying indebtedness of a $64,219 first mortgage, at ten percent interest, on the Mitchells' home.[138] The Mitchells, dissatisfied with United States Mutual's response to the Mitchells' request for an account statement, stopped making payments to United States Mutual on the wraparound and began to pay the first mortgage holder directly.[139] United States Mutual declared the wraparound in default and instituted foreclosure proceedings.[140] After the foreclosure sale, the Mitchells sued United States Mutual for charging a usurious interest rate on the wraparound.[141]

The *Mitchell* court determined that the effective rate of interest on the wraparound ranged from twelve percent to twenty and one-eighth percent, a rate well above the seven percent rate that Michigan law allowed.[142] The *Mitchell* court then concluded that United States Mutual's wraparound was usurious under the Michigan usury statute.[143] The court, therefore, granted the Mitchells' motion for summary judgment against United States Mutual.[144]

A foreclosing wraparound mortgagee, after computing the debt of the wraparound mortgagor, determining an appropriate bid amount, and insuring that accelerating the wraparound will not violate a usury statute, should consider the possibility that a bankruptcy trustee may avoid the

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interest); Mindlin v. Davis, 74 So. 2d 789, 793 (Fla. 1954) (holding that courts measure interest lender receives on refinancing wraparound against smaller base of lender's net investment rather than larger base of face amount of wraparound); Note, *Wrap-Around Financing*, *supra* note 10, at 797-801 (concluding that refinancing wraparounds are usurious if refinancing lender receives interest on funds that lender did not actually advance).

136. 144 Mich. App. 302, 375 N.W.2d 424 (1985).

137. Mitchell v. Trustees of United States Mut. Real Estate Inv. Trust, 144 Mich. App. 302, 305, 375 N.W.2d 424, 426 (1985). In *Mitchell* the wraparound included, in addition to the proceeds of the loan, $3,181 in fees that the Mitchells paid to United States Mutual. *Id.*

138. *Id.*

139. *Id.* at 307, 375 N.W.2d at 427.

140. *Id.*

141. *Mitchell*, 144 Mich. App. at 307, 375 N.W.2d at 427. The *Mitchell* court considered a Michigan statute that limited interest charges to seven percent per annum. *See id.* at 309, 375 N.W.2d at 428 (construing MICH. COMP. LAWS ANN. § 438.31 (1978)).

142. *Id.* at 309 n.2, 375 N.W.2d at 428 n.2. The *Mitchell* court determined the rate of interest charged by calculating the interest on the basis of the $10,200 United States Mutual advanced to the Mitchells, rather than on $77,600, the face amount of the wraparound. *Id.*; *see supra* notes 109-11 and accompanying text (discussing actual cash advanced version of loan amount theory for testing whether wraparound is usurious).

143. *Mitchell*, 144 Mich. App. at 318, 375 N.W.2d at 432.

144. *Id.*; *see supra* note 114 (criticizing face amount version of loan amount theory).

foreclosure sale if the wraparound mortgagor commences a bankruptcy case within ninety days to one year of the foreclosure sale.[145] The Bankruptcy Code affords the bankruptcy trustee the opportunity to avoid a foreclosure sale as a fraudulent transfer if the wraparound mortgagor files

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145. *See* Waters, *supra* note 28, at D-18 (suggesting that wraparound mortgagee, when determining amount to bid at foreclosure sale, consider potential grounds for setting aside foreclosure sale).

For example, if the wraparound mortgagor files a bankruptcy petition within 90 days after the foreclosure sale, the bankruptcy trustee may avoid the foreclosure sale as a preferential transfer. *See* 11 U.S.C. § 547 (1988) (providing grounds for bankruptcy trustee to avoid foreclosure sale as preferential transfer). Under section 547(b) of the Bankruptcy Code, a bankruptcy trustee may avoid, as a preference, a transfer of the debtor's property if the property is transferred: (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) while the debtor was insolvent; (4) on or within 90 days before the date of the filing of the petition; and (5) so as to enable the creditor to receive more than the creditor would receive if the case were a chapter 7 bankruptcy case. *Id.*; *see also* Park North Partners, Ltd. v. Park North Associates, 80 Bankr. 551, 554-55 (Bankr. N.D. Ga. 1987) (illustrating bankruptcy trustee's ability to avoid wraparound foreclosure sale as preferential transfer); Smith v. American Consumer Fin. Corp., 21 Bankr. 345, 350 (Bankr. M.D. Fla. 1982) (setting aside foreclosure sale as preferential transfer).

In *Park North Partners, Ltd. v. Park North Associates*, 80 Bankr. 551, 551 (Bankr. D. Ga. 1987) the district court reviewed a bankruptcy court's holding that a wraparound foreclosure sale did not operate as a preferential transfer. Three months after Park North Associates (Associates), the wraparound mortgagee, foreclosed upon and used a credit bid to purchase property at a foreclosure sale, Park North Partners (Partners), the wraparound mortgagor, filed a petition for bankruptcy and subsequently sued Associates, claiming that the foreclosure sale resulted in a preferential transfer to Associates. Park North Partners, Ltd. v. Park North Assocs., 72 Bankr. 79, 80-81 (Bankr. N.D. Ga. 1987). The bankruptcy court held that Partners failed to prove that Associates, as a creditor, received a preferential transfer. *Id.*

On appeal the United States District Court for the Northern District of Georgia recognized that a debtor's payment to a secured creditor, to the extent of the value of the secured creditor's claim, does not constitute a preferential transfer. Park North Partners, Ltd. v. Park North Assocs., 80 Bankr. 551, 551 (Bankr. N.D. Ga. 1987). The district court stated, however, that a foreclosure sale could constitute a preferential transfer if the secured creditor received more from the foreclosure that the creditor would have received in a Chapter 7 liquidation, which would not exceed the value of the creditor's claim. *Id.* at 554. The court thus held that, if a secured creditor at foreclosure received property valued in excess of the amount of the creditor's claim, the foreclosure sale constitutes a preferential transfer. *Id.* at 554-55. The district court, consequently, vacated the bankruptcy court's order and remanded the case to the bankruptcy court to determine the fair market value of the property at the time Partners filed the bankruptcy petition. *Id.* at 555.

On remand the bankruptcy court found that the fair market value of the property at the time Partners filed the bankruptcy petition was $1,050,000. Park North Partners, Ltd. v. Park North Assocs., 85 Bankr. 916, 919 (Bankr. N.D. Ga. 1988). Because Associates received more from the foreclosure sale (property valued at $1,050,000) than Associates would have received in a Chapter 7 liquidation ($857,210), the bankruptcy court found that the foreclosure sale constituted a preferential transfer. *Id.* The bankruptcy court, pursuant to section 550 of the Bankruptcy Code, 11 U.S.C. § 550 (1988), awarded Partners a money judgment totaling $192,790, which represented the difference between the fair market value of the property and the balance of the wraparound. *Id.*

a bankruptcy petition within twelve months after the foreclosure sale.[146] Bankruptcy trustees rely on the Bankruptcy Code, which requires that the wraparound mortgagor receive a reasonably equivalent value of the property from the foreclosure sale, to avoid a foreclosure sale as a fraudulent transfer.[147] One court has interpreted "reasonably equivalent value" to require that a debtor receive at least seventy percent of the fair market value of the property at foreclosure.[148] Courts, by treating the amount of the underlying indebtedness differently, have arrived at different figures for "reasonably equivalent value," and have yet to agree on the treatment of underlying indebtedness. [149]

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146. *See* 11 U.S.C. § 548(a)(2) (1988) (empowering bankruptcy trustee to avoid foreclosure sale as fraudulent transfer). Under section 548(a) of the Bankruptcy Code, a bankruptcy trustee may set aside a transfer of property if: (1) the debtor had an interest in the property transferred; (2) the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer; (3) the transfer occurred within one year of the filing of the bankruptcy petition; and (4) the transfer was for less than a "reasonably equivalent value." *Id. See also* Becker value." *Id.*; *see also* Becker & Bingham, *supra* note 87, at H-27 (suggesting that wraparound mortgagee should consider effect of Bankruptcy Code's fraudulent transfer section when wraparound mortgagee determines bid price at foreclosure sale); Waters, *supra* note 28, at D-18 (same).

147. *See* 11 U.S.C. § 548(a)(2)(A) (1988) (empowering bankruptcy trustee to avoid wraparound foreclosure as fraudulent transfer if debtor receives less than reasonably equivalent value in exchange for transfer); Becker & Bingham, *supra* note 87, at H-27 (suggesting that reasonably equivalent value requirement of Bankruptcy Code's fraudulent transfer provision presents ground for trustee to avoid foreclosure sale); Waters, *supra* note 28, at D-18 (same).

148. *See* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980) (noting that no previous court had approved transfer of debtor's property for less than seventy percent of market value of property). Courts have generally interpreted *Durrett* as announcing that courts should view reasonably equivalent value in the foreclosure context as 70% of the fair market value of the property. *See* Bundles v. Baker, 856 F.2d 815, 819-20 (7th Cir. 1988) (analyzing *Durrett* definition of reasonably equivalent value and noting courts' and commentators' interpretation of *Durrett*). According to two commentators, most courts are now interpreting the seventy percent standard only as a general guideline. *See* Becker & Bingham, *supra* note 87, at H-17 (explaining that recent cases indicate that courts do not rigidly apply *Durrett* seventy percent standard); Walker v. Littleton, 888 F.2d 90, 93 (11th Cir. 1989) (stating that *Durrett* seventy percent rule provides useful guideline to evaluate fairness of transfer); *Bundles*, 856 F.2d at 823-24 (stating that courts should not limit definition of reasonably equivalent value to percentage comparison but should consider all facts of each case).

149. *See* Becker & Bingham, *supra* note 87, at H-28 - H-32 (discussing different effects of recognizing underlying indebtedness in computing reasonably equivalent value); Waters, *supra* note 28, at D-20 to D-24 (same). Courts have recognized four ways of treating the underlying indebtedness when deciding whether the debtor received a reasonably equivalent value from a foreclosure sale. *See* Willis v. Borg-Warner Acceptance Corp., 48 Bankr. 295, 301 (Bankr. S.D. Tex. 1985) (summarizing four approaches courts use in determining reasonably equivalent value when foreclosure does not affect underlying indebtedness).

The first approach ignores the underlying indebtedness on the property and divides the foreclosure sale price by the fair market value of the property to determine the reasonably equivalent value. *See* Smith v. American Consumer Fin. Corp., 21 Bankr. 345, 351 (Bankr. M.D. Fla. 1982) (comparing foreclosure sales price to fair market value of property). The

In addition to avoiding usury claims, determining bid amounts, and considering the impact of the Bankruptcy Code on wraparound foreclo-

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Smith approach equation for computing reasonably equivalent value is as follows:

$$\frac{\text{Foreclosure Sale Price (Bid)}}{\text{Fair Market Value}} = \text{Reasonably Equivalent Value \%}$$

See Becker & Bingham, *supra* note 87, at H-28 (explaining *Smith* approach to compute reasonably equivalent value); Waters, *supra* note 28, at D-20 (same). Commentators and courts have criticized the *Smith* approach for ignoring the underlying indebtedness and the economic reality of the transaction. *See In re* Richardson, 23 Bankr. 434, 442 n.11 (Bankr. D. Utah 1982) (criticizing *Smith* approach for failing to credit successful bidder for first lien indebtedness because purchaser at junior lien foreclosure takes property subject to first lien indebtedness); Becker & Bingham, *supra* note 87, at H-28 (same); Waters, *supra* note 28, at D-20 (same).

The second approach recognizes the underlying indebtedness on the property by adding the amount of underlying indebtedness to the foreclosure sale price and then dividing the resulting sum by the fair market value of the property. *See* Lawyers Title Ins. Corp. v. Madrid, 21 Bankr. 424, 426 (Bankr. 9th Cir. 1982), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir. 1984) (adding underlying indebtedness to foreclosure sale price and then comparing sum to fair market value of foreclosed property). The *Madrid* approach equates reasonably equivalent value as follows:

$$\frac{\text{Underlying Indebtedness + Foreclosure Sale Price}}{\text{Fair Market Value}} = \text{Reasonably Equivalent Value \%}$$

See Becker & Bingham, *supra* note 87, at H-28 to H-29 (illustrating *Madrid* approach); Waters, *supra* note 28, at D-20 (same). The *Madrid* approach has been criticized for giving credit to the junior lien purchaser for an amount that the purchaser is not legally obligated to pay (the senior indebtedness) because the purchaser takes the property subject to the senior liens. *See Richardson*, 23 Bankr. at 442 n.11 (criticizing *Madrid* approach to calculating reasonably equivalent value). Additionally, from the bankruptcy debtor's perspective, the *Madrid* approach fails to recognize that the debtor remains obligated for an amount that includes the underlying indebtedness if the outstanding balance method is adopted. *See id.* (same).

The third approach compares the foreclosure sale price to the debtor's equity remaining in the property after subtracting the amount of presale liens from the value of the property. *See* Coleman v. Home Savings Assoc., 21 Bankr. 832, 834 (Bankr. S.D. Tex. 1982) (computing reasonably equivalent value by dividing debtor's equity in property by foreclosure sale price). The *Coleman* equation for reasonably equivalent value is as follows:

$$\frac{\text{Foreclosure Sale Price}}{\text{Fair Market Value - All Encumbrances}} = \text{Reasonably Equivalent Value \%}$$

See Becker & Bingham, *supra* note 87, at H-29 (explaining *Coleman* approach); Waters, *supra* note 28, at D-21 (same). The *Coleman* approach is criticized for giving double credit to the amount of the foreclosure bid: the *Coleman* approach subtracts all preforeclosure liens, including the lien being foreclosed upon, from the fair market value of the property and then uses the foreclosure bid as a comparison figure to reach the reasonably equivalent value percentage. *See Richardson*, 21 Bankr. at 441-42 n.11 (criticizing *Coleman* approach for giving double credit to foreclosure bid); Becker & Bingham, *supra* note 87, at H-29 (same); Waters, *supra* note 28, at D-21 (same).

The final approach compares the foreclosure bid to the debtor's equity remaining in the property after subtracting the postsale liens from the value of the property. *See Richardson*, 21 Bankr. at 441 (comparing foreclosure bid amount to debtor's equity in property after subtracting senior liens from fair market value). The *Richardson* reasonably

sures, the parties to a wraparound should determine how to proceed in the event that the successful bidder incorrectly calculates the debt owed on the wraparound.[150] In such an instance two results are possible: excess

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equivalent value equation is as follows:

$$\frac{\text{Foreclosure Bid Amount}}{\text{Fair Market Value - Senior Liens}} = \text{Reasonably Equivalent Value \%}$$

See Becker & Bingham, *supra* note 87, at H-30 (explaining *Richardson* computation of reasonably equivalent value); Waters, *supra* note 28, at D-22 (same). Commentators criticize the *Richardson* approach for crediting the debtor with too much equity because the *Richardson* approach calculates reasonably equivalent value as if no senior lien encumbered the property. *See* Becker & Bingham, *supra* note 87, at H-30 (criticizing *Richardson* approach for ignoring senior lien); Waters, *supra* note 28, at D-22 (same).

Becker and Bingham suggest that the *Richardson* approach also ignores that a purchaser at a foreclosure sale, while not legally obligated to satisfy the senior lien, would not have purchased the property unless the purchaser intended to satisfy the senior lien. *See* Becker & Bingham, *supra* note 87, at H-30 (criticizing *Richardson* approach). Commentators also suggest that the *Richardson* approach requires the junior lienholder who purchases the property at the foreclosure sale to pay more than seventy percent of the fair market value of the property to assure that the debtor receives a reasonably equivalent value from the sale. *See id.* (explaining that *Richardson* approach requires junior lienholder to bid amount exceeding 70% of fair market value); Waters, *supra* note 28, at D-22 (same). Becker and Bingham offer the following example: Assume that the fair market value of the property is $100, encumbered by a first lien in the amount of $50 and a second lien in the amount of $20. Becker & Bingham, *supra* note 87, at H-30. The debtor's equity in the property is $30. *Id.* To assure that the debtor receives 70% of the fair market value, the second lien purchaser under the *Richardson* formula would have to bid $35 (70% of $50 [the postsale senior lien]). *Id.* If the junior lienholder bids $35 and also accommodates the first lien of $50, the junior lienholder has paid $85 for property worth $100, when only $70 would be required to meet the most demanding reasonably equivalent value interpretation. *See id.* (explaining that *Durrett* only requires 70% of fair market value for debtor to receive reasonably equivalent value).

According to three leading commentators on junior lien foreclosure, most courts appear to be adopting the *Richardson* approach in determining whether a debtor received a reasonably equivalent value at a foreclosure sale. *See* Becker & Bingham, *supra* note 87, at H-31 (noting trend of courts adopting *Richardson* approach); Waters, *supra* note 28, at D-23 (same). Becker and Bingham argue, however, that the *Madrid* approach is the correct approach to use when determining whether a debtor received a reasonably equivalent value from a foreclosure sale under the 70% standard. *See* Becker & Bingham, *supra* note 87, at H-32 (stating that *Madrid* approach is only approach "true to the guidelines of *Durrett*"). Becker and Bingham suggest that the *Madrid* approach encourages third party bidding by allowing junior lienholders to include the full amount of the senior lien in their bids. *See id.* (suggesting that *Madrid* approach is only approach that encourages third party bidding).

Waters, likewise, agrees that the *Madrid* approach is the correct approach to determining the question of reasonably equivalent value. *See* Waters, *supra* note 28, at D-24 (stating that *Madrid* approach is correct test to determine if debtor received reasonably equivalent value based on *Durrett*). Waters argues that the *Madrid* approach more closely follows the *Durrett* requirements because the *Madrid* approach uses the fair market value of the property as the benchmark. *See id.* (advocating *Madrid* approach to determine reasonably equivalent value). In addition, the *Madrid* approach recognizes the economic reality that a junior lienholder will protect the junior lienholder's interest in the property by meeting the first lien obligation. *See id.* (same).

150. *See* Waters, *supra* note 28, at D-10 (suggesting that wraparound mortgagees consider application of foreclosure sale proceeds).

proceeds are generated[151] or a deficiency results.[152] Although the priority of liens on the property should direct the application of any excess proceeds, the law with respect to lien priority in wraparound transactions is complex, uncertain, and inconsistent.[153] The sparse case law that addresses wraparound financing has yet to clarify the issue of lien priority.[154] In deciding who should receive the proceeds from a foreclosure sale, courts should examine the wraparound instruments connected with the foreclosed property.[155] If the wraparound instruments fail to address foreclosure procedures, then the court should imply an agreement that is consistent with the parties' expressed intent.[156]

Despite an express foreclosure provision in the wraparound documents, the Texas Supreme Court in *Summers v. Consolidated Capital Special Trust* implied a covenant that directed the trustee to apply excess proceeds from a foreclosure "upstream": to senior lienholders, then to junior lienholders, and, finally, to the defaulting wraparound mortgagor.[157] The *Summers* decision is inconsistent with the traditional view that the foreclosure of a junior lien, such as a wraparound, does not affect senior mortgages, which still encumber the property.[158] One commentator argues that a more sound approach would apply any excess proceeds from the wraparound foreclosure to junior lienholders and then to the defaulting mortgagor, ignoring the senior lienholders.[159] In addition to protecting senior lienholders by requiring the upstream payment of proceeds, the *Summers* court's pro-senior lienholder decision militates against most foreclosure notice statutes, which generally do not require that foreclosing

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151. *See id.* (explaining that excess proceeds result when foreclosure sale price exceeds amount of debt that wraparound mortgagor owes wraparound mortgagee).

152. *See supra* note 52 (explaining that deficiency results when foreclosure sale price is less than amount of debt that wraparound mortgagor owed wraparound mortgagee).

153. *See* Gunning, *supra* note 2, at 46 (noting lack of unanimity of lien priority law); Galowitz, *supra* note 1, at 122 (discussing lien priority of wraparounds).

154. *See* Waters, *supra* note 28, at D-19 (noting that cases involving lien priority in wraparounds confuse more than clarify lien priority law).

155. *See* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 583 (Tex. 1989) (stating that courts should examine written contract and should imply covenant for application of foreclosure proceeds only when express contract is silent); *cf.* Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 838, 229 Cal. Rptr. 509, 512 (1986) (noting that parties can and should address foreclosure procedures in wraparound documents, including how foreclosure proceeds should be applied).

156. *See* Danciger Oil & Ref. Co. v. Powell, 137 Tex. 484, 490, 154 S.W.2d 632, 635 (1941) (stating that courts should imply covenants when necessary to give effect to actual intention of parties as reflected in contract).

157. *See Summers*, 783 S.W.2d at 583 (discussing application of excess proceeds from wraparound foreclosure).

158. *See generally,* Baggett, *supra* note 8, at 114 (stating that foreclosure of junior liens does not affect senior liens); Waters, *supra* note 28, at D-7 (same).

159. *See* Baggett, *supra* note 8, at 114 (suggesting that trustee should apply excess proceeds to inferior lienholders and subsequently to defaulting wraparound mortgagor because foreclosure of junior lien should not affect senior liens).

junior lienholders notify senior lienholders of a foreclosure.[160] By protecting a senior lienholder from the foreclosure of a junior lien of which the senior lienholder would not have notice, the *Summers* court decision is an anomaly.[161] Courts following the *Summers* directive to pay senior lienholders when the wraparound documents do not contemplate the application of foreclosure proceeds still must decide which senior lienholder to pay first. Courts either could pay the most senior lienholder first and then distribute proceeds "downstream" or could pay the most junior of the senior lienholders first and progress vertically because the more senior lienholders are better protected by their own foreclosure remedies.[162] The *Summers* decision is devoid of guidance on which distribution scheme courts should follow.

Given the lack of judicial guidance on the foreclosure of wraparounds, parties to wraparound agreements carefully should draft all wraparound provisions, particularly the foreclosure provisions.[163] Attorneys should advise parties to a wraparound of the possible distressing results of a wraparound foreclosure.[164] First, the attorney should examine the wraparound transaction under the applicable usury law.[165] Second, before advising a wraparound mortgagee of what amount to bid at foreclosure, the wraparound mortgagee's attorney should determine the wraparound mort-

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160. *See, e.g.*, N.C. GEN. STAT § 1-339.54 (1983) (requiring that trustee notify only judgment debtor of foreclosure); TEX. PROP. CODE ANN. § 51.002 (Vernon 1984) (requiring that trustee notify only parties obligated to pay debt on property that is subject of foreclosure); VA. CODE ANN. § 55-59.1 (1986) (requiring that trustee notify only present owner of property to be sold at foreclosure).

161. *See supra* note 160 and accompanying text (illustrating that protecting senior lienholder from foreclosure which does not affect and of which the senior lienholder is not required to be notified is anomolous).

162. *See* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 24-4, at 1131, § 24-5, at 1138 (3d ed. 1988) (discussing various lien priority schemes).

163. *See* Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580, 584 (Mauzy, J., dissenting) (discussing legal uncertainty surrounding wraparound financing). Justice Mauzy, in his dissenting opinion in *Summers*, suggests that the best way to avoid the risk of judicial uncertainty about wraparounds is to take Polonius's advice to Laertes, "neither a borrower nor a lender be." *Id.* at 584 n.1 (citing W. Shakespeare, *Hamlet, Prince of Denmark* Act I, Scene III). Justice Mauzy also suggests that a more feasible way of avoiding the risk of wraparounds is for borrowers to use safer, more conventional means of financing. *Summers*, 783 S.W.2d 580, 584 n.1 (Tex. 1989) (Mauzy, J., dissenting); *see also* Armsey v. Channel Assocs., 184 Cal. App. 3d 833, 838, 229 Cal. Rptr. 509, 513 (suggesting that parties to wraparounds include proper procedures for declaring default and conducting foreclosure).

164. *See* Goren & Meyer, *supra* note 60, at 1052 (cautioning that attorneys advise wraparound clients carefully on foreclosure matters). Goren and Meyer note that at least one attorney has been sued for malpractice by a wraparound mortgagor. *Id.* The attorney advised the wraparound mortgagor to bid an amount at the foreclosure sale that exceeded the true debt of the wraparound. *Id.* The wraparound mortgagor later claimed that the foreclosure sale generated excess proceeds and sued the wraparound mortgagee, who subsequently sued the attorney for malpractice. *Id.*

165. *See supra* notes 103-44 and accompanying text (discussing usury implications of wraparounds).

gagor's debt.[166] Third, attorneys should consider the possible grounds on which a wraparound mortgagee may have a foreclosure sale set aside. The attorney should recognize that a wraparound mortgagor who files a bankruptcy petition might adversely affect the foreclosure sale.[167] Finally, assuming that the foreclosure sale generates excess proceeds, the attorney must advise the client on the proper application of the proceeds.[168]

Recognizing that parties can structure a wraparound transaction in a myriad of ways, the following suggestions demonstrate how parties to a wraparound might avoid some of the common foreclosure problems, such as debt computation, bidding at a foreclosure sale, and application of excess foreclosure proceeds.[169] In the instruments that embody a wraparound transaction,[170] the drafters should address the following foreclosure issues:[171]

I. GENERAL FORECLOSURE PROVISIONS[172]

A. The wraparound includes the underlying liens.

B. The wraparound mortgagee will pay the underlying indebtedness from the wraparound mortgagor's payments on the wraparound.

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166. *See supra* notes 53-98 and accompanying text (discussing outstanding balance and true debt methods of wraparound debt computation). If the jurisdiction follows the outstanding balance method, then the attorney can ignore the underlying indebtedness for the purpose of determining the amount owed under the wraparound. *See supra* notes 72-78 and accompanying text (discussing outstanding balance method of wraparound debt computation). If the jurisdiction follows the true debt method, the attorney should subtract the balance of the underlying indebtedness from the balance of the wraparound to determine the amount that the wraparound mortgagor owes the wraparound mortgagee. *See supra* notes 53-65 and accompanying text (discussing true debt method of wraparound debt computation). The conservative approach to determining the wraparound mortgagee's bid amount at foreclosure is the true debt method. *See* Bentley, *supra* note 2, at X-60 (advising that conservative approach would have wraparound mortgagee bid only true debt at foreclosure sale); Goren & Meyer, *supra* note 60, at 1052 (advising conservative wraparound mortgagee to bid true debt to avoid creating excess proceeds).

167. *See supra* notes 145-49 and accompanying text (discussing provisions in Bankruptcy Code that allow courts to avoid foreclosure sales).

168. *See supra* notes 153-62 and accompanying text (discussing application of excess proceeds).

169. *See supra* notes 53-98 and accompanying text (discussing computation of wraparound debt and bidding at foreclosures); *supra* notes 153-62 and accompanying text (discussing application of foreclosure sale proceeds).

170. *See supra* note 14 and accompanying text (discussing wraparound instruments: the mortgage or deed of trust and the promissory note).

171. *But see* Comment, *Critical Inquiry*, *supra* note 8, at 1565 (concluding that even careful drafting of wraparound agreements may not alter judicial interpretation of legal effect of wraparounds).

172. *See* Bentley, *supra* note 2, at X-12 (suggesting general provisions that drafters should include in wraparound instruments). Bentley states that, when a wraparound transaction involves a series of prior notes which themselves are wraparounds, the parties should include a provision that addresses whether the mortgagee is obligated to pay all of the prior notes, wraparound and otherwise, or only the preceding wraparound. *Id.* Bentley suggests that the wraparound documents should contain a usury savings clause that disclaims that the lender intends to collect a usurious rate of interest. *Id.*

C. The wraparound mortgagor will make payments on the wraparound prior to the date payments are due on the underlying indebtedness, and the wraparound mortgagee will notify the wraparound mortgagor when the wraparound mortgagee has made payments on the underlying indebtedness.

D. When the balance of the wraparound equals the principal balance of the underlying indebtedness, the wraparound mortgagor will be considered to have paid the wraparound in full and will be entitled to a full release of the lien securing the wraparound's payment.[173]

E. A default in the payment on the underlying notes or liens securing the wraparound payment does not constitute a default on the wraparound itself unless the holder of the underlying notes or liens declares a default.[174]

F. The mortgagee is obligated to pay all of the prior notes, wraparound and otherwise, or, alternatively, that the mortgagee is obligated to pay only the preceding wraparound.

G. Upon foreclosure, the property will be sold subject to the underlying indebtedness.[175]

II. COMPUTING DEBT PROVISION

Defining the procedure for declaring a default, including what sum will represent the principal amount of the wraparound due upon default.[176]

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173. *See id.* at X-13 (suggesting that wraparound mortgagor deal directly with holders of underlying notes by using provision that releases wraparound mortgagor from liens on wraparound once wraparound mortgagor reduces balance of wraparound to amount equal to balance of underlying indebtedness).

174. *But see* R. KRATOVIL & R. WERNER, *supra* note 7, at 380 (suggesting that most important wraparound clause is cross default provision). Kratovil and Werner explain that a cross- default clause states that a default on the first mortgage constitutes a default on the wraparound. *Id.* Kratovil and Werner recommend a cross-default clause to protect the wraparound mortgagee from the borrower agreeing with the first mortgage holder that the borrower will make payments on the first lien and default on the wraparound. *Id.*

175. One leading commentator on wraparound foreclosures suggests that the following general provisions be included in the deed of trust:

> It is stipulated and agreed that the lien created by this instrument is secondary and inferior to the lien securing the unpaid balance of that certain $____ indebtedness described in and secured by a Deed of Trust of record in Volume ____, Pages ____of the Deed of Trust Records of ____ County, *[State]*, which indebtedness the Grantors herein have not assumed, but which the Beneficiary herein is obligated to pay as and when due, as provided in the hereinbefore mentioned Deed, and in the event said Beneficiary fails to pay when due any installment or installments falling due thereon, then, so long as Grantors herein are not in default in the payment of the Note hereby secured, or in default in the performance of the covenants of this Deed of Trust, Grantors herein shall have the right to pay any such delinquent installment or installments and receive credit upon the Note hereby secured for all sums so paid, and in such manner as Grantors may direct, as of the date of such payment.

Bentley, *supra* note 2, at X-28 to X-29.

176. In light of Summers v. Consolidated Capital Special Trust, 783 S.W.2d 580 (Tex.

III. BID AMOUNT AT FORECLOSURE PROVISIONS

A. Limiting the foreclosing wraparound mortgagee's credit bid at foreclosure by stating that the mortgagee can enter a credit bid only in an amount equal to the difference between the unpaid underlying indebtedness and the unpaid wraparound balance.[177] This provision would provide further that any bid over that difference would require cash.

B. The purchaser at foreclosure is purchasing only the wraparound mortgagee's equity in the property, the equity being equal to the amount of the defaulted debt.[178]

C. By crediting the purchaser's purchase price in the amount of the underlying indebtedness, the purchaser takes the property "subject to" the underlying liens. In other words, the parties would agree that the purchaser may pay for the property partly in cash and partly by taking the property "subject to" the underlying liens.[179]

D. If the parties did not agree that the principal balance of the wraparound upon foreclosure would be the true debt of the wraparound, then the parties would designate that the total amount of the bid is a credit against the balance of the wraparound being foreclosed.[180] For example:

> It is stipulated and agreed that the purchaser of the Mortgaged Premises at a public sale is to be considered as having taken the underlying indebtedness into account in making a bid. The purchaser's bid shall be composed of cash, recognizing Mortgagee's equity in the property, and of additional consideration in the

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1989) and Lee v. Key West Towers, Inc., 783 S.W.2d 586 (Tex. 1989), a provision defining the principal amount due under the wraparound upon default is crucial if the parties to the wraparound do not intend for the outstanding balance method of debt computation to apply. Absent such an express provision, a court could rely on *Summers* and *Lee* to use the outstanding balance method and hold that the entire outstanding balance of the wraparound is due. The parties expressly may agree, however, that the true debt method applies to permit the mortgagee to pay the wraparound in full by paying the difference between the balance of the wraparound and the unpaid underlying indebtedness. A sample true debt clause in a deed of trust is the following:

> It is stipulated and agreed that in the event of default on the lien created by this instrument, payment of the "principal balance" means payment of the difference between the balance of the lien created by this instrument and the balances of the Prior Mortgage Documents; and NOT the balance of the lien created by this instrument.

177. *See supra* notes 87-91 and accompanying text (discussing cash bid requirement).

178. *See* FPCI RE-HAB 01 v. E & G Invs., 207 Cal. App. 3d 1018, 1023, 225 Cal. Rptr. 157, 161 (1989) (suggesting that wraparound instruments provide that amount in default at foreclosure sale be limited to wraparound mortgagee's equity).

179. *See* Bentley, *supra* note 2, at X-61 (explaining how parties agree to allow purchaser to make net bid on property by paying some of bid in cash and by taking property subject to underlying indebtedness).

180. *See id.* (suggesting how parties can agree to use true debt method of debt computation in structuring wraparound).

amount of the underlying indebtedness, recognizing purchaser's acceptance of the Mortgaged Premises subject to the Prior Mortgage Documents.

IV. APPLICATION OF FORECLOSURE SALE PROCEEDS PROVISIONS

A. Defining the formula, either true debt method or outstanding balance method, for determining whether a deficiency or excess proceeds exist upon foreclosure of a wraparound.

B. A distribution scheme that distributes excess proceeds first to any junior lienholders other that the holder of the wraparound and then to the defaulting mortgagor.[181]

C. Prohibiting the wraparound mortgagee from seeking a deficiency judgment against the wraparound mortgagor or the wraparound mortgagor's successors or assigns. Alternatively, the wraparound mortgagor should limit a wraparound mortgagee's remedy for a deficiency to the true debt of the wraparound: the difference between the balance of the wraparound and the unpaid underlying indebtedness.

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181. *See supra* note 159 and accompanying text (discussing one distribution scheme for distributing excess proceeds).