



Foreclosure

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- [Background](#)
- [Types of Foreclosure](#)
- [Acceleration](#)
- [Foreclosure by Judicial Sale](#)
- [Foreclosure By Power of Sale](#)
- [Federal Laws Affecting Foreclosure](#)
- [Statutory Redemption](#)
- [Additional Resources](#)
- [Organizations](#)

Background

FORECLOSURE is the [LEGAL RIGHT](#) of a [MORTGAGE](#) holder or other third-party [LIEN](#) holder to gain ownership of the property and/or the right to sell the property and use the proceeds to pay off the mortgage if the mortgage or lien is in [DEFAULT](#). It is a concept that has existed for centuries.

Initially, the law had it that a mortgage default resulted in the automatic ownership of the property by the holder of the mortgage (sometimes referred to as the mortgagee). But the law developed over the years so as to allow mortgagors time to pay off mortgages before their property was taken away. This process of taking away the mortgagor's property because of default is what constitutes foreclosure.

Today, numerous state laws and regulations govern foreclosure to protect both the mortgagor and the holder of the mortgage from unfairness and [FRAUD](#). In the United States, although states have their own variations, the basic premises of foreclosure law remain the same.

Types of Foreclosure

The mortgage holder can usually initiate foreclosure anytime after a default on the mortgage. Within the United States, there exist several types of foreclosure. Two are widely used, with the rest being possibilities only in a few states.

The most important type of foreclosure is foreclosure by judicial sale. This is available in every state and is the required method in many. It involves the sale of the mortgaged property done under the supervision of a court, with the proceeds going first to satisfy the mortgage, and then to satisfy other lien holders, and finally to the mortgagor. Because it is a legal action, all the proper parties must be notified of the foreclosure, and there will be both pleadings and some sort of judicial decision, usually after a short trial.

The second type of foreclosure, foreclosure by power of sale, involves the sale of the property by the mortgage holder not through the supervision of a court. Where it is available, foreclosure by power of sale is generally a more expedient way of foreclosing on a property than foreclosure by judicial sale. The majority of states allow this method of foreclosure. Again, proceeds from the sale go first to the mortgage holder, then to

other lien holders, and finally to the mortgagor.

Other types of foreclosure are only available in limited places and are therefore considered minor methods of foreclosure. Strict foreclosure is one example. Under strict foreclosure, when a mortgagor defaults, a court orders the mortgagor to pay the mortgage within a certain period of time. If the mortgagor fails, the mortgage holder automatically gains title, with no obligation to sell the property. Strict foreclosure was the original method of foreclosure, but today it is only available in New Hampshire and Vermont.

Acceleration

The concept of acceleration is used to determine the amount owed under foreclosure. Acceleration allows the mortgage holder the right when the mortgagor defaults on the mortgage to declare the entire debt due and payable. In other words, if a mortgage is taken out on property for \$10,000 with monthly payments required, and the mortgagor fails to make the monthly payments, the mortgage holder can demand the mortgagor make good on the entire \$10,000 of the mortgage.

Virtually all mortgages today have acceleration clauses. However, they are not imposed by [STATUTE](#), so if a mortgage does not have an acceleration clause, the mortgage holder has no choice but to either wait to foreclose until all of the payments come due or convince a court to divide up parts of the property and sell them in order to pay the [INSTALLMENT](#) that is due. Alternatively, the court may order the property sold subject to the mortgage, with the proceeds from the sale going to the payments owed the mortgage holder.

Foreclosure by Judicial Sale

Foreclosure by judicial sale requires the mortgage holder to proceed carefully in order to ensure that all affected parties are included in the court case, so the purchaser of the foreclosed property receives valid title to the property.

Parties and Omissions

A mortgage holder bringing a suit for foreclosure in court must join any "necessary" parties to the case. To understand what a necessary party is, it must be realized that the purpose of a foreclosure sale is to sell the property as it was when the mortgage was first taken out. Anyone who acquired an interest in the property after the mortgage was taken out must be dealt with in the court case before the property can be sold.

Necessary parties include parties who acquired easements, liens, or leases after the mortgage being foreclosed was executed. They can be added, or "joined" to the case as parties without their consent. The intent is to terminate their interest in the property. If a party is not joined, then their interest in the property is not affected by the foreclosure, and the purchaser does not acquire an interest in the property fee of their rights.

For example, if party A takes out a mortgage from party B and then takes out a second mortgage from party C, and party B decides to foreclose on the property and sell the property to party D at foreclosure, party B must extinguish the interest of party C to sell the property to party D. Otherwise party C can enforce their mortgage on party D.

The other type of party involved in a foreclosure case is called a "proper" party. A proper party is a party that is useful, but not necessary, to a foreclosure case. An example would be a party who had an interest in the property before the mortgage was executed. Since this party would not be affected by the foreclosure, the

Encyclopedia of Everyday Law: Foreclosure

individual is considered a voluntary party to a case and normally cannot be included in the case without consenting to it. However, often courts will require these parties to be joined anyway to the case to clarify their status with respect to the mortgage being foreclosed upon.

Procedures

The procedure for a judicial sale varies from state to state, but generally calls for a court appointed official or a public official such as the sheriff to conduct the actual sale of the foreclosed property. The mortgage holder can bid for the mortgaged property.

If a lien holder who acquired the lien after the mortgage was executed (also known as a junior lien holder) is not named as a party in the foreclosure, the individual can either foreclose the lien subject to the mortgage sold at foreclosure or redeem the lien and acquire the property by paying the purchaser the mortgage debt. In the case of a omitted junior lien holder, the purchaser of the property has the option of paying the lien holder outright for their interest in the property, or reforeclosing on the original mortgage to eliminate the junior lien holder, - in which case there would be another foreclosure sale.

Deficiency Judgments

When the foreclosure sale is not enough to satisfy the amount of the mortgage, the mortgage holder may bring a deficiency judgment against the mortgagor to make up the difference. For example, a mortgage holder of a \$10,000 mortgage, who only receives \$8,000 in a foreclosure sale, may sue the mortgagor for the remainder of the amount due under the mortgage.

Deficiency judgments are tempered in many jurisdictions by "fair value" legislation. This requires the deficiency to be calculated using the difference between the mortgage debt and the fair value of the real estate. In the above example, a court in a fair value [JURISDICTION](#) might determine that the fair value of the property was \$9,000. In that case, the mortgage holder could only obtain a deficiency judgment of \$1,000.

Foreclosure By Power of Sale

Foreclosure by the power of sale, where law allows it, usually saves time and money over foreclosure by judicial sale. It accomplishes the same thing as a judicial sale. However, there are also some difficulties associated with this method of foreclosure.

Availability and Disadvantages

Today, 29 states (Alabama, Alaska, Arizona, California, Colorado, the District of Columbia, Georgia, Hawaii, Idaho, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, North Carolina, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia and Wyoming) allow foreclosure by the power of sale.

However, foreclosure by the power of sale is often subject to [JUDICIAL REVIEW](#) at a later date because there are issues about title that must be resolved by the court. These would include actual defects in the [DEED](#), and the priority of various lien holders and lessees on the property. In addition, in many jurisdictions the mortgage holder is prohibited from seeking a deficiency judgment if the holder chooses to sell the property through extra-judicial means. Also, the mortgage form must generally allow for power of sale and cannot be in the form of an absolute deed for a foreclosure by the power of sale to take place.

Deed of Trust

In many jurisdictions, a [DEED OF TRUST](#) is required in order to conduct a foreclosure by the power of sale. A deed of trust conveys the property from the mortgage holder to the [TRUSTEE](#), who holds the property in trust for the mortgage holder. In the instance of foreclosure, the trustee, not the mortgage holder, conducts the sale of the mortgaged property. The trustee is generally instructed by the mortgage holder to foreclose on the mortgage and is under no obligation to determine whether this foreclosure is justified.

A deed of trust and trustee supervised foreclosure allows the mortgage holder to bid for the foreclosed property, provided the trustee and the mortgage holder are not closely associated. Otherwise, a mortgage holder cannot bid for the mortgaged property when the foreclosure is by power of sale.

Constitutional Issues

Foreclosure by power of sale requires notice of the sale to interested parties. Generally speaking, this is done by taking out an advertisement in a local newspaper in the jurisdiction in which the property is located. Many states also require notice be given to the mortgagor.

This procedure has resulted in some constitutional controversy. It has been argued in several cases that foreclosure by power of sale legislation fails to comply with the notice and [HEARING](#) requirements of the Fourteenth Amendment of the U. S. Constitution. Courts have consistently rejected this theory when it comes to private foreclosure actions with no public official conducting the foreclosure sale, ruling that there is no state action necessary to invoke the terms of the Fourteenth Amendment. However, there have been rulings indicating that if the mortgage holder is a government entity or if a public official conducts the foreclosure sale, the Fourteenth Amendment might be invoked and stricter notice requirements might apply. The [CASE LAW](#) on this issue is so far unsettled.

Federal Laws Affecting Foreclosure

While the Fourteenth Amendment has a debatable nexus to foreclosure actions, at least two federal laws clearly apply to foreclosure actions

Bankruptcy

The filing of any [BANKRUPTCY](#) action automatically stays a foreclosure proceeding, regardless of type. At that point, whether the stay will be lifted depends on whether the mortgagor has equity in the mortgaged property. If the bankruptcy has been filed under a Chapter 11 petition, the bankruptcy court may "terminate, annul, modify or condition such stay" for cause, including the lack of adequate protection of an interest in property of the mortgage holder, or if the mortgagor does not have equity in the property and the property is not necessary for an effective reorganization.

If it has been filed as a straight bankruptcy petition, asking for discharge of all debts, the mortgage holder will be allowed to foreclose if the bankrupt [DEBTOR](#) has no equity in the property. If there is equity in the property, the property can be sold by the bankruptcy court.

Soldier and Sailors Relief Act

The Soldiers and Sailors Relief Act of 1940 gives special protection to mortgagors on active duty in the armed forces for mortgage loans executed prior to when they went into service. The Act provides that a service

person can apply to a court to set aside a [DEFAULT JUDGMENT](#) leading to a foreclosure action. Because of this provision, a mortgage holder initiating a foreclosure action against a mortgagor who fails to answer the foreclosure complaint must file an [AFFIDAVIT](#) with the court stating the mortgagor is not on active duty in the armed services.

If the mortgagor is in the armed services, the individual must be present or represented at the foreclosure hearing, meaning foreclosure by power of sale is not available. If a court finds that the mortgagor's ability to meet the terms of the mortgage has been affected by their service in the armed forces, they can stay the foreclosure action as long as the person is in the service.

Statutory Redemption

STATUTORY redemption allows the mortgagor to redeem the mortgage even after foreclosure sale. About one-half the states have statutory redemption laws. Generally, these laws give anywhere from six months to a year for the mortgagor to redeem the mortgage by payment of the foreclosure sale price plus a statutory rate of interest to the sale purchaser. Junior lien holders also have a right to redeem under these statutes, in order of their priority, though not until the period for the mortgagor to redeem runs out. As a rule, the mortgagor can retain possession of their property during this statutory redemption period.

Additional Resources

"The Constitutionality of Texas Nonjudicial Foreclosure: Protecting Subordinate Property Interests From Deprivation Without Notice" Krock, Kenneth M., *Houston Law Review*, Fall 1995.

How To Save Your Home From Foreclosure. RJM Marketing, 1998.

Land Transactions and Finance. Nelson, Grant, and Dale Whitman, West Group, 1998.

Real Estate Finance in a Nutshell. Bruce, Jon W., West Group, 1997.

Organizations

Federal Home Loan Mortgage Corporation (Freddie Mac)

8200 Jones Branch Drive
McLean, VA 22102-3110 USA
Phone: (703) 903-2000
URL: <http://www.freddiemac.com>
Primary Contact: Leland C. Brendsel, Chairman

Federal National Mortgage Association (Fannie Mae)

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892 USA
Phone: (202) 752-7000
E-Mail: headquarters@fanniemae.com
URL: <http://www.fanniemae.com>
Primary Contact: Primary Contact, Franklin Raines, Chairman

Mortgage Bankers Association of America (MBAA)

1919 Pennsylvania Avenue, NW.
Washington, DC 20006-3438 USA

Phone: (202) 557-2700

URL: <http://www.mbaa.org>

Primary Contact: John Courson, Chairman

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