Explaining the Equity of Renegotiation and Secured Credit: Explaining the Equity of Redemption

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[Selected excerpts]

I. INTRODUCTION

"Once a mortgage, always a mortgage." This cryptic comment, oft-repeated, summarizes a central tenet of mortgage law: **The equity of redemption[2] is essential, immutable, and unwaivable**. In other words, every mortgage borrower has the right, at any time after default, to redeem the collateral by repaying the debt until the lender has completed a "foreclosure" on the collateral. Indeed, a mortgage substitute that would dispense with the equity of redemption is the holy grail of real estate finance, and has captured the efforts and attentions of lawyers and lenders for centuries.[3] **Every effort, however ingenious, has been**

met by the unyielding resistance of the courts: one may not "clog the equity of redemption." [4] The idea that the equity of redemption is an inherent and inseparable part of every mortgage is now so commonplace, so accepted, that it elicits relatively little comment or question. *(emphasis added)*

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2. 4 JOHN D. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1193, at 568-69 (5th ed. The equity of redemption refers to the mortgage borrower's: right after default in every jurisdiction... to perform his obligation under the mortgage and have the title to his property restored free and clear of the mortgage. The important words to emphasize here are 'after default.' [The mortgagor... has the right to pay or otherwise perform his obligations after default under the mortgage at any time until a valid foreclosure sale. GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 7.1, at 467 (3d ed. 1994)

3. In Emanual College v. Evans, 21 Eng. Rep. 494, 495 (1625-26), the mortgage was dis guised as a 500-year lease in an attempt to avoid the restrictions on mortgages. In Noakes & Co. v. Rice, [1902] App. Cas. 24, 32 (H.L. 1901) (appeal taken from Eng.), the mortgage provided (to no avail) that upon default the mortgagor would be barred "from all equity of redemption." See also H.W. Chaplin, The Story of Mortgage Law, 4 HARV. L. REv. 1, 11-12 (1890) (discussing other early examples including drafting a mortgage as a sale with an option to repurchase, or creating what we now know as a deed of trust, or using a deed absolute).

4. Perhaps the classic statement of this is found in Pomeroy's Treatise on Equity Jurisprudence: Once a Mortgage, Always a Mortgage; Collateral Agreements and Agreements Clogging the Equity of Redemption- “In general, all persons able to contract are permitted to determine and control their own legal relations by any agreements which are not illegal, or opposed to good morals or to public policy; but the mortgage forms a marked exception to this

principle. The doctrine has been firmly established from an early day that when the character of a mortgage has attached at the commencement of the transaction, so that the instrument, whatever be its form, is regarded in equity as a mortgage, that character of mortgage must and will always continue. If the instrument is in its essence a mortgage, the parties cannot by any stipulations, however express and positive, render it anything but a mortgage, or deprive it of the essential attributes belonging to a mortgage in equity. The debtor or mortgagor cannot, in the inception of the instrument, as a part of or collateral to its execution, in any manner deprive himself of his equitable right to come in after a default in paying the money at the stipulated time, and to pay the debt and interest, and thereby to redeem the land from the lien and encumbrance of the mortgage; the equitable right of redemption, after a default is preserved, remains in full force, and will be protected and enforced by a court of equity, no matter what stipulations the parties may have made in the original transaction purporting to cut off this right." POMEROY, supra note 1, § 1193, at 568-69.

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The complementary problems that are commonly said to lie at the heart of foreclosure law are the risk of forfeiture of the debtor's equity[20] in the collateral and the realization of an unjust windfall by the foreclosing lender. . . . .

Start with the equity of redemption, which is the borrower's right to redeem the property by repaying the debt at any time until the foreclosure[22] has been completed. The equity of redemption provides the borrower with the right, even after default, to repay the mortgage debt and free the property from the mortgage lien, and so retain any value that the property has in excess of the debt. **The equity of redemption has been an**

established rule of mortgage law since the early seventeenth century and was the first major legal protection for mortgage borrowers.[23] (emphasis added)

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20. A borrower's "equity" refers to the value of the property in excess of the liens on that property. See BLACK'S LAW DICTIONARY 540 (6th ed. 1990).

22. ***While we commonly talk about "foreclosing a mortgage," it is more precise to refer to foreclosing the equity of redemption.*** That is, a decree of foreclosure determines that after a specified date or event, the borrower will have no further right to redeem the property. See BLACK'S LAW DICTIONARY 646 (6th ed. 1990). (emphasis added)

23. See generally David Sugarman & Ronnie Warrington, Land Law, Citizenship and the Invention of "Englishness.' The Strange World of the Equity of Redemption, in EARLY MODERN CONCEPTIONS OF PROPERTY 111, 111-21 (John Brewer & Susan Staves eds., 1995)

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Under strict foreclosure (where foreclosure vests title in the lender), there will be a forfeiture by the borrower and a windfall to the lender if the property is worth more than the debt.[24] The American attempt to solve this problem is found in the foreclosure sale: the property is sold at auction, in an attempt to secure the value of the property for application to the debt, **with any excess returned to the mortgagor.**[25] (emphasis added w comment: not so here)

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24. See, e.g., Steven Wechsler, Through the Looking Glass: Foreclosure by Sale As De Facto Strict Foreclosure-An Empirical Study of Mortgage Foreclosure and Subsequent Resale, 70 CORNELL L. REV. 850, 859 (1985) (noting that this result was unfair, harsh, and oppressive). This statement must be qualified by recognition of the substantial costs that the lender may in cur in converting its ownership of illiquid real property into cash. It is quite possible that the property is worth more than the debt, and thus the borrower faces a forfeiture, yet the lender will not realize a windfall because of the substantial transaction costs involved in foreclosing upon and disposing of the collateral. See Mann, Strategy, supra note 21, at 221-25; Debra Pogrund Stark, Facing the Facts: An Empirical Study of the Fairness and Efficiency of Foreclosures and a Proposal for Reform, 30 U. MICH. J.L. REFORM 639, 675-77 (1997).

25. Interestingly, "[i]n some early cases mortgagors complained that foreclosure by sale benefitted mortgagees and sought to have mortgagees limited to a decree of strict foreclosure. This objection, though sometimes conceded by the courts, was brushed aside on the ground that the sale would equally benefit mortgagors." Teffl, supra note 21, at 589 (citing Lansing v. Goelet, 9 Cow. 346 (N.Y. 1827); 2 JOSEPH STORY, EQUITY JURISPRUDENCE § 1025 n.1 (13th ed. 1886)). The mortgagors' objections arose from the liberal way strict foreclosure had been applied by the English Chancellor, giving mortgagors repeated opportunities to exercise the right of redemption and even to reopen the foreclosure and redeem after the foreclosure had been completed. This is still true in England today. See E.H. BURN, CHESHIRE AND BURN's MODERN LAW OF REAL PROPERTY 702 (15th ed. 1994). As a result, mortgages in England are normally enforced by exercise of a power of sale, rather than by foreclosure, and execution of the contract of sale terminates the mortgagor's equity of redemption. See id. at 696.

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The equity of redemption is universal: it exists in every state, and in every mortgage.[49] It cannot be waived in the loan agreement or mortgage[50] and any attempt to avoid or limit

("clog") the equity of redemption as part of the initial transaction is void.[51]

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49. For an excellent discussion of the difficulties that the equity of redemption has caused for modem real estate financing techniques, see Jeffrey L. Licht, The Clog on the Equity of Redemption and Its Effect on Modern Real Estate Finance, 60 ST. JOHN'S L. REV. 452 (1986). The point of this Article is not to critique the application of mortgagor protections to any particular financing structure, but to explore the value, if any, in mandating protections for commercial mortgagors.

50. See, e.g., Oakland Hills Dev. Corp. v. Lueders Drainage Dist., 537 N.W.2d 258, 263 (Mich. Ct. App. 1995); Russo v. Wolbers, 323 N.W.2d 385, 390 (Mich. Ct. App. 1982).

51. See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 3.1 (1997). The Restatement provides: (a) From the time the full obligation secured by a mortgage becomes due and payable until the mortgage is foreclosed, a mortgagor has the right to redeem the real estate from the mortgage under the principles of§ 6.4. (b) Any agreement in or created contemporaneously with a mortgage that impairs the mortgagor's right described in subsection (a) of this Section is ineffective. Id.

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Another set of justifications for mortgagor protections in the consumer context can be found in the importance or sanctity of the homestead. As Margaret Radin has written, people become emotionally attached to their homes, so that their sense of well-being may become closely linked with the preservation of the home.[81] Indeed, residences are accorded a special place in many areas of our legal system, ranging from the home

mortgage income tax deduction to bank ruptcy exemptions. Mortgagor protections can also be defended in terms of fairness [82] or distributional equity.

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81. See Margaret Jane Radin, Property and Personhood, 34 STAN. L. REV. 957, 991-1002 (1982) (discussing how the "personhood perspective" in relation to the home is "implicit in our law").

82. See, e.g., 1 ARTHUR INTON CORBIN, CORBIN ON CONTRACTS § 128 (1960) (discussing the equity of redemption in terms of unconscionability); McGovern, supra note 57, at 143-44 (discussing historical notions of fairness in the creditor-debtor relationship).

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The equity of redemption, by compelling a period of delay between default and liquidation of the collateral, creates the time that may be needed for negotiations to succeed.[136] . . . .

The equity of redemption also facilitates renegotiation by mitigating the bilateral monopoly problem, serving as a check on the lender's incentive to act opportunistically to obtain the collateral where the collateral value exceeds the debt. Should the lender attempt to secure the collateral by inducing a breach, or persist in acting unreasonably after default in order to secure the lion's share of the value available through renegotiation, the borrower has an "exit option": it can retain the property by refinancing prior to completion of the foreclosure by the lender.

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136. See generally Joseph Farrell & Robert Gibbons, Cheap Talk Can Matter in Bargaining, 48 J. ECON. THEORY 221 (1989) (discussing use of "talk" in trading probability of continued seri ous negotiations for bargaining position).