

CLOGGING REVISITED

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Editors' Synopsis: This Article discusses the clogging of the equities doctrine as applied to traditional real estate transactions and forms of real estate finance by examining statutory and case law, as well as other related articles and the new Restatement (Third) of Property: Mortgages. Specifically, the Article examines clogging issues related to convertible mortgages and options to purchase, deeds in lieu of foreclosure, shared appreciation and contingent interest loans, and sale-leaseback transactions. The Article briefly reviews a few states' clogging statutes and outlines how these statutes apply to certain real estate transactions. Additionally, the Article explains how an illegal clog could be created when a mortgagee demands a collateral advantage and how a due-on-sale clause is not considered a clog on the equity. Further, the Article examines mezzanine financing and synthetic leases—two relatively new forms of real estate transactions—that may create clogging problems. The final section concerns clogging issues related to title insurance.

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I. INTRODUCTION

A conveyance once a mortgage is always a mortgage. This phrase, which became one of the maxims of equity, can be traced to a seventeenth century English case in which the mortgage limited redemption to the mortgagor or his male heirs. This restriction was held to be a clog on the equity of redemption, and therefore unenforceable. As a result, an assignee of the mortgagor was permitted to redeem the mortgaged property.¹ The

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¹ See *Howard v. Harris*, 1 Eng. Rep. 406 (Ch. 1683).

clogging doctrine invalidates two types of mortgage provisions. First, no provision may prevent the mortgagor from redeeming and retaining ownership of the mortgaged property by paying the indebtedness in full prior to entry of a valid foreclosure decree. Second, no provision may grant the mortgagee a “collateral advantage.”² This Article will examine the application of the clogging doctrine to a variety of traditional real estate transactions, and it will speculate on its application to some new forms of real estate financing.

II. CONVERTIBLE MORTGAGES AND OPTIONS TO PURCHASE

Clogging issues commonly arise in connection with convertible mortgages. These are mortgages in which the mortgagee has an option to purchase the mortgaged property at some future time (either on or before the maturity date of the loan) for either a fixed purchase price or the fair market value of the property at the time the option is exercised. The option may arise as the result of a default by the mortgagor, upon the occurrence of a specified event, or at the expiration of a stated time period.³

² See, e.g., *West v. Reed*, 55 Ill. 242, 244 (1870) (“It is settled beyond controversy, that contracts between a mortgagor and mortgagee, for the purchase or extinguishment of the equity of redemption, are regarded with jealousy by courts of equity, and will be set aside if the mortgagee has, in any way, availed himself of his position to obtain an advantage over the mortgagor.”); *Humble Oil & Refining Co. v. Doerr*, 303 A.2d 898, 906 (N.J. Super. Ct. Ch. Div. 1973) (stating that “the [clogging] doctrine is universally applied, both in the United States and England”); *Lincoln Mortgage Investors v. Cook*, 659 P.2d 925, 927 (Okla. 1982) (stating that “the [clogging] doctrine voids any provision in an original mortgage agreement limiting or modifying the right of redemption by payment of the full mortgage debt after default for any reason”). See also RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, § 3.1 cmt. a (1996) [hereinafter RESTATEMENT] (“Under [the clogging] rule, no agreement contained in the mortgage, or contemporaneous with it, could cut off a delinquent mortgagor’s equity of redemption without resort to foreclosure by the mortgagee. Thus the equity courts refused to enforce attempts by a mortgagee, at the inception of the mortgage transaction, to have the mortgagor waive the right to insist on foreclosure in the event of a default.”); 1 GRANT S. NELSON & DALE A. WHITMAN, REAL EST. AND FIN. L. § 3.1 (3d ed. 1993).

³ Normally, if an entity acquires a “naked” option to purchase real estate (*i.e.*, an option unrelated to any recorded interest, such as a mortgage, that it may otherwise have in the property), it does not acquire any actual interest in the property that is the subject of the option. This is because the entity obtaining the option to purchase can obtain an interest in the real estate only at such time as the option is exercised according to its terms. Any security interest granted in such an option to purchase would be considered personalty rather than realty, and the interest would be deemed to be a “general intangible” under section 9-106 of the Uniform Commercial Code (UCC). Such an interest normally would be perfected by filing a UCC financing statement with the Secretary of State’s office in the jurisdiction in which the debtor is located. Under section 9-306(2) of the UCC, the perfected security interest would attach to any proceeds if the debtor sold the option right to a third party. On the other hand, if the option subsequently expired by its terms, or was terminated because of failure to exercise the option, default, or by operation of law, the security interest would be rendered valueless because the debtor would no longer have any legal or property rights to which the interest could attach.

In *In re Merten*, 164 B.R. 641 (Bankr. S.D. Cal. 1994), the bankruptcy court addressed a third situation. In *Merten*, the debtors (husband and wife) held two options to purchase entered into with different lessors. One option agreement was separate from the lease agreement; the other was contained in the lease. The debtors exercised the options after filing a Chapter 11 bankruptcy petition. They had granted a creditor a pre-petition security interest in all of their contract rights and general intangibles, and the creditor had perfected the security interest pre-petition by filing a UCC financing statement with the California Secretary of State. The creditor held deeds of trust on certain lands held by the debtors, but not on the property that was the subject of either of the lease options. The court found that under applicable California law, a security interest in a debtor’s unexercised option to acquire real estate is a general intangible subject to the UCC, and a creditor who has properly filed a pre-petition UCC financing statement with respect to its interest in the option has a perfected security interest in the unexercised option right. However, the court permitted the debtors to exercise their options to purchase the properties post-petition, holding that upon the debtor’s exercise the creditor was divested of any security interest it had in the collateral under the UCC because the option rights no longer existed. The court also found that a sale had occurred pursuant to which the holder of the options acquired an actual interest in the subject real property, and whatever security interest the secured creditor may have had in the option right was abrogated and transferred to the real estate. However, because the creditor’s transferred interest, which was now

Several courts have held that the option feature of a convertible mortgage is unenforceable as a clog on the equity of redemption. In *Barr v. Granahan*,⁴ the Wisconsin Supreme Court held that specific performance of an option to purchase real estate would be inequitable and unenforceable if the option were given without consideration other than making the loan and if the value of the property had greatly increased.⁵ Other courts that found no overreaching by the mortgagee have upheld the validity and enforceability of the mortgagee's option to purchase. In *Blackwell Ford, Inc. v. Calhoun*,⁶ the Michigan appellate court looked to the economic substance of the transaction and the parties' intent.⁷ The court noted that the option to purchase had been negotiated separately from the mortgage and was intended to create specific independent economic benefits for both parties.⁸ In addition, the option was not intended to cut off any party's remedies.⁹ As a result, the court held that the option was enforceable even though it had been executed as part of a concurrent mortgage transaction.¹⁰

exclusively an interest in real estate, was not properly recorded and perfected in the county recorder's office as an interest in the real estate, the court further held that it was not enforceable against the bankruptcy trustee or subsequent purchasers or creditors without notice under the "strong arm" provisions of section 544 of the Bankruptcy Code. The court therefore permitted the debtor to exercise the options and to sell the properties, through a double escrow, to a third party, free and clear of the security interest of the creditor.

This case illustrates the importance to a creditor that obtains a security interest in a naked option of perfecting its security interest in the option, not only by filing a UCC financing statement with the Secretary of State's office in the jurisdiction in which the debtor is located, but also by recording an instrument with the county recorder's office evidencing its interest in the real property to which the option relates. See Steven O. Weise, *U.C.C. Article 9: Personal Property Secured Transactions*, 50 BUS. LAW. 1553, 1555 (1995) (stating, in connection with the author's discussion of *In re Merten, supra*, that "[i]t seems that the option to acquire the property is so related to the property that real property law ought to govern an interest in the option. The secured party should have had the debtor record the option and then should have recorded a deed of trust or mortgage against that interest").

⁴ 38 N.W.2d 705 (Wis. 1949).

⁵ *Id.* at 707. See also *Star Enter. v. Thomas*, 783 F. Supp. 1564, 1568 (D.R.I. 1992) (holding that a purported lease transaction was in fact an equitable mortgage, and noting that an option to purchase granted to the lender as part of the original transaction, which the court disallowed, "must be deemed to be an option to purchase the equity of redemption. Regarded in this fashion, it is a transaction which equity views suspiciously and carefully scrutinizes."); *Doerr*, 303 A.2d at 909 (holding that, based on the significant difference in the sophistication level of the parties and the option price as opposed to the market value of the property, the transaction was unconscionable and unenforceable as a clog on the equity of redemption); *Coursey v. Fairchild*, 436 P.2d 35, 39 (Okla. 1967) (stating that "[i]n keeping with [the clogging] doctrine the law will not, upon the discharge of the debt, permit a mortgagee to take advantage of an option to purchase the mortgaged premises at a specified amount, if such option was given *concurrently* with, and as a condition for, the making of the loan"); *Hopping v. Baldrige*, 266 P. 469 (Okla. 1928) (voiding, as an impermissible clog on the equity of redemption, an option to purchase obtained by the mortgagee as part of the original loan transaction); *Lewis v. Frank Love, Ltd.*, 1 All E.R. 446 (Ch. 1961) (holding that even though the option agreement was contained in a separate document and the maturity date of the loan had been extended for an additional two years, the transaction violated the clogging doctrine).

⁶ 555 N.W. 2d 856 (Mich. Ct. App. 1996).

⁷ *Id.*

⁸ See *id.* at 860.

⁹ See *id.* at 861.

¹⁰ See *id.* at 862. See also *Getty Petroleum Corp. v. Giordano*, No. 87-3165, 1988 U.S. Dist. LEXIS 4657 (D. N.J. May 19, 1988) (ruling that an option contained in a lease was enforceable notwithstanding that the option price was set at an amount significantly below the market value of the property); *Cunningham v. Esso Standard Oil Co.*, 118 A.2d 611 (Del. 1955) (granting specific performance of the option to purchase); *MacArthur v. North Palm Beach Utils.*, 202 So. 2d 181 (Fla. 1967) (ruling that the option was incidental to the underlying sale and lending transaction, and denying the claim of the borrower-purchaser that the option was invalid as a clog on the equity of redemption); *Smith v. Smith*, 135 A. 25 (N.H. 1926) (holding that an option to purchase that was given for separate consideration and not directly related to the mortgage was not a clog on the equity of redemption); *Gavin v. Johnson*, 41 A.2d 113, 116-17 (Conn. 1945) (holding that Connecticut does not have a per se rule against clogging and that the court will look instead to the underlying fairness of the agreement).

In general, an option to purchase granted to the mortgagee must not be open to the claim that it is merely additional security to the note and mortgage, and it should not become automatically effective upon default by the mortgagor. An option to purchase at market value, perhaps determined by independent appraisal at the time of exercise, would most likely be held equitable and enforceable. Other methods could also be used to determine the fair market value of the property at the time of the option's execution. For example, a market multiple of net cash flow or the application of a price index to the fair market value of the property at the commencement of the loan are sufficient methods. If the option purchase price is set at an amount less than the amount of the mortgage note, the risk that the option will be deemed void as a clog on the mortgagor's right of redemption is substantially greater. The courts will look with suspicion upon any option by the mortgagee to purchase the property at a fixed price and may hold the option to be unenforceable if taken contemporaneously by the mortgagee as part of the original loan transaction.

Because the burden of proving fairness in such situations is normally placed upon the mortgagee, the following factors should be addressed: the care taken to establish the voluntary nature of the transaction, the business sophistication of the mortgagor, and the knowledge and experience of the mortgagor's counsel. Additionally, there should be no duress or unconscionable behavior, there should be independent and adequate consideration for the option to purchase or other release of the equity of redemption, and there should be no direct relation to the mortgage loan.¹¹

The mortgagor's equity of redemption and the clogging issue are specifically addressed in Chapter 3 of the recently published *Restatement*.¹² The *Restatement* deals with transactions involving the use of real property as security for the payment of an obligation. The *Restatement* is the first attempt by the American Law Institute to cover the law of mortgages. According to the Introduction to the *Restatement*, "[A] major goal of this *Restatement* . . . is to assist in unifying the law of real property security by identifying and articulating legal rules that will meet the legitimate needs of the lending industry while at the same time providing reasonable protection for borrowers."¹³ Chapter 3 of the *Restatement* reaffirms the general prohibition against clogging the borrower's equity of redemption. However, the *Restatement* permits the mortgagee to obtain an option to purchase, or other equity kicker, in connection with the mortgage loan as long as the exercise of the option or other equity kicker

¹¹ See GEORGE E. OSBORNE, MORTGAGES, § 97 at 145-47 (2d ed. 1970); Noel W. Nellis & Carl J. Seneker, II, *Brief Notes and Citations on Usury Considerations in Equity Transactions*, in REALTY JOINT VENTURES 1982: CAPITAL SOURCES, NEGOTIATION AND DOCUMENTATION 279 (PLI Practice Course Handbook Series No. 223, 1982); Andrea C. Barach, *A Practical Guide to Equity Participation Loans: Legal Principles and Drafting Considerations*, 20 REAL EST. L.J. 115 (1991); Robert K. Hagan, *What You Should Know About Convertible Mortgages*, PRAC. REAL EST. LAW., Jan. 1993, at 25; Levy et al., *Convertible Mortgages Lure Creative Investors and Owners*, 18 REAL EST. REV. 30 (1989); Jeffrey L. Licht, *The Clog on the Equity of Redemption and its Effects on Modern Real Estate Finance*, 60 ST. JOHN'S L. REV. 452 (1985); John C. Murray, *Clogging the Equity*, 8 MICH. REAL PROP. REV. 132 (1981); Laurence G. Preble & David W. Cartwright, *Clogging the Equity of Redemption; Old Wine in New Bottles*, PROB. & PROP., Nov.-Dec. 1987, at 7; Donald H. Siskind, *Structuring and Documenting Convertible Mortgages*, REAL EST. FIN. J., Fall 1989, at 14; C.C. Williams, Jr., *Clogging the Equity of Redemption*, 40 W. VA. L.Q. 31 (1933); Bruce Wyman, *The Clog on the Equity of Redemption*, 21 HARV. L. REV. 459 (1908); Howard E. Kane, *The Prohibition Against Clogging the Equity of Redemption: Recent Developments*, Tab 6 at 15-21 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Tab 24 at 5 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics).

¹² RESTATEMENT, *supra* note 2, §§ 3.1-3.3.

¹³ *Id.* Introduction. The Introduction refers to the mortgagor's equity of redemption as "the basic and historic right of a debtor to redeem the mortgage obligation after its due date, and ultimately to insist on foreclosure as the means of terminating the mortgagor's interest in the mortgaged real estate."

is not dependent on the mortgagor's default under the loan obligation.¹⁴

III. CLOGGING STATUTES (OPTIONS TO PURCHASE)

Several states have enacted statutes that specifically address the enforceability of options held by mortgagees to purchase the mortgaged property. These statutes permit the mortgagee (subject to certain restrictions) to obtain an option to acquire an interest in the mortgagor's property or the right to participate in the mortgagor's business as part of the mortgage transaction. For example, in New York, if the loan amount exceeds \$250,000, the lender may take an option to acquire the borrower's property without violating the clogging rule provided that the right to exercise the option is not conditioned on the borrower's default.¹⁵ In California, mortgage lenders are statutorily permitted to obtain an option to acquire an interest in the mortgaged property in connection with a commercial loan transaction.¹⁶ In Tennessee, lenders may, by statute, participate in a borrower's "business enterprise or venture" as part of a loan transaction (other than in connection with agricultural property).¹⁷ This includes the right to acquire equity in the enterprise or venture, as long as the original principal amount of the loan is not less than \$500,000.¹⁸ Virginia recently enacted a statute providing that, notwithstanding any rule of law or equity denominated "fettering," "clogging the equity of redemption," "claiming collateral advantage," or any similar rule, a lender may acquire a present or future ownership interest in the encumbered collateral from the borrower.¹⁹ The statute further provides that an option to acquire an interest in the property taken by the lender in connection with a mortgage loan is effective and enforceable in accordance with its terms as long as the option is not dependent on the occurrence of a default under the mortgage.²⁰

However, in Oklahoma mortgagees are statutorily prohibited from entering into contracts that interfere with the mortgagor's right of redemption. Under this statute, "[a]ll contracts for the forfeiture of property subject to a lien, in satisfaction of the obligation secured thereby, and all contracts in the restraint of the right of redemption

¹⁴ See *id.* § 3.1. See also John B. Neukamm, *An Overview of the Restatement of the Law of Mortgages* (last modified Oct. 28, 1997) <http://www.flabarrppl.org/rp_overview.html> (summarizing the RESTATEMENT). In accord with section 3.1 of the *Restatement*, The Uniform Land Security Interest Act permits the mortgagor to grant the mortgagee an option to purchase, so long as the mortgagee's exercise of the option is not based on default by the mortgagor. See Unif. Land Security Interest Act § 211 (1985), 7A U.L.A. 267 (Supp. 1997) [hereinafter ULSIA].

¹⁵ See N.Y. GEN. OBLIG. LAW § 5-334 (McKinney 1995).

¹⁶ See CAL. CIV. CODE § 2906 (West 1985). See also *Hamud v. Hawthorne*, 338 P.2d 387, 390 (Cal. 1959) (holding, in a case decided prior to enactment of California Civil Code § 2906, that an agreement by the borrower to waive or restrain the exercise of his redemptive rights was statutorily ineffective and invalid in California).

¹⁷ TENN. CODE ANN. §§ 47-24-101, -102 (1995 & Supp. 1997).

¹⁸ See *id.*

¹⁹ VA. CODE ANN. § 55-57.2 (Michie 1995). See also ULSIA, *supra* note 14, § 211 (providing that a secured party may, without affecting its rights as evidenced by its security interest, acquire "any direct or indirect present or future ownership interest in the collateral," and may also acquire an option to purchase the property, or an interest therein, at a future date so long as the option is not triggered by a default under the security agreement). The Alternative Mortgage Transaction Parity Act of 1982 preempted state law restrictions on the use of variable-rate mortgages secured by interests in residential property. 12 U.S.C. §§ 3801-3806. This legislation effectively overturned the clogging doctrine with respect to residential mortgages, except in the five states (Maine, Massachusetts, New York, South Carolina, and Wisconsin) that elected to override the federal preemption. See Curtis J. Berger, *ULSIA and the Protected Party: Evolution or Revolution?*, 24 CONN. L. REV. 971, 976, 993 (1992); ULSIA § 211 cmt. 2 (1985).

²⁰ See VA. CODE ANN. § 55-57.2.

from a lien, are void,” except with respect to certain obligations between a bailee and the owner of the property.²¹

In Illinois, a subcommittee of the Chicago Bar Association’s Real Property Law Committee drafted proposed legislation in 1993, entitled “The Recordable Option Act.”²² The proposed legislation would apply only to commercial real estate and would provide that a recorded option or memorandum of option to purchase real estate would be valid against subsequent creditors and purchasers with claims against the real estate, “as if it were a deed conveying the estate or interest conveyed therein.”²³ However, this proposed legislation has languished, and its future prospects are uncertain.

IV. DEEDS IN LIEU OF FORECLOSURE

A deed in lieu of foreclosure has been described as “a transaction in which a borrower, after default, conveys to its lender by absolute deed title to real property pledged as security for the indebtedness. The consideration for this conveyance consists of relieving the borrower of all *in personam* liability for the loan.”²⁴

Because a deed in lieu of foreclosure cuts off the right of redemption prior to foreclosure, the mortgagor may claim that this transaction constitutes an impermissible clog of its right of redemption. However, because a deed in lieu of foreclosure is subsequent to the original mortgage, and because it is a voluntary conveyance for independent and valuable consideration, and because it serves a socially useful purpose of allowing the mortgagor to avoid a time-consuming, costly, and public foreclosure, and possibly allowing the mortgagor to avoid personal liability on the debt, an arms-length, fully documented deed-in-lieu transaction should survive a clogging challenge.²⁵

Clogging issues may arise when the mortgagor agrees to give a deed in lieu of foreclosure to the mortgagee in the future if certain conditions arise, such as a default in the underlying mortgage loan obligation. An example of this type of arrangement occurs when a borrower places a deed in escrow with the lender or with a third party, such as a title insurance company. Courts might construe such an agreement as an equitable mortgage, and the borrower may claim that the lender must foreclose to enforce the provisions of the agreement. Courts of equity

²¹ OKLA. STAT. tit. 42, § 11 (1990). *See also Coursey*, 436 P.2d at 38-40 (holding that, by statute [OKLA. STAT. tit. 42, § 11], any agreement that the parties entered into at the inception of the mortgage by which the mortgagor waives or unduly restricts his statutory right of redemption is invalid and unenforceable).

²² The RECORDABLE OPTION ACT (Chicago Bar Ass’n Real Property Comm., Proposed Legislation 1993).

²³ *Id.* The proposed Act would also provide that, notwithstanding any rule of law or equity denominated “fettering,” “clogging the equity or redemption,” or “claiming a collateral advantage,” or any similar rule, a party secured by a mortgage or deed of trust, without affecting its security interest, could acquire from the borrower any present or future ownership interest in the collateral, including the income and any proceeds or increase in value of the collateral. The secured party would further be permitted to obtain an option to acquire an interest in the real property granted to such party, which option would take priority as of the date of its recording but would be effective in accordance with its terms so long as the exercise of the option was not dependent upon the occurrence of a default under the mortgage or deed of trust. This language tracks the language of § 211 of ULSIA, *supra* note 14.

²⁴ *Morrow Dev. Corp. v. Gordon Management, Inc.*, 875 P.2d 411, 413 n.3 (Okla. 1994).

²⁵ *See* RESTATEMENT, *supra* note 2, § 3.1, (“The deed in lieu transaction clearly serves the public interest. It not only avoids the expense and delay of a foreclosure proceeding, but also reduces the pressure on scarce judicial resources. While the deed in lieu does not violate the anticlogging doctrine and is normally to be encouraged, it is closely scrutinized to ensure it is free from fraud or oppression on the part of the mortgagee and is supported by adequate consideration.”).

will closely scrutinize these types of transactions because the borrower's right of redemption will be cut off by the deed in lieu of foreclosure when the default or other triggering event occurs.

Several courts have held that when the mortgagor places a deed in escrow in connection with a mortgage transaction, with instructions to release the deed to the mortgagee immediately in the event of a future default, the deed is void and unenforceable. In *First Illinois National Bank v. Hans*,²⁶ the defendants executed an assignment of their interest as contract-for-deed purchasers for a parcel of land as security for a mortgage loan.²⁷ The assignment provided that in the event of a default the defendants would "execute to the Assignee a Quit Claim Deed for the [Hartman property], which shall stand as a deed in lieu of foreclosure."²⁸ The Illinois appellate court declared this provision null and void, holding that the transaction created an equitable mortgage that the mortgagee must foreclose.²⁹ The court reaffirmed the principle that parties cannot use an express stipulation in the mortgage to transform the instrument into an outright conveyance upon default.³⁰ Doing so would operate to deprive the mortgagor of his or her redemptive rights.

In *Basile v. Erhal Holding Corp.*,³¹ the mortgagor gave the mortgagee both a mortgage and a deed in lieu of foreclosure.³² The mortgagee would not record the deed unless the mortgagor defaulted.³³ The mortgagor subsequently defaulted and demanded a right of redemption.³⁴ The Supreme Court of New York, Appellate Division, held that the deed was not intended as an absolute conveyance, but was a mortgage because it was further security for the loan.³⁵ The court granted redemption rights to the mortgagor.³⁶ In *Larson v. Hinds*,³⁷ the parties placed a deed to the property in escrow as part of the loan transaction, with the deed to be immediately delivered to the mortgagee in the event of a subsequent loan default by the mortgagor.³⁸ The Colorado Supreme Court stated that the agreement "comes as close to a formal security transaction as could have been accomplished without the execution of a mortgage or deed of trust,"³⁹ and held that the agreement constituted a security transaction as a matter of law because it deprived the mortgagor of any right to redeem the property.⁴⁰ Ultimately, the court held that the transaction violated the public policy of the State of Colorado.⁴¹

²⁶ 493 N.E.2d 1171 (Ill. App. Ct. 1986).

²⁷ *Id.* at 1172.

²⁸ *Id.*

²⁹ *See id.* at 1174.

³⁰ *See id.*

³¹ 538 N.Y.S.2d 831 (N.Y. App. Div. 1989).

³² *Id.* at 832.

³³ *See id.*

³⁴ *See id.* at 832-33.

³⁵ *See id.* at 833.

³⁶ *See id.*

³⁷ 394 P.2d 129 (Colo. 1964).

³⁸ *Id.* at 131.

³⁹ *Id.* at 132.

⁴⁰ *See id.* at 133.

⁴¹ *See id.* *See also* Pollak v. Milsap, 122 So. 16 (Ala. 1928) (holding transaction involving loan of money secured by deed is enforceable as a mortgage); Kartheiser v. Hawkins, 645 P.2d 967 (Nev. 1982) (holding that in a quiet title action by a third party who took title to the encumbered property, quitclaim deeds given by the mortgagor to the mortgagee at the time of delivery of the deeds of trust were merely further security for the mortgage loan and did not surrender grantor's equity in the properties); Marple v. Wyoming Prod. Credit

At least one bankruptcy court has ruled that, in the event of a subsequent bankruptcy by or against the mortgagor prior to release of the deed from escrow, a deed placed in escrow by the mortgagor is ineffective to convey title to the mortgagee or to extinguish the rights of the mortgagor in the property. In *In re Sky Group International, Inc.*,⁴² the mortgagor placed a deed to the mortgagee in escrow before the filing of an involuntary bankruptcy petition against the mortgagor.⁴³ The bankruptcy court held that under state law the mortgagor had not relinquished either its legal or equitable interests in the real property by executing the deed and placing it in escrow.⁴⁴ The court also ruled that title to the real property would remain in the mortgagor until the event occurred which would satisfy the escrow and the escrow agent made actual delivery of the deed to the mortgagor.⁴⁵ Because the deed was not delivered until after the involuntary petition had been filed, the mortgagor retained both legal and equitable title to the real property at the time of the filing.⁴⁶ Consequently, the real property remained part of the bankruptcy estate.⁴⁷

In recent years, courts have held that a mortgagor may not be compelled to give or agree to give a deed to the mortgagee or place a deed in escrow as part of the original mortgage transaction. Despite these holdings, a deed that the parties place in escrow may not constitute a clog if the deed is delivered in connection with a subsequent workout of a delinquent loan or as part of the mortgagee's agreement not to foreclose or to exercise other contractual or legal remedies. In *Ringling Bros. Joint Venture v. Huntington National Bank*,⁴⁸ the Florida appellate court held that a deed placed in escrow in connection with a mortgage loan workout was enforceable under state law and was not a clog on the equity of redemption.⁴⁹ The deed in escrow was given by the mortgagor to avoid foreclosure and therefore, the court held that the mortgagor received valuable new consideration to relinquish its right of redemption.⁵⁰ In *Oakland Hills v. Lueders Drainage District*,⁵¹ the Michigan appellate court disallowed a deed in escrow as a clog on the equity of redemption because it was part of the initial mortgage transaction.⁵² However, in *dicta* the court indicated that the arrangement would not be a clog on the equity and would be enforceable if it had been entered into after a subsequent default and for separate consideration.⁵³ In

Ass'n, 750 P.2d 1315 (Wyo. 1988) (refusing to enforce deed held in escrow which was to be reconveyed upon default).

⁴² 108 B.R. 86 (Bankr. W.D. Pa. 1989).

⁴³ *Id.* at 88.

⁴⁴ *See id.* at 91-92.

⁴⁵ *See id.* at 92.

⁴⁶ *See id.*

⁴⁷ *See id.* But see *In re O.P.M. Leasing Servs., Inc.*, 46 B.R. 661 (Bankr. S.D.N.Y. 1985) (holding that, although under New York law legal title to property placed in escrow remains with the grantor until occurrence of the condition specified in the escrow agreement, the grantee has an equitable interest in the property and a judgment lien creditor with notice of the escrow agreement is subject to the equity interest of the grantee); *Verity v. Metropolis Land Co.*, 288 N.Y.S. 625 (N.Y. App. Div. 1936) (upholding an arrangement in which the mortgagor agreed, in consideration of an extension of a mortgage loan and release of the mortgagor's personal liability, to deliver a deed in lieu of foreclosure to the mortgagee in the event of a subsequent default. The mortgagee had instituted an action to set aside its waiver of personal liability and unwind the transaction, but the court gave effect to the agreement because it helped the mortgagor, despite the effect on the mortgagor's equity of redemption.).

⁴⁸ 595 So. 2d 180 (Fla. Dist. Ct. App. 1992).

⁴⁹ *Id.* at 182.

⁵⁰ *See id.* at 183.

⁵¹ 537 N.W.2d 258 (Mich. Ct. App. 1995).

⁵² *Id.* at 264.

⁵³ *See id.*

an earlier decision, *Russo v. Wolbers*,⁵⁴ the Michigan appellate court held that although the mortgagor may not barter away the equity of redemption as part of the original mortgage transaction, the mortgagor may, in the absence of fraud, undue influence, oppression, or duress, convey the fee interest at a subsequent date for adequate consideration.⁵⁵

Courts also have recharacterized a deed the mortgagor placed in escrow as a continuing security device or an equitable mortgage. In *Wallace v. McCabe*,⁵⁶ the New York Supreme Court declared that a deed that was absolute on its face was a mortgage.⁵⁷ The court found that a deed delivered into escrow by the mortgagor in settlement of the debt constituted mortgage security for borrowed monies because the agreement recited the existence of the debt, management of the property remained in the mortgagor, and the mortgagor was entitled to recover the properties upon payment of the debt.⁵⁸ In *Coffin v. Green*,⁵⁹ the mortgagor delivered a deed into escrow with the stipulation that it would be delivered to the mortgagee if the mortgagor failed to pay the pre-existing mortgage on the property before a specified date or if the mortgagor satisfied the mortgage before such date.⁶⁰ The Arizona Supreme Court held that this arrangement constituted the delivery of an instrument of additional security for the mortgage rather than a conditional sale of the mortgaged property.⁶¹ In *McGuigan v. Millar*,⁶² the California appellate court held that the evidence indicated that the parties intended to treat the borrower's agreement to deliver a deed to the lender as a disguised security device.⁶³ This transaction was held to be a mortgage securing indebtedness and created an impermissible waiver of the right of redemption.⁶⁴ In *Messner v. Carroll*,⁶⁵ a mortgagor in default delivered an executed deed into escrow shortly before the maturity date of the mortgage debt.⁶⁶ The terms of the escrow purported to convey the property to the mortgagee with a stipulation that the mortgagor would receive the deed and note upon payment in full of the mortgage debt.⁶⁷ The Oklahoma Supreme Court held that this arrangement was not a conditional conveyance of the property, but instead constituted additional security for the mortgage because the parties continued to have a debtor-creditor

⁵⁴ 323 N.W.2d 385 (Mich. Ct. App. 1982).

⁵⁵ *Id.* at 389. *See also* *Guam Hakubotan, Inc. v. Fursuawa Inv. Corp.*, 947 F.2d 398 (9th Cir. 1991) (ruling that a deed delivered to the mortgagee as part of a loan extension agreement, to be recorded upon a subsequent default by mortgagor, was not an equitable mortgage); *Hans*, 493 N.E.2d at 1172 (holding that a separate agreement to execute a quitclaim deed for the property to the lender in the event of a future default to avoid foreclosure expenses may be enforceable in Illinois under certain circumstances. However, such an agreement, if contained as a provision in the original mortgage, is unenforceable as an impermissible attempt to extinguish the borrower's equity of redemption.); *Dawson v. Perry*, 30 Va. Cir. 372 (1993) (ruling that when a recorded deed of foreclosure was part of the original mortgage transaction, the deed was not obtained for separate and adequate consideration and prevented the mortgagor from exercising the equity of redemption, thus violating the clogging prohibition); Annotation, *Deed Placed in Escrow to be Delivered to Grantee upon Failure to Pay Debt due him as a Mortgage*, 65 A.L.R. 120 (1930).

⁵⁶ 245 N.Y.S.2d 854 (Sup. Ct. 1964).

⁵⁷ *Id.* at 856.

⁵⁸ *See id.*

⁵⁹ 185 P. 361 (Ariz. 1919).

⁶⁰ *Id.* at 362.

⁶¹ *See id.*

⁶² 4 P.2d 607 (Cal. Ct. App. 1931).

⁶³ *Id.* at 611-12.

⁶⁴ *See id.* at 612.

⁶⁵ 159 P. 362 (Okla. 1916).

⁶⁶ *Id.* at 363.

⁶⁷ *See id.* at 364.

relationship.⁶⁸

Several states have enacted statutes specifically addressing whether a deed given by a mortgagor to a mortgagee may constitute a continuing security device. In Minnesota, for example, there is a statutory presumption that a conveyance, if absolute in form, is not given as further or new security for the debt.⁶⁹ On the other hand, Illinois has a statute which states that “[e]very deed conveying real estate, which shall appear to have been intended only as a security in the nature of a mortgage, though it be an absolute conveyance in terms, shall be considered as a mortgage.”⁷⁰

⁶⁸ See *id.* at 364-65. See also *Peugh v. Davis*, 96 U.S. 332 (1877) (holding that a deed given as security will, in equity, be considered a mortgage); *Smith v. Player*, 601 So. 2d 946 (Ala. 1992) (reforming deed into mortgage and setting aside mortgagee’s transfer of property to third party); *Harbel Oil Co. v. Steele*, 318 P.2d 359 (Ariz. 1957) (stating that an assignment of a sublease for a specified term constituted an interest in real property capable of being mortgaged which, under statute, may be foreclosed only by an action in court. Thus, the parties’ rental agreement to rescind the sublease and surrender the premises was void as a clog on the equity to redeem.); *Davis v. Davis*, 890 S.W.2d 280 (Ark. Ct. App. 1995) (upholding decision that deed was a mortgage, following mortgagor’s clear, unequivocal, and convincing evidence that deed was intended to secure a debt); *Cohn v. Bridgeport Plumbing Supply Co.*, 115 A. 328 (Conn. 1921) (holding void as a restraint on the equity of redemption an agreement, made subsequent to the transfer of the mortgage, that failure to pay by a specified date would result in absolute transfer of the mortgage to the assignee); *Felbinger & Co. v. Traiforos*, 394 N.E.2d 1283 (Ill. App. Ct. 1979) (holding that in the absence of fraud, undue influence, oppression, or the like, the mortgagee may acquire the mortgagor’s equity of redemption or the entire estate for a valuable consideration); RESTATEMENT, *supra* note 2, § 3.2, reporter’s note (commenting that § 3.2 is consistent with the majority view that the parties’ intent, and not the transaction’s form, controls whether a conveyance is a deed absolute or mortgage); 4 A.J. CASNER, AMERICAN LAW OF PROPERTY § 16.6 (1952) (describing the early Anglo-Saxon forms using property transfers as security for a debt); W.W. Allen, Annotation, *Deed from Mortgagor or Privy to Mortgage Holder as Extinguishing Equity of Redemption*, 129 A.L.R. 1435 (1940) (discussing cases in which the mortgagee claims that the equity of redemption has been extinguished by deed from mortgagor to mortgagee or by deed and accompanying agreement); 55 AM. JUR. 2D *Mortgages* § 1304 (1996) (reviewing the requirements for a valid conveyance of the equity of redemption from the mortgagor to the mortgagee); 28 AM. JUR. 2D *Escrow* § 10 (1966) (discussing the equitable interest created when property is placed in escrow until the performance of a condition).

⁶⁹ See MINN. STAT. ANN. § 559.18 (West 1990 & Supp. 1996). See also GA. CODE ANN. § 44-14-32 (1997) (prohibiting use of parol evidence to show that deed absolute on its face is a mortgage, unless there has been fraud in the procurement); MISS. CODE ANN. § 89-1-47 (1997) (precluding use of parol evidence to prove that an absolute conveyance or other writing is a mortgage in the absence of fraud). Some states have enacted statutes that expressly permit a party to prove by parol evidence if necessary that a deed absolute on its face was in fact a mortgage. See, e.g., ARIZ. REV. STAT. ANN. § 33-702(A) (West 1997); IDAHO CODE § 45-905 (1997).

⁷⁰ 765 ILL. COMP. STAT. 905/5 (West 1996). In *Flack v. McClure*, 565 N.E.2d 131, 136 (Ill. App. Ct. 1990), the court stated that the burden of proof rests upon the party asserting a mortgage when a deed absolute was conveyed. The court also listed six factors that a court should evaluate in determining the existence of an equitable mortgage: (1) whether a debt exists (which, the court noted, is the essential element to establish an equitable mortgage); (2) the relationship of the parties; (3) whether legal assistance was available; (4) the sophistication and circumstances of each party; (5) the adequacy of consideration; and (6) who retained possession of the property. Based on its analysis of these factors, the court held that the evidence, especially that demonstrating the existence of a debt relationship and grossly inadequate consideration, clearly supported the trial court’s finding of an equitable mortgage. See also MD. CODE ANN., REAL PROP. § 7-101 (1997) (providing that a deed absolute in terms is considered a mortgage when it appears, by any other writing, to be intended merely as additional security for a debt or performance of an obligation); N.Y. REAL PROP. LAW § 320 (McKinney 1998) (providing that any deed conveying real property which appears by any other written instrument to be intended only as a security, must be considered a mortgage even though it appears by its terms to be an absolute conveyance); OKLA. ST. ANN. tit. 46, § 1 (West Supp. 1997) (stating that every instrument purporting to be an absolute conveyance of real estate but intended as security for the payment of money, is deemed a mortgage, and must be recorded and foreclosed as such); UTAH CODE ANN. § 78-40-8 (Michie 1977) (providing that a mortgage of real property, whatever its actual terms, is deemed a conveyance for the purpose of enabling the owner to avoid the commencement of a foreclosure proceeding to recover possession of the property). Other states provide that no defeasance to any deed of real property that is absolute on its face is effective to convert the document to a mortgage with respect to third parties unless the grantor’s defeasance right is in writing and is recorded in the mortgage records. See, e.g., CAL. CIV. CODE § 2950 (West 1993); ME. REV. STAT. ANN. tit. 33, § 202 (West Supp. 1997); PA. STAT. ANN. tit. 21, § 951 (West 1997); WYO. STAT. ANN. § 34-1-127 (Michie 1997).

Section 3.2 of the *Restatement* provides that parol evidence is admissible to establish that a deed absolute on its face was in fact intended as security for an obligation and should be deemed a mortgage.⁷¹ Section 3.2 also provides that the parties' intention to create a security device must be proved by "clear and convincing evidence."⁷² The section further provides that the parties' intention may be shown by the following: the statements of the parties; the existence of a substantial disparity between the value received by the grantor and the actual value of the real property at the time of conveyance; the fact that the grantor retained possession of the real property; the fact that the grantor continued to pay real estate taxes; the fact that the grantor made improvements to the real estate subsequent to the conveyance; and the nature of the parties to the transaction and their relationship both prior to and after the conveyance.⁷³ Section 3.2 also states that when, in addition to the deed, a separate writing exists indicating that a financing transaction was intended, parol evidence is admissible to establish that the writings, taken together, constitute a single security transaction.⁷⁴

Clogging issues may also occur in connection with deed-in-lieu transactions when the mortgagor retains a residual right (such as an option to repurchase the property or a right of first refusal), with respect to the property after the conveyance, or else retains possession of the property under a lease or occupancy agreement from the mortgagee. If the mortgagee grants such a continuing right to the mortgagor, a court could conclude that a deed was not intended and that the conveyance actually constitutes an equitable mortgage. If so, the court may void the deed. Prior to granting any such rights to the mortgagor, the mortgagee should consult the title insurer to determine if it will agree to insure title without raising an exception for a possible equitable mortgage claim by the mortgagor. If any such continuing rights are granted, the deed-in-lieu documents should specifically state that the continuing interest does not transform the deed obtained by the mortgagee into a mortgage and that an absolute conveyance is intended by the parties. In addition, the documentation should provide that the mortgagor will not be entitled to equitable or injunctive relief and that the mortgagor will be limited to an action for damages for breach of contract.⁷⁵

The mortgagee should also require the mortgagor to waive any right to control the manner of use, development, operation, or subsequent disposition of the property by the mortgagee after conveyance. If the mortgagee leases the property back to the mortgagor, the rental should be set at or near, but not in excess of, the market rate; and the term of the lease should be relatively short. Title insurers are likely to decide whether to insure these types of transactions against an equitable mortgage claim on a case-by-case basis. The section on title insurance coverage in connection with transactions involving potential clogging issues, contained later in this Article, discusses additional concerns and requirements that title insurers may raise in connection with continuing possessory or quasi-ownership rights granted to the mortgagor as part of the conveyance.

In *Beeler v. American Trust Co.*,⁷⁶ the California Supreme Court held that even though the debtor had

⁷¹ RESTATEMENT, *supra* note 2, § 3.2(a).

⁷² *Id.*

⁷³ *Id.* § 3.2(b).

⁷⁴ *Id.* § 3.2(c).

⁷⁵ *See id.* § 3.3(a) (providing that parol evidence is admissible to establish that a deed accompanied by a written agreement conferring on the grantor the right to purchase the property was in fact intended as security for an obligation, and is therefore a mortgage). Section 3.3(b) states that such intention must be proved by "clear and convincing evidence," and lists several factors from which such intention may be inferred. Section 3.3(c) provides that the presence of an express negation of the creation of a mortgage in any of the documents is relevant to the parties' intent, but does not preclude a determination that the transaction constitutes a mortgage.

⁷⁶ 147 P.2d 583 (Cal. 1944).

executed an affidavit contemporaneously with the deed declaring that the transaction was an absolute conveyance and was not intended as a mortgage, a purported deed in lieu of foreclosure would be treated as a mortgage when the borrower leased the property back and retained an option to purchase for the amount of the debt.⁷⁷ In *Strike v. Trans-West Discount Corp.*,⁷⁸ the California appellate court held that, notwithstanding the delivery of a “grant deed” to the lender, the borrowers’ retention of possession of the property, their payment of all taxes and assessments, and their payment of all insurance, maintenance and utility expenses, evidenced the parties’ intention to treat the deed as a security device.⁷⁹

V. SHARED APPRECIATION AND CONTINGENT INTEREST LOANS

A participating or equity kicker mortgage loan generally provides for payment by the mortgagor of a below-market fixed interest rate to the mortgagee (often at a higher than usual loan-to-value ratio), with additional contingent interest payments (payable monthly, quarterly, semi-annually, or annually) based on the gross or net cash flow (or a percentage over a floor amount of such gross or net cash flow) generated by the operation of the mortgaged property. Additional shared appreciation payments may also be required, based on a stated percentage of the appreciation in value of the mortgaged property at the time of any stipulated equity event⁸⁰ over the stipulated or appraised value of the mortgaged property at the time the loan is made or at a prior equity event not resulting in a payoff of the mortgage loan.

A participating loan may also be described as a lending-transaction arrangement in which the mortgagee makes a loan at a fixed rate of interest, usually at less than the current market rate, in exchange for a piece of the action. This form of consideration could be any of the following: participation in contingent interest based on gross income or net cash flow from the mortgagor’s operation of the mortgaged property; participation in the appreciation of the mortgaged property; a tenant-in-common interest in the ownership of the mortgaged property; participation in an actual partnership or other joint venture with the mortgagor in connection with the ownership and operation of the mortgaged property; or an option to convert its interest as mortgagee at a designated time during the term of the loan to an ownership interest by purchasing all or a portion of either the mortgaged property or the entity owning the mortgaged property, at either a fixed rate or a market price to be determined

⁷⁷ *Id.* at 595.

⁷⁸ 155 Cal. Rptr. 132 (Cal. Ct. App. 1979).

⁷⁹ *Id.* at 137. *But see* *Blick v. Nickel Sav. Inv. & Bldg. Ass’n*, 216 S.W.2d 509, 512-13 (Mo. 1948) (ruling that when deeds to two properties owned by the mortgagor were conveyed to the mortgagee and the mortgages were simultaneously released of record, and the deeds of conveyance contained no mention of any present or continuing indebtedness, the transaction did not constitute an equitable mortgage even though the intention of the parties was to grant the mortgagor a right or option to repurchase the property within a reasonable time. The court noted that the proof necessary to recharacterize a deed as a mortgage must be “clear, satisfactory and convincing”). *See also* Brant K. Maller, *Financing Ideas: Unclogging the Equity of Redemption*, 14 REAL EST. L.J. 161 (1985) (discussing generally the clogging doctrine); John C. Murray, *Deeds in Lieu of Foreclosure: Practical and Legal Considerations*, 26 REAL PROP. PROB. & TR. J. 459, 464, 468 (1991) (presenting an encyclopedic discussion of the relevant concerns in a workout effectuated by a deed in lieu of foreclosure); Preble & Cartwright, *supra* note 11 (providing a general overview of the clogging doctrine); Debra P. Stark, *Avoiding the Recharacterization of Certain Deed-in-Lieu-of-Foreclosure Transactions: Ensuring That What You Draft is What You Get*, 110 BANKING L.J. 330 (1993) (analyzing reported decisions regarding whether executory deed transactions are unenforceable as a clog of the equity of redemption of defaulting borrowers); Edward A. Stern, Note, *Mortgages: When is an Absolute Conveyance a Mortgage?*, 8 U. FLA. L. REV. 132 (1955) (discussing the case of *Rosenthal v. LeMay*, 72 So. 2d 289 (Fla. 1964)).

⁸⁰ For example, a sale or any other transfer, conveyance or disposition of the mortgaged property, maturity of the mortgage loan, subordinate financing of the mortgaged property, condemnation or casualty loss, prepayment of the mortgage loan, or payments due on annual or other stated anniversary dates based on current appraisals.

upon exercise of the option.

Clogging issues should not normally arise in connection with contingent interest and shared appreciation loans because the mortgagor may redeem the mortgaged property from a subsequent foreclosure and pay off the loan. Furthermore, these types of loan transactions provide a useful economic and social purpose by making capital available to mortgagors and permitting mortgagees to participate in the property's increased income and value over time (instead of participating only in the downside), in exchange for benefits granted to mortgagors such as higher loan-to-value ratios and lower interest rates.⁸¹

Equity kicker loans may provide that contingent interest and shared appreciation payments be made in cash or, alternatively, be capitalized into principal during the term of the loan. Although it may be argued that the capitalization of such additional payments (which involves computing interest on interest and compounding interest and creates negative amortization of the loan) may run afoul of the clogging doctrine, this should not always be the case. The clogging doctrine is not implicated when the mortgagee acquires an additional interest in the mortgagor's real estate solely to enhance the return on its investment in exchange for concessions granted to the mortgagor, and not in an attempt to avoid the prohibition against clogging or obtain an additional remedy for default by the mortgagor.⁸² If the mortgagee elects to refinance the loan at maturity, separate consideration will have been established at such time to support capitalizing the contingent interest payments and adding them to the principal balance of the new loan.

Shared appreciation payments normally should be available to the mortgagee prior to maturity only if and

⁸¹ See RESTATEMENT, *supra* note 2, § 3.1 cmt. g (stating that “the shared appreciation mortgage . . . arguably could be viewed as running afoul of the collateral advantage concept. However, while [this concept has] been recognized in English law, [it is] not part of American law, [is] not adopted by this Restatement, and should not be permitted to pose obstacles to socially useful financing transactions.”). See also ULSIA, *supra* note 14, § 211 (permitting the lender to obtain a present or future ownership interest in the collateral, including “rights to any income, refinancing proceeds, or increase in value derived from the collateral”); Berger, *supra* note 19, at 992-93 (stating that “[s]ection 211 [of ULSIA] would . . . validate not only shared-appreciation mortgages, but also convertible mortgages . . .”). The mortgagee nevertheless may want to satisfy itself that a loan transaction containing a participating feature will not result in a claim of unconscionability against the mortgagee, which could result in a court's refusing to enforce the mortgage loan documents (or at least the “unconscionable” terms). Even though the participating features of a mortgage loan may not constitute a collateral advantage that would violate the clogging doctrine, the mortgagor may argue that the degree, percentage, or scope of participation afforded to the mortgagee is so great or so onerous that it should be deemed unconscionable (and thus inequitable) behavior on the part of the mortgagee, thereby making the participating feature of the mortgage unenforceable. In *LaFond v. Rumler*, 574 N.W.2d 40 (Mich. Ct. App. 1997), the court held that a provision in a land contract addendum which provided that the vendor and vendee would share equally any proceeds from a subsequent sale of the property by the vendee made within the next 15 years, to the extent such proceeds exceeded the original purchase price paid by the vendee, was unenforceable because it went “unreasonably beyond protecting the defendant's interest in ensuring payment under the original land contract.” *Id.* at 44. The court reasoned that the vendor's right to reject offers the vendee might otherwise accept and the fact that an appraiser, who would be a stranger to both the property and the contract, would have ultimate and binding authority to settle any disputes regarding the property's value, rendered the shared appreciation feature of the land contract an unreasonable and impermissible restraint on alienation because it restricted the vendee's freedom to resell the property at a price of her choosing. The court also noted, in support of its decision, that the disputed provision could prevent the vendee from recovering the value of improvements made at her sole expense because she would have to share any subsequent profit with the vendor. See also Bernard H. Goldstein, *Unconscionability: Some Reconsiderations With Particular Reference to New-Type Mortgage Transactions*, 17 REAL PROP. PROB. & TR. J. 412, 416-17 (1982); Matthew J. Kiefer, *Participating Mortgages: The Risk for Lenders*, 14 REAL EST. L.J. 218, 220-24 (1986); Robert Kratovil, *Unconscionability—Real Property Lawyers Confront a New Problem*, 21 J. MARSHALL L. REV. 1, 19 (1987).

⁸² See RESTATEMENT, *supra* note 2, cmt. c (stating that “no case law supports the proposition that interest on interest is a clog. . . . Its purpose clearly is not to penalize default or to create obstacles to redemption.”).

to the extent that cash becomes available to the mortgagor pursuant to an equity event such as a sale, refinancing, condemnation, or insurance award. These types of loan transactions, however, sometimes require shared appreciation payments based on periodic re-appraisal of the market value of the mortgaged property when no additional cash payment is available to the mortgagee. Methods of determining the contingent interest or shared appreciation during the term of the loan should be clearly and objectively established, especially in the event of such triggering occurrences as foreclosure, refinancing, prepayment, application of insurance or condemnation proceeds, or periodic appraisals of the mortgaged property. Also, the mortgagee should not be granted the right to determine and receive payments of contingent interest or shared appreciation beyond the maturity date of the underlying mortgage loan.

The mortgagor may claim, especially when a foreclosure has been commenced by the mortgagee, that because the contingent interest or shared appreciation mortgage really is not a mortgage at all, but rather is a disguised equity interest of the mortgagee in the mortgaged property, the foreclosure proceeding should be dismissed. To avoid such a claim by the mortgagor, the mortgage should contain covenants that clearly establish the parties' intention that the participation rights granted to the mortgagee as part of the loan transaction do not constitute the granting of any equity interest in the mortgaged property.⁸³

VI. OTHER EXAMPLES OF ILLEGAL CLOGS

An illegal clog on the borrower's equity of redemption may also occur when the mortgagee demands and receives a collateral advantage to which it is not entitled. An example would be that as a condition to making a loan the mortgagor convey an interest in certain rights in the property to the mortgagee. In *Coursey*, the Oklahoma Supreme Court held that the conveyance of mineral rights by the mortgagor eleven days after modification of the mortgage was part of the same transaction and was thus void because it was not given separately for independent consideration.⁸⁴ In *Cook*, the court stated

[e]xamples of contract provisions which have been struck down as impermissible clogs are: limitations on the time period in which to redeem, warranties not to redeem, limitations on who may redeem, provisions giving the Mortgagee an option to purchase on default, and limitations on the quantity of property that may be redeemed.⁸⁵

⁸³ See Stephen A. Cowan & John P. Eastham, *Debt/Equity Transactions: An Objective Approach to Recharacterization*, in CONTROL RIGHTS AND RESULTING LIABILITY (American College of Real Estate Lawyers 1989); Barach, *supra* note 11; Peter L. Freeman, *Alternative Mortgage Instruments and Potential Mortgage Enforcement Problems*, THE URBAN LAWYER, Fall 1982, at 760; Laurence G. Preble, *Control Aspects of Participating Loans*, COM. REAL EST. FIN., A.B.A. 349 (1993); Preble, *supra* note 11; Albert D. Quentel & Jeffery P. Agron, *Participating Mortgages: Do They Solve the Problems of Partnerships?*, COM. REAL EST. FIN., A.B.A. (1993); Lou J. Viverito, Comment, *The Shared Appreciation Mortgage: A Clog on the Equity of Redemption?*, 15 J. MARSHALL L. REV. 131 (1982).

⁸⁴ 436 P.2d at 38-40.

⁸⁵ 659 P.2d at 927 (quoting Osborne, *supra* note 11, at 144-47). See also RESTATEMENT, *supra* note 2, § 3.1, reporter's note at 108 (recognizing that modern case law provides broad support for the doctrine against the clogging of a mortgagor's equity of redemption); Murray, *supra* note 11, at 134 (discussing various court opinions regarding clogs on the equity of redemption); Williams, *supra* note 11 (providing a historical review of the doctrine against clogging, concluding that the rule's use should focus upon relief against oppression). For examples of cases refusing to permit mortgagees to shorten the redemption period unilaterally, see *Bradbury v. Davenport*, 46 P. 1062 (Cal. 1896) (attempting to limit the right to four months); *Frazer v. Couthy Land Co.*, 149 A. 428 (Del. Ch. 1929) (attempting to limit right of redemption to three years).

In an unpublished decision by the Michigan Court of Appeals, *Wilson v. Taylor*,⁸⁶ the court stated that the land-contract forfeiture judgment issued by the lower court against the borrowers impermissibly clogged their right of redemption because it contained language stating that payments made by the borrowers after entry of the judgment would be applied first to maintain current payments and then to the outstanding judgment.⁸⁷ The lender argued that the borrower had voluntarily agreed to the language in the judgment and understood its meaning.⁸⁸ The court found, as a factual matter, however, that the borrowers had not been represented by legal counsel, did not understand that they had a legally protected right of redemption, and therefore had not voluntarily or knowingly waived their redemption right.⁸⁹

The exercise of a due-on-sale clause in a mortgage has been held not to constitute a clog on the equity of redemption. In *Cook*, the court stated that

[t]he instant due-on-sale clauses do not require forfeiture of the mortgaged property on unauthorized transfer; nor do they purport to nullify or limit Mortgagor's or Buyers' right to redeem on default. We hold that the due-on-sale clauses do not constitute a clog on the equity of redemption.⁹⁰

VII. MEZZANINE FINANCING

As the result of the increased securitization of real estate and the packaging of pools of loans for sale into the secondary market, mezzanine financing has become very popular in recent years. Mezzanine financing (or, perhaps more appropriately, mezzanine capital) fills the gap between the first mortgage financing, which usually has a loan-to-value ratio of forty to seventy-five percent, and the equity participation of the principals of the borrower, which is usually no more than ten percent of the cost of the project. Mezzanine financing commonly supplies financing of fifty to ninety percent of the project's capital structure cost. This type of financing can take several forms. Most commonly, it involves extending credit to the partners or other equity holders of a borrower and taking a pledge of such parties' equity interests (including the right to distributions of income). Alternatively, the lender may take a preferred equity position which is entitled to distributions of excess cash flow after debt service, ahead of the borrower's principals. A "combination" loan structure may also be used to combine a first mortgage loan with mezzanine financing at an aggregate loan-to-value ratio of ninety to ninety-five percent. This type of structure may contain a shared appreciation or contingent feature, an exit fee paid by the borrower, or sometimes, both.⁹¹

⁸⁶ No. 164978, LC No. 93-064685-AV (Mich. Ct. App., Jan. 5, 1996), *rev'd on other grounds*, 577 N.W.2d 100 (Mich. 1998). The Michigan Supreme Court noted that it was not properly presented with the question of a clogging of the equity of redemption, because the court of appeals already had ruled in favor of the defendants-vendees on the clogging issue and the plaintiff-vendor had failed to raise the issue on appeal and had furnished the court with only a one-sentence argument with no citation to authority. 577 N.W.2d at 105.

⁸⁷ *Id.* Under Michigan law, when, as occurred in this case, the judgment of possession is based on the forfeiture of a contract to purchase and the purchaser has paid less than fifty percent of the purchase price the borrower is entitled to a ninety-day redemption period before a writ of restitution may be issued.

⁸⁸ *See id.*

⁸⁹ *See id.*

⁹⁰ 659 P.2d at 928.

⁹¹ *See* Mark Finerman, *The Return of Mezzanine Capital*, 11 REAL EST. FIN. REV. 17 (1998).

Mezzanine financing provides a financing or capital vehicle that fills the spread between relatively low-risk senior secured debt and high-risk subordinated equity interests. The borrower is therefore able to obtain a first mortgage loan at a lower loan-to-value ratio, thus decreasing the cost of such primary debt financing and providing the lender with a more favorable debt service coverage ratio. The same lender can supply both the first mortgage financing and the mezzanine financing, or the funding can come from separate, unrelated entities. Because of the possibility that the mezzanine lender may acquire an equity interest in, or actually control, the equity owner, if the mezzanine lender is a third party, the mortgage lender may have stricter requirements than the mezzanine lender with respect to certain granting or denying approvals. For example, the mortgage lender may have greater rights to withhold consent to proposed actions of or requests by the borrower and the mezzanine lender to the exercise of rights and remedies in the event of the borrower's default. The mortgage lender may also require strict due diligence of the mezzanine lender, and may prohibit a transfer or pledge of the mezzanine loan without the mortgage lender's consent and rating agency's approval.

Mezzanine financing is commonly used in securitized financings, in which rating agencies (such as Duff & Phelps, Moody's, and Standard & Poors) generally disfavor subordinate real estate financing because they believe it increases the risk of bankruptcy. Therefore, many securitized first-mortgage lenders prohibit subordinate mortgage debt, but permit mezzanine financing that allows the subordinate lender to take collateral in the form of an equity or participating interest in the borrowing entity. The borrowing entity for the mezzanine loan is normally an independent bankruptcy-remote entity or special-purpose entity that is unlikely either to become the subject of a bankruptcy or to be substantively consolidated if a bankruptcy of a related person or entity occurs. The special-purpose entity is often an intermediate holding company which is separate from the borrowing entity that obtains the first mortgage loan. To demonstrate the separate nature of the entities, a "non-consolidation" opinion is required along with assurance that the general partner (or member, if the mortgage borrower is a limited liability company) of the mortgage borrower is not liable for the mezzanine loan.⁹²

⁹² See The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527, 559, 598 (1995); Tribar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW 717, 724-30 (1991). The bankruptcy-remote aspects of a special-purpose entity may be enhanced by requiring that one or more of the directors, general partners, or members of the special-purpose entity be independent, or by requiring a super-majority vote (which would necessarily include at least one of the independent parties) to approve a voluntary bankruptcy filing. An employee, officer, or representative of the lenders could obtain a direct ownership or equity interest in the special-purpose entity, but this would invite subsequent challenges based on lender liability, equitable subordination, and violations of public policy. Numerous courts have held that as a corporation approaches insolvency, the directors owe a fiduciary duty to the creditors of the corporation. See, e.g., *In re Andreuccetti*, 975 F.2d 413, 421 (7th Cir. 1992); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *In re Kingston Square Assoc.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) ("[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors. Nearly all states' law is in accord . . ."); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-89 (Del. Ch. 1992); *Credit Lyonnais Bank, Nederland, N.V. v. Pather Communications Corp.*, No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); *Tampa Waterworks v. Wood*, 121 So. 789 (Fla. 1929); *Franci v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981). As a result of negative experiences involving bankruptcy filings by and against borrowers, real estate lenders have learned that creating a borrowing entity with very few creditors, such as a bankruptcy-remote special-purpose entity, makes it much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or to avoid early dismissal. See, e.g., *Barakat v. Life Ins. Co. of Va.*, 99 F.3d 1520, 1526 (9th Cir. 1996) (stating that when the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor "should [not] be able to cramdown a plan that disadvantages the largest creditor"); John C. Murray, *The Lender's Guide to Single-Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 461-71 (1996); Gregory Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992); Stillman, *supra* note 11.

A typical mezzanine financing structure may involve a junior tranche of securitized financing, subordinate to the senior lienholder, payable at a fixed rate out of available cash flow from the project. As previously mentioned, mezzanine financing often consists of a loan to the equity holders of the special-purpose borrower, and is secured by a pledge of the equity interests in the borrower. The borrower under such a loan must be an equity holder in the borrower and not the special-purpose entity borrower itself.

Since the rating agencies require that a limited partnership have a bankruptcy-remote general partner who cannot be an obligor under mezzanine financing, loans to the equity holders of the borrower are secured by a pledge of the limited partnership interest or by a pledge of shares of the corporate general partner of the borrower, but not by actual equity in the borrowing entity. The partnership agreement, however, may permit the foreclosing mezzanine lender to remove the general partner and convert it to a limited partner. The collateral for a mezzanine loan may also include a pledge of stock or other equity interest in the borrower's general partner, or a guarantee from the ultimate parent company.

Another variation of a mezzanine financing transaction involves secured subordinated debt with a participating interest, with a slightly higher interest rate than the senior debt and contingent interest (based on net cash flow), or a shared appreciation feature based on an equity event such as sale, prepayment, condemnation, refinancing, or re-valuation.⁹³ A third variation uses combined debt and equity, usually evidenced by a convertible preferred participation in the equity interest of the borrower. The debt portion, which is usually small, may consist of a convertible mortgage, or may be secured by non-real property collateral.

A mezzanine financing structure might also use straight equity with a preferred return. The equity interest may take the form of a preferred equity interest in an intermediate partnership or limited liability company that is a holding company—evidenced by a capital contribution to the special-purpose borrower in exchange for an equity share in the borrower, such as a limited partnership interest. The preferred equity interest has a preferred right of payment over the borrower's other common equity. The preferred interest holder may also seek a veto over any proposed property refinancing if the realized amount would be insufficient to repay both the senior debt and the preferred equity interest. Because of the potential conflict with the senior mortgage debt holder's interest, the rating agencies usually will not permit the preferred equity holder to obtain such a right. Additionally, rating agencies generally require that the preferred equity and the mezzanine loan not be transferred without written confirmation by the agency and that such transfer will not result in a downgrade, withdrawal, or qualification of the then-existing rating on the senior mortgage debt. To ensure that existing equity maintains a significant and meaningful continuing equity interest in the property, the rating agencies generally will require that the aggregate amount of preferred equity and senior indebtedness not exceed eighty percent of the value of the property.

Clogging issues may arise as the result of the foregoing variations of mezzanine financing structures, usually resulting from allegations of lender control based on overreaching; pledge and participation rights; conversion options and rights; equity kickers, including contingent interest and shared appreciation; and lack of independent and adequate consideration for the participating features of the transaction. In the event of a default, the mezzanine financing provider normally will seek the right to take over, or at least participate in, the management and control of the borrowing entity (to prevent certain unwanted actions and consequences, such as bankruptcy). The mezzanine financing provider may also seek the alternative or additional right to convert its debt interest

⁹³ In order to constitute debt, the financing must have a minimum debt-service coverage of 1:1.

to an equity ownership interest in the borrower. The parties could employ a variety of techniques to accomplish this purpose, including the grant by the borrower of the right to convert the lender's mortgage interest to a limited partnership interest in the borrowing entity upon the occurrence of a future stipulated event, or the grant to the lender of options or warrants to purchase the stock of a corporate borrowing entity.⁹⁴ The mezzanine financing provider may also seek a security assignment of any or all other non-mortgage collateral of the borrower.

A significant issue may also exist regarding which state's case and statutory law should apply to a clogging claim. Many mezzanine financings involve multi-site and multi-state transactions and provide that a specific state's law (often New York's) exclusively governs all enforcement actions under the mortgage and other loan documents.

Virtually no case law exists that has applied the clogging doctrine specifically to these types of transactions; however, mortgagees should be aware of the potential clogging issues mentioned elsewhere in this Article when drafting documentation to evidence and secure these types of transactions.⁹⁵ The courts ought not to take an overly restrictive view of the clogging doctrine as applied to mezzanine financing transactions.⁹⁶

A sample form of an Owner's Certificate, or "anti-clogging affidavit," is attached as an appendix to this Article. The borrowing entity delivers such a certificate to assure the mortgagee (and its counsel) that the feature of the mortgage loan, which provides the mortgagee with an option to purchase an equity interest in the mortgagor when a future occurrence or contingency happens, does not constitute a clog on the mortgagor's equity of redemption.

VIII. SALE-LEASEBACK TRANSACTIONS

Courts may recharacterize sale-leaseback transactions as either equitable mortgages or joint ventures; however, to date no final court decision has ever recharacterized a sale-leaseback transaction as a joint venture. The recharacterization tests applied by the bankruptcy courts can serve as useful guidelines when analyzing

⁹⁴ See RESTATEMENT, *supra* note 2, § 3.1 at 103 (stating that "[a]n inflexible application of the clogging principle could render questionable the enforceability of such warrants [to purchase stock in the corporate mortgagor] because they enable the mortgagee to acquire indirectly an interest in corporate real estate without resort to foreclosure").

⁹⁵ See Jack M. Feder, *Either a Partner or a Lender Be: Emerging Issues in Real Estate Finance*, 26 TAX LAW. 191 (1983); Richard R. Goldberg, *Convertible Mortgage Anti-Clogging Affidavit*, Real Estate Financing Documentation: Coping with the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997 at 309; Richard R. Goldberg, *Convertible Mortgage Option Agreement*, Real Estate Financing Documentation: Coping with the New Realities, ALI-ABA Course of Study, Jan. 16-18, 1997 at 291; William B. Dunn, *Overview of Today's World of Financing*, REAL ESTATE 2000: A PRACTITIONER'S GUIDE FOR THE RESURGENCE OF THE REAL ESTATE MARKET, Tab A at 4-7 (July 23-26, 1997) (Twenty-Second Annual Summer Conference, State Bar of Michigan Real Property Law Section); Philip M. Horowitz, *Co-Lending Arrangements*, Tab 9 (American College of Real Estate Lawyers Annual Meeting on Finance Topics) (April 4-5, 1997); Kane, *supra* note 11, Tab 6 at 19; William G. Murray, *Filling the Gaps*, Tab 22 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); Harris Ominsky, *Construction Finance-Mezzanine Debt/Super Equity Issues*, WE'RE THE GOVERNMENT AND WE'RE HERE TO HELP, NEGOTIATE, NEGOTIATE, NEGOTIATE, Tab 12 (October 16-17, 1998) (American College of Real Estate Lawyers Fall Meeting); Laurence G. Preble, *Who's On First? Negotiating Intercreditor Agreements With Senior and Subordinate Debt*, Tab 23 (April 4-5, 1997) (American College of Real Estate Lawyers Annual Meeting on Finance Topics); Stillman, *supra* note 11.

⁹⁶ See RESTATEMENT, *supra* note 2, § 3.1 at 103 ("An overly dogmatic approach to options granted to mortgagees in loan transactions will unduly discourage the flow of capital to a variety of socially useful projects.").

transactions and evaluating whether, and under what circumstances, these transactions may be subject to the risk of recharacterization. Courts have applied a fact-based analysis to determine whether the substance of the transaction accords with its form and the expressed intent of the parties. Although the issue of whether a transaction is characterized as a sale or a mortgage depends to some extent on the parties' expressed intention and the economic substance of the transaction, these factors, and not its label, will ultimately determine whether the transaction is a true sale-leaseback or a financing transaction.

In *In re PCH Associates*,⁹⁷ the Second Circuit Court of Appeals held that based on the substance, as opposed to the form, of the transaction, the transaction was not a lease under section 365 of the Bankruptcy Code and the deed given to the purchaser-lessor was not an absolute deed but was instead an equitable mortgage.⁹⁸ The parties characterized the transaction as a sale-leaseback, but actually it had all the economic features of a mortgage financing transaction with the purchaser-lessor bearing few if any of the risks of ownership.⁹⁹

In a sale-leaseback transaction, the seller-lessee may attempt to have the sale and leaseback recharacterized as an equitable mortgage to provide the seller-lessee with an opportunity to redeem the property at a foreclosure sale. If the seller-lessee defaults under the lease and the buyer-lessor attempts to exercise its contractual and statutory remedies for the tenant's breach, the seller-lessee may claim that the buyer-lessor's attempt to exercise such remedies constitutes an unenforceable clog on the equity of redemption and that the buyer-lessor must instead foreclose its equitable mortgage. This claim by the seller-lessee may be difficult to prove, because, unlike a synthetic lease which is discussed below, there is no expressed intention by the parties that the document executed by the parties is anything other than a lease.¹⁰⁰

IX. SYNTHETIC LEASES

In recent years many United States and foreign banks, as well as other capital sources, have become increasingly active in offering "off-balance-sheet" financing for corporate real estate acquisition, construction, and expansion. This method of structured financing is attractive to a corporate user of real estate because, if properly structured as a true synthetic leasing transaction, the lessee-corporate user may expense the rental payments made to the lessor under the synthetic lease. Further, the lessee-corporate user's balance sheet is not "tainted" by real estate assets, ownership, or mortgage debt. Notwithstanding this characterization of the lease for financial accounting purposes, the lessee-corporate user retains all the tax benefits and burdens of ownership, including the ability to depreciate the real estate assets and to obtain any appreciation on a subsequent purchase

⁹⁷ 949 F. 2d 585 (2d Cir. 1991).

⁹⁸ *Id.* at 597-98. See also *In re Fabricators, Inc.*, 926 F.2d 1458 (5th Cir. 1991) (upholding bankruptcy court's recharacterization of loan as a capital contribution); *In re Ellis*, 674 F.2d 1238 (9th Cir. 1982) (determining that a deed with a repurchase option was a mortgage); *In re Kassuba Trust*, 562 F.2d 511 (7th Cir. 1977) (looking at the intent of parties, rather than form, to determine nature of mortgage).

⁹⁹ See 949 F.2d at 597-98.

¹⁰⁰ See Thomas C. Homburger & Brian Gallagher, *To Pay or Not to Pay: Claiming Damages for Recharacterization of Sale Leaseback Transactions Under Owner's Title Insurance Policies*, 30 REAL PROP. PROB. & TR. J. 443, 488-89 (1995); Thomas C. Homburger & Gregory R. Andre, *Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 REAL PROP. PROB. & TR. J. 95 (1989); Joel Simpson Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL EST. L.J. 664 (1974); Thomas C. Homburger & Gregory R. Andre, *Sale and Leaseback Transactions: Commercial Landlord/Tenant Practice 5-1* (1996) (unpublished manuscript on file with the Illinois Institute for Continuing Legal Education).

of the real property and improvements from the lessor by the lessee-corporate user or on resale to a third party.

The lease commonly states that the transaction is between unrelated parties and that the parties intend the lease to be treated as an operating lease for financial accounting purposes, but as a financing arrangement or loan for tax, bankruptcy, and commercial purposes. In addition, the lease states that the lessee will make such filings and take such actions as are required to evidence and further such an intention. The lease also contains the grant of a security interest and mortgage or deed of trust on the leased property to secure the lessee's performance under the lease. It contains specific enforcement provisions and remedies similar to those found in a mortgage or other real property financing transaction, including the right to foreclose the property under applicable state law by judicial sale or power of sale and to enforce the assignment of rents.

If the lessee defaults under the lease and the lessor attempts to exercise its statutory and contractual remedies for a lease default to evict the tenant and recover the unpaid rental (including additional rental and any make-whole premium due to the lessor), the lessee may claim that the synthetic leasing transaction constitutes an impermissible clog on the equity of redemption.¹⁰¹ Notwithstanding the typical dispossession and summary possession remedy provisions that may be contained in the lease, a court could find that, based on the language contained in the lease and the parties' expressed intention, the lessor must exercise the foreclosure remedies contained in the lease and provide the lessee the benefit of any statutory and equitable rights of redemption.¹⁰²

X. TITLE INSURANCE

Title insurance coverage issues with respect to clogging claims arise most commonly in connection with mortgage transactions providing for the grant of a purchase option to the mortgagee. In certain instances, after careful underwriting and risk analysis based on the documentation and the facts of a particular transaction, and depending on applicable state statutory or case law (as well as regulatory considerations), title insurance companies issuing mortgagees' policies may be persuaded to issue a limited affirmative endorsement pertaining to the clogging issue and acknowledge the mortgagee's continuing right to foreclosure remedies.¹⁰³ This is so because, even if a purchase option (or other collateral right) granted to a mortgagee in connection with a mortgage transaction is subsequently determined by a court to constitute an impermissible and unenforceable clog on the borrower's right of redemption, a court most likely still will permit the mortgagee to exercise its usual foreclosure remedies that arise as the result of the mortgagor's default; the mortgagee just will not be permitted to exercise

¹⁰¹ See generally David Holmes, *The Use of Synthetic Leases to Finance Build-to-Suit Transactions*, *Real Estate Transactions*, REAL EST. FIN. J., Winter 1996, at 17 (stating that use of a synthetic lease structure allowed the lender to narrow the risk of default to the lessee's obligation); James D. Bridgeman & Nancy R. Little, *The Synthetic Lease—Is It a Lease or Is It a Loan?* D-1 (May 15-17, 1997) (unpublished manuscript from the CLE and Committee Meeting of the ABA Section of Real Property, Probate and Trust Law Second Annual Non-Traditional Real Estate Forum) (discussing that a synthetic lease could provide the lessor with foreclosure right and the lessee with rights of redemption); Ellen E. Jamason, *Basics of Synthetic Leases*, Tab D (1997) (unpublished manuscript from the Real Estate Finance Hot Tips and Workshop, ABA Section of Real Property, Probate and Trust Law Annual Meeting) (stating that "if the corporate tenant fails to exercise the purchase option, and the property's market value has dropped to below 10-20% of its cost, the lessor may not be entitled to pursue the corporate tenant for the difference between market value and the amount advanced by lessor").

¹⁰² See John C. Murray, *Off-Balance-Sheet Financing: Synthetic Leases*, 32 REAL PROP. PROB. & TR. J. 193, 228 (1997).

¹⁰³ At least arguably, the standard mortgagee's loan policy already provides this coverage unless a specific exception has been raised or the title insurer is not aware of the additional rights given to the mortgagee that might result in a clogging claim.

the additional rights that constitute a clog. An endorsement could, depending on the circumstances, insure against loss or damage from the invalidity, unenforceability, or impairment of the lien of the mortgage resulting from application of the clogging doctrine by reason of the additional rights granted to the mortgagor or by reason of the form of the transaction (such as the right to a deed in lieu upon a future default in connection with a modification of a mortgage loan).

When a mortgagee wishes to obtain a purchase option in connection with a mortgage loan, he or she commonly will ask the title insurer for insurance for the purchase option. The request may be for an endorsement to the loan policy. Such an endorsement affirmatively insures the validity and priority of the option and specifically incorporates the purchase option into Schedule A of the policy as an insured interest. The availability of such an endorsement may depend on the existence of a state statute establishing the enforceability of such an option, case law in the jurisdiction that supports such a transaction, or a consideration of other legal and underwriting factors.

Because the mortgage loan and the option to purchase represent two separate and distinct interests in the property, the mortgage lender may request, and the title insurer may issue, two separate policies—a mortgagee’s policy for the loan and an owner’s policy for the option to purchase. Although the owner’s policy for the option will insure the validity and priority of the option, it will not insure against further sale or alienation of the property by the mortgagor or the failure of the mortgagee to fulfill the conditions of the option. Furthermore, the policy will not insure as to liens or encumbrances that may attach to the property after issuance of the policy or with respect to any liens or encumbrances created or suffered by (or agreed or consented to) by the mortgagor or created by statute (including real estate taxes, special assessments, demolition liens, drainage liens and water liens). In addition, the policy will not insure as to the right of the mortgagee to any award to be distributed as the result of any condemnation proceeding affecting the mortgaged property. The policy also will exclude coverage for any mechanic’s lien claims whether incurred prior to or after the date of the policy or endorsement, as well as any expenses required to obtain conveyances, releases, rights, interests, or liens of record known to the mortgagee at the time of the exercise of the option.

The mortgagee must bring any necessary suit, at his or her own expense, to enforce his or her claim to a deed to the secured property from the party vested in title and to obtain the removal or discharge of any subsequent liens against the property. Also, because the option to purchase may be considered an executory contract under section 365 of the Bankruptcy Code, and could be assumed or rejected by a trustee in bankruptcy or a debtor in possession, the title insurer will not want to remove the creditors’ rights exclusion from the title policy.¹⁰⁴ The

¹⁰⁴ See 11 U.S.C. § 365(a) (1994). The Bankruptcy Code does not define “executory contract.” An executory contract has been described generally as a contract in which obligations remain to be performed by both sides. See *National Labor Relations Board v. Bildisco & Bildisco*, 465 U.S. 513, 522-23 n.6 (1984) (holding that an executory contract is one “on which performance remains due to some extent on both sides”); *Griffel v. Murphy (In re Wegner)*, 839 F.2d 533, 536 (9th Cir. 1988) (ruling that a contract is executory if “the obligations of both parties are so unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other”); *In re Anchor Resolution Corp.*, 1998 WL 300577 (Bankr. D. Del. 1998) at *6 (citing *Enterprise Energy Corp. v. United States (In re Columbia Gas Sys. Inc.)*, 50 F.2d 233, 239 (3d Cir. 1995)); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). With respect to the issue of whether an option to purchase constitutes an executory contract that can be rejected under section 365(a) of the Bankruptcy Code, see *In re Helms*, 139 F.3d 702, 706 (9th Cir. 1997) (en banc), in which the court held that whether an option is an executory contract depends on whether the option requires further performance from each party at the time the bankruptcy petition is filed, and that performance that is due at the sole discretion of the optionee (*i.e.*, the decision by the optionee whether or not to exercise the option), “doesn’t count unless he has chosen

title insurer may also, under certain circumstances, require that the option to purchase granted to the mortgagee contain an “unwind” provision that would permit the mortgagor to repurchase the option for a stipulated fee or charge. This would nullify the mortgagee’s option right and preserve the mortgagor’s right of redemption in the event of a subsequent default by the mortgagor and foreclosure by the mortgagee.

The document containing the option to purchase normally will be recorded prior to the mortgage, so that the option will survive the mortgage’s subsequent foreclosure or extinguishment. The owner’s policy could then show the existence of the mortgage lien as an encumbrance subordinate to the option to purchase. The title insurer would also commonly agree to continue the coverage of the owner’s policy upon the exercise of the option by the mortgagee.

The measure of damages under the policy would be determined by

(A) the excess of the fair market value of the property at the time the insured attempts to exercise the option (or when a lawsuit contesting the validity of the option is filed, if filed prior to the attempted exercise of the option) above the price at which the insured could acquire the property by exercise of the option; and (B) the unreimbursed portion of the consideration given by the insured to obtain the option.¹⁰⁵

In connection with shared appreciation and contingent interest mortgages, additional or alternative endorsements may be applicable and available which specifically insure the participating features and recharacterization risks of these types of loan transactions.¹⁰⁶

to exercise it.” The court stated that an option to purchase may on occasion be deemed an executory contract “where the optionee has announced that he is exercising the option, but [has] not yet followed through with the purchase at the option price.” The Ninth Circuit in *In re Helms* expressly overruled its previous decision in *Gill v. Easebe Enters.* (*In re Easebe Enters.*), 900 F.2d 1417, 1419 (9th Cir. 1990), which held that all options are executory. Cases holding that an option to purchase is an executory contract under section 365 of the Bankruptcy Code include *Steffan v. McMillan* (*In re Coordinated Fin. Planning Corp.*), 65 B.R. 711, 713 (9th Cir. B.A.P. 1986); *Horton v. Rehbein* (*In re Rehbein*), 60 B.R. 436, 441 n.6 (9th Cir. B.A.P. 1986); *Rivercity v. Herpel* (*In re Jackson Brewing Co.*), 567 F.2d 618, 623-24 (5th Cir. 1978); *In re A.J. Lane & Co.*, 107 B.R. 435, 437 (Bankr. D. Mass. 1989); *In re Hardle*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989); *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D. Minn. 1985); *In re Waldron*, 36 B.R. 633, 6360-40 (Bankr. S.D. Fla. 1984), *rev’d on other grounds*, 785 F.2d 936 (11th Cir. 1986). Other bankruptcy court decisions, however, hold that an option contract is not an executory contract. *See, e.g., Brown v. Snellen* (*In re Geising*), 96 B.R. 229, 232 (Bankr. C.D. Mo. 1989); *In re Lewis*, 94 B.R. 478, 495 (Bankr. D. Mass. 1988); *Travelodge Int’l, Inc. v. Continental Properties, Inc.* (*In re Continental Properties II, Inc.*), 15 B.R. 732, 736 (Bankr. D. Haw. 1981). *See also* 1 WILLISTON ON CONTRACTS § 5:16 (4th ed. 1990) (“The traditional view regards an option as a unilateral contract which binds the optionee to do nothing, but grants him the right to accept or reject the offer in accordance with its terms within the time and in the manner specified in the option.”); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 COLO. L. REV. 845, 898-99 (1988) (discussing problems surrounding a bankruptcy trustee’s option to reject any executory contract).

¹⁰⁵ Raymond J. Werner, *Endorsements and Affirmative Coverages for Commercial Title Insurance*, in *TITLE INSURANCE* 1997, 1047, 1098-99 (PLI Handbook 1997).

¹⁰⁶ *See* Oscar H. Beasley, *Title Policy Endorsements Relating to Alternative Mortgage Forms*, 17 REAL PROP. PROB. & TR. J. 375, 380 (1982); Hugh A. Brodkey, *Title Insurance Considerations in Mixed Debt/Equity Financing*, in *REALTY JOINT VENTURES* (PLI Handbook 1986); John C. Murray, *Recharacterization Issues in Real Estate Transactions*, in *TITLE INSURANCE: HANDLING CRITICAL ISSUES FACING BUYERS, SELLERS AND LENDERS* 223, 225, 229 (PLI Handbook 1997) and attached exhibits; Hugh A. Brodkey, *A Title Insurer Looks at Mixed Debt/Equity Transactions* (paper presented at ALI-ABA Course of Study, Commercial Real Estate Financing, January 24, 1990). The mortgagee seeking to take an option to purchase, or other collateral rights, in connection with a mortgage loan should furnish the title insurer, well in advance of the closing for its full review, input, and approval, copies of all proposed documentation,

With respect to sale-leaseback and synthetic lease transactions, the title insurer will customarily create a special exception in the owner's or lender's title insurance policy as the result of any subsequent recharacterization of the interest of the insured party in the land described in Schedule A of the policy. This is so even though there is no coverage under the title insurance policy for any matter "created, suffered, assumed or agreed to" by the insured, or a "[d]efect, lien, encumbrance, adverse claim or other matter . . . attaching to or created subsequent to the Date of Policy" (based on the conduct of the parties after the transaction has closed).¹⁰⁷

Title insurance insures against defects in title or in the recorded documents; it does not insure against problems arising from or relating to the underlying transaction or the relationship between the insured and other parties to the transaction. In *Lawyers Title Insurance Corp. v. JDC (America) Corp.*,¹⁰⁸ the Eleventh Circuit Court of Appeals held that the title insurer had no duty to defend a claim that the insured's mortgage was unenforceable due to the insured mortgagee's status as a partner in a joint venture for which the mortgaged property was held in trust.¹⁰⁹ The mortgagee's policy included an exclusion for matters "created, suffered, assumed or agreed to" by the insured which applied to the claims of the lender because the claims involved actions of the insured in entering into various relationships with the borrower.¹¹⁰ The court further held that the policy's coverage against the "invalidity and unenforceability of the insured mortgage" did not apply because the "the provision insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt."¹¹¹ In addition, the court noted that "[t]he defenses asserted by [the insured] on behalf of the joint venture . . . all explicitly related to the effect of the parties' relationship [or] the collectibility of the debt . . . rather than the validity of the mortgage itself."¹¹² In *Ticor Title Insurance Co. of California v. FFCA/IIP 1988 Property Co.*,¹¹³ the Federal District Court for the Northern District of Indiana held that, in connection with a sale-leaseback transaction, the seller-lessee's claim that the purchaser-lessor's ownership interest in the property was in fact a mortgage security interest required proof of the insured party's intent.¹¹⁴ The claim therefore was not a matter covered by title insurance because of the policy exclusion for matters "created, suffered, assumed, or agreed to by the insured claimant."¹¹⁵

as well as other relevant information and data regarding the transaction.

¹⁰⁷ See Exclusions 3(a) and 3(d), respectively, of the ALTA Loan Policy (October 17, 1992); Joel E. Smith, Annotation, *Title Insurance: Exclusion of Liability for Defects, Liens or Encumbrances Created, Suffered, Assumed or Agreed to By the Insured*, 87 A.L.R. 3d 515 (1996).

¹⁰⁸ 52 F.3d 1575 (11th Cir. 1995).

¹⁰⁹ *Id.* at 1583-84.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 1583.

¹¹² *Id.*

¹¹³ 898 F. Supp. 633 (N.D. Ind. 1995).

¹¹⁴ *Id.* at 640-41.

¹¹⁵ *Id.* See also *Transamerica Title Ins. Co. v. Alaska Fed. Sav. & Loan Ass'n*, 833 F.2d 775, 776 (9th Cir. 1987) (holding that if the insured intended to obtain only an equitable lien, this would be a matter "created" by the insured and would be excepted from coverage under the terms and provisions of the title insurance policy); *Bank of Miami Beach v. Lawyers' Title Guar. Fund*, 214 So. 2d 95 (Fla. Dist. Ct. App. 1968), *cert. dismissed*, 239 So. 2d 97, 99 (Fla. 1970) (holding that title insurance does not cover the invalidity or unenforceability of a mortgage due to forged signatures on the mortgage note and that "a guarantee of the validity of the mortgage lien cannot and should not be construed as guaranteeing that the insurer [sic] has made a careful investigation of the origin of the mortgage debt and guarantees its payment or validity. If such coverage is contemplated, the policy should specifically so provide.") (emphasis in original); *Goode v. Federal Title & Ins. Corp.*, 162 So. 2d 269, 270 (Fla. Dist. Ct. App. 1964) (stating that "[i]t must be borne in mind that

If the title insurer is aware of the nature of and the facts surrounding a sale-leaseback or synthetic lease transaction, is this enough to cause it to be deemed to have provided coverage against the risk of recharacterization unless the title insurer has raised a specific recharacterization exception? It has been suggested that, in connection with recharacterization issues involving sale-leaseback transactions:

[a]n investigation by the insurer of the facts surrounding a sale leaseback transaction . . . may create a sufficient level of knowledge through which the insurer would be deemed to have assumed the obligation to insure or defend against loss from a recharacterization. This result would follow whether the inquiry was undertaken voluntarily by the insurer or in response to a request by the insured that the policy expressly insure against loss due to a sale leaseback transaction recharacterization. Similarly, an insured may be deemed to assume such an obligation through a failure of an insurer to respond to information specifically disclosed by the insured which made it obvious that a recharacterization was possible . . . [T]he [title] insurer is well advised to disclaim specifically any obligation to indemnify the insured against loss from a sale leaseback transaction recharacterization. The alternative is for the insurer to run the risk of assuming this kind of indemnification obligation.¹¹⁶

Title insurers are justifiably reluctant to issue policies in connection with sale-leaseback and synthetic lease transactions without a specific recharacterization exception. It may also be difficult, if not impossible, to obtain any affirmative coverage or endorsement against a clogging claim in connection with a sale-leaseback or synthetic leasing transaction, because the original documents are designated as leases and not as mortgages and, most likely, have not been recorded in the mortgage records.¹¹⁷

a title policy insuring a mortgagee insures only the title to the lands securing his debt and not the debt . . .”) (quoting 60 A.L.R.2d 972, 976); *Bidart v. American Title Ins. Co.*, 734 P.2d 732, 734 (Nev. 1987) (holding that because an equitable-lien claim requires proof of the insured’s intent, it falls within the “created or suffered” exception in the title policy and is not a covered defect); *Gerrold v. Penn Title Ins. Co.*, 637 A.2d 1293, 1295 (N.J. Super. Ct. App. Div. 1994) (ruling that title insurance does not cover the invalidity or unenforceability of a mortgage due to failure of consideration); *Title Ins. Corp. v. Wagner*, 431 A.2d 179, 182 (N.J. Super. Ct. Ch. Div. 1981) (ruling that a claim of fraud against the insured was clearly within the title policy exclusions for defects “created . . . by the insured” and the title insurer was, therefore, not required to defend the claim).

¹¹⁶ See Homburger and Gallagher, *supra* note 100, at 488-89. See also Robert S. Bozarth, *The Title Insurance Perspective*, D-31 (May 15-17, 1997) (unpublished manuscript from the CLE and Committee Meeting of the ABA Section of Real Property, Probate and Trust Law Second Annual Non-Traditional Real Estate Forum); Robert S. Bozarth, *Some Modern Developments in Title Insurance of Mortgages*, 13-19 (Oct. 11, 1996) (unpublished manuscript from a presentation to the Annual Meeting of the American College of Mortgage Attorneys).

¹¹⁷ Another form of real estate financing involving a leasehold interest in the property is beginning to be utilized by some creative real estate developers and investors. Known as “lease-leaseback” financing, the transaction is structured so that, instead of the developer-lessee obtaining a leasehold mortgage to finance the improvement to the real property, the developer-lessee assigns its leasehold interest to an investor, which assignment is then recorded in the public real estate records. The investor then subleases its interest in the ground-leased property back to the developer-ground lessee, with the sublease payments designed to enable the investor to recover its investment in the project along with a reasonable profit. The improvements are then constructed by the developer-ground lessee. The landlord, tenant (the original ground lessee), and the investor then enter into a tri-party agreement which provides that, notwithstanding the assignment of the ground leasehold interest to the investor, the landlord will look solely to the original ground lessee (the investor’s subtenant) for the rent and all of the other tenant obligations under the ground lease unless and until the investor takes certain specified actions. The same bankruptcy and recharacterization issues exist in this type of transaction as occur in connection with synthetic leasing and sale-leaseback transactions, including the risk that a court could subsequently treat the lease-leaseback transaction as a security device rather than an operating lease. If the investor is treated as a leasehold mortgagee, and the tenant rejects the lease in a bankruptcy proceeding, the law is not clear as to whether such rejection terminates only the tenant’s, but not the mortgagee’s, rights or whether both parties’ rights are terminated. See, e.g., *Eastover Bank v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1084 (5th Cir. 1994)

With respect to a deed-in-escrow transaction, the documentation usually provides that the deed will be delivered out of escrow to the mortgagee in the event of a future loan default or other specified event. Title insurance companies are often asked to hold the deed in escrow and issue title insurance for the transaction. Title insurance coverage should be available, and the title policy issued, only after the deed comes out of escrow. At the time the deed is delivered into escrow no delivery of the deed has actually occurred and a bankruptcy may be filed subsequently by or against the mortgagor (unless the deed-in-lieu transaction is part of an approved bankruptcy plan). In such a case, the property likely would be determined by a bankruptcy court to remain part of the debtor's estate because the escrow arrangement constitutes an executory contract and no actual delivery had occurred.¹¹⁸ The mortgagor as debtor in possession, or a trustee appointed for the bankruptcy estate, also may argue that the automatic stay that applies as of the filing date of the bankruptcy petition prohibits the delivery of the deed and any other escrowed documents. Furthermore, other creditors may challenge such escrows as fraudulent conveyances or preferential transfers.

Even if the escrowed documents have been delivered out of escrow to the mortgagee prior to the mortgagor's bankruptcy, the mortgagor or the bankruptcy trustee may seek subsequently to avoid the transfer as a fraudulent conveyance, a preference, or an unperfected lien subject to the strong arm powers of the trustee under section 544 of the Bankruptcy Code.¹¹⁹ For purposes of determining the preference limitation period,¹²⁰ or the fraudulent conveyance limitation period¹²¹ for bringing an avoidance action (which are usually significantly longer under similar state fraudulent conveyance and fraudulent transfer laws), most courts hold that the transaction is no longer executory and the transfer period commences when the deed is placed in escrow and not when the deed is conveyed or released out of escrow.¹²² It is therefore important that the title insurance company handling the escrow arrangement and insuring title upon delivery or release of the deed, ascertain when the deed is placed in escrow. When the deed is released and the title insurance company is asked to provide the policy, it must make

(holding that lessee's deemed rejection of the ground lease, due to the lessee's failure to assume the ground lease within sixty days of date of the lessee's bankruptcy filing, did not terminate the leasehold mortgagee's interest); *In re Gillis*, 92 B.R. 461, 465 (Bankr. D. Haw. 1988) (ruling that termination of lease extinguished mortgagee's security interest in the lease since there was no remaining leasehold interest to which the security interest could attach). Careful drafting of the language in both the sublease (such as stating the intention of the parties that the transaction is an operating lease and not a financing transaction) and the tri-party agreement (such as stating that the investor has the right to enter into a new lease with the landlord or assign its interest in the new lease to a third party in the event that the ground lessee rejects the lease in bankruptcy or is otherwise ousted from possession as the result of an uncured default under the ground lease) is imperative. See Kathi W. Borkholder, *Ground Leases—Lease/Leaseback Financing as an Alternative to the Traditional Mortgage, Real Prop. Programs*, Tab S-1 (May 14-16, 1998) (ABA Section of Real Property, Probate and Trust Law, 9th Annual Spring CLE and Committee Meeting).

¹¹⁸ See, e.g., *In re Scanlan*, 80 B.R. 131, 134 (Bankr. S.D. Iowa 1989) (holding that delivery of a deed to an escrow agent, when the obligations of the other party have not been fulfilled, does not constitute full performance by the debtor and the deed may be rejected as an executory contract and the property ordered reconveyed to the debtor); *Shaw v. Dawson*, 48 B.R. 857, 861 (Bankr. D.N.M. 1985) (ruling that a real estate contract, in which the debtors were the purchasers of the land, was an executory contract). But see *In re Rehbein*, 60 B.R. at 441 and *In re Leefers*, 101 B.R. 24, 28 (Bankr. C.D. Ill. 1989) (ruling that when the deed has been placed in escrow and neither party has any further material obligations to perform, the contract is not executory and may not be rejected).

¹¹⁹ See 11 U.S.C. § 544 (1994). Section 544 vests a bankruptcy trustee with the rights of a hypothetical lien creditor whose lien was perfected at the time of the filing of the bankruptcy petition. If another creditor who claims a lien against the applicable property has not properly perfected its lien as of the filing of the bankruptcy petition, the trustee or the debtor in possession can avoid that creditor's lien and that creditor then becomes merely a general creditor of the estate.

¹²⁰ Ninety days, or, in the case of a transfer to an insider, one year, under section 547 of the Bankruptcy Code.

¹²¹ One year under section 548 of the Bankruptcy Code.

¹²² See, e.g., *In re Rehbein*, 60 B.R. at 441; *In re Leefers*, 101 B.R. at 28.

sure that there is fair and adequate consideration for the transaction (such as extinguishment or reduction of the underlying indebtedness and waiver, forbearance, or relinquishment of the rights and remedies of the mortgagee otherwise available for non-payment of the debt) and that the value of the property is less than the outstanding debt.

The title insurance company will want to review and approve all of the underlying documents and agreements. It will also likely require that the escrow agreement contain provisions absolving the title insurance company from all liability other than gross negligence and permitting it to bring an interpleader action in the event of a dispute among any of the parties to the agreement.¹²³

Mortgagees may try to bankruptcy-proof a deed-in-lieu transaction by using third party indemnifications or springing or exploding guaranties, or by requiring the borrower to establish a bankruptcy-remote entity to hold title to the property. If a deed is placed in escrow as part of an approved bankruptcy plan, the plan and confirmation order should include specific findings of fact and conclusions of law that the conveyance of the property constitutes an absolute transfer of the property and is not intended by the parties as an equitable mortgage. The escrow instructions should state that, in the event of a subsequent default under the plan or the loan documents—as the same may have been revised or restated pursuant to the plan—the title insurance company, as escrow agent, will release the deed and other escrowed documents and deliver them to the designated party. Since this type of arrangement will have been approved specifically by the bankruptcy court, it should be enforced even if the mortgagor is later the subject of a second bankruptcy case, based on collateral estoppel, *res judicata* principles, and equitable grounds. In other words, the mortgagee should be entitled to relief from the automatic stay in the subsequent bankruptcy proceeding and to specific enforcement of the escrow arrangement.

In *In re Howe*,¹²⁴ the Fifth Circuit Court of Appeals upheld the decision of the bankruptcy court that the debtor-mortgagor was precluded, under the principle of *res judicata*, from filing a lender liability claim against the mortgagee (who was the largest creditor of the bankrupt debtor-mortgagor) five years after the confirmation of the debtor-mortgagor's Chapter 11 bankruptcy reorganization plan.¹²⁵ The plan contained a provision that if the debtor-mortgagor failed to comply with the plan, a deed in escrow to the debtor-mortgagor's property would be released to the mortgagee.¹²⁶ Because the debtor-mortgagor had not performed under the bankruptcy plan, the bankruptcy court denied the debtor-mortgagor's motion to dismiss the Chapter 11 proceedings and granted the mortgagee's motion for release of the deed.¹²⁷ The Fifth Circuit agreed with the bankruptcy court's holding that because the plan contained "built-in provisions that eliminate default"—if the debtor-mortgagor could not pay, the mortgaged property would be transferred to the mortgagee—there was no material default under the plan that would necessitate the dismissal of the Chapter 11 proceedings or prevent the delivery of the deed to the mortgagee.¹²⁸

Title insurance coverage for equitable-mortgage claims is also excluded by the terms of the title insurance

¹²³ See Patrick E. Mears, *Can Bankruptcy Trump an Escrow?*, BUS. LAW TODAY, Sept./Oct. 1996, at 40.

¹²⁴ 913 F.2d 1138 (5th Cir. 1990).

¹²⁵ *Id.* at 1144-45.

¹²⁶ See *id.* at 1148-49.

¹²⁷ See *id.*

¹²⁸ *Id.* at 1149.

policy, and would be available only by a special endorsement.¹²⁹ However, if the title insurer is aware of facts that would put it on notice that the parties intend, or may have intended, that a deed from the mortgagor to the mortgagee is actually a continuing mortgage or security device, the company may be deemed to have provided coverage against the risk of recharacterization to the insured under a title policy, unless the title insurer has raised a specific recharacterization exception.¹³⁰

XI. CONCLUSION

Careful consideration of the clogging issue is crucial in connection with many types of real estate transactions, whether the transactions are traditional—such as equity kicker mortgages and deeds in lieu of foreclosure—or relatively new—such as mezzanine financing and synthetic leases. Counsel should draft loan documents carefully when a specific transaction contains one or more of the potential clogging features described in this Article. The use of anti-clogging affidavits and other forms of additional and supportive language and documentation should be considered to confirm the parties' intention and reduce the risk of a subsequent clogging challenge. Title insurance companies may be able and willing, under certain conditions and circumstances, to provide coverages and endorsements specifically tailored to transactions involving potential clogging issues. One hopes that the case law will continue to develop in this area and provide guidance with respect to the continually evolving and innovative methods of real estate financing being developed and implemented by creative lawyers and other professionals.

APPENDIX

OWNER'S CERTIFICATE*

THIS CERTIFICATE is made as of the ____ day of _____, 19____, by _____ Limited Partnership, a _____ limited partnership ("Owner"), to and for the benefit of _____, Inc., a _____ corporation ("_____"), and _____ banking corporation, as agent and investment manager for _____, a _____ corporation under the Investment Management Agree-

¹²⁹ See, e.g., *Transamerica Title Ins. Co.*, 833 F.2d at 776 (stating that "if [the insured] intended to obtain only an equitable lien . . . [it] will be deemed to have 'created' this 'defect' in title," and finding that a claim that a deed of trust coupled with a repurchase option is actually a mortgage also falls within the exception in the title policy for matters "created" by the insured because "[t]he basis for the rule that a deed coupled with a repurchase option is presumed to be a mortgage is that it best effectuates the parties' intent, absent proof of contrary intent"); *Flack*, 565 N.E.2d 131 (holding that the burden of proof rests with the party asserting a mortgage when a deed absolute has been conveyed; the court listed six factors that should be evaluated in determining the existence of an equitable mortgage and held that the evidence, especially that demonstrating the existence of a debt relationship and grossly inadequate consideration, clearly supported the trial court's finding of an equitable mortgage); *Bidart*, 734 P.2d at 734 (holding that a deed could be recharacterized as an equitable mortgage only if the claimant could "prove that [the insured] intended the deed to operate as a mortgage," and that an equitable mortgage claim was therefore excluded from coverage under the title policy as a matter "created" by the insured). See *supra* notes 54-68 and accompanying text.

¹³⁰ See *supra* note 116 and accompanying text.

* The document that follows was prepared by Richard R. Goldberg of Ballard, Spahr, Andrews & Ingersoll, Philadelphia, Pennsylvania, and was published in ALI-ABA Course of Study, Real Estate Financing Documentation: Coping with the New Realities, Orlando, Florida (Jan. 16-18, 1997) at 309. The author expresses his appreciation to Mr. Goldberg for granting permission to reprint this document.

ment dated _____, 19__ and the Participation Agreement dated _____, 19__ (_____ and _____ being collectively referred to as “Option Holder”).

RECITALS

A. Pursuant to that certain Loan Agreement dated as of _____, 19__ (the “Loan Agreement”) by and between Owner, as borrower, and Option Holder, as lender, Option Holder has agreed to loan to Owner up to _____ million and _____ thousand dollars (\$_____) (“Loan”), such Loan to be secured, *inter alia*, by a [mortgage] [deed of trust] on certain improved real property owned by Owner located in the City of _____, _____ (“Property”).

B. Pursuant to that certain Option Agreement dated as of the date hereof (“Option Agreement”) by and between Owner and Option Holder, Owner has granted to Option Holder an option (“Option”) to purchase from Owner a Class B Limited Partnership Interest in Owner (as defined in the Option Agreement) and to become a Class B limited partner in Owner on the terms and subject to the conditions contained in the Option Agreement.

In order to induce Option Holder to execute and deliver the Loan Agreement and to consummate the transactions contemplated therein and to induce Option holder to execute and deliver the Option Agreement and pay the Option Fee (as hereinafter defined), Owner hereby certifies to Option Holder and agrees with Option Holder as follows:

1. Owner and its general partner are sophisticated and experienced in the fields of real estate development, operation and financing.

2. In connection with the negotiation of the terms of the Loan Agreement, the Option Agreement and the documents attached as exhibits thereto, Owner has been represented by competent and experienced legal counsel of its choice.

3. As consideration for the Option, Owner has received an option fee of \$_____ hundred thousand dollars (\$_____) (“Option Fee”) from Option Holder.

4. In addition to the Option Fee, Option Holder’s making the Loan to Owner constitutes additional consideration to Owner for Owner’s granting the Option to Option Holder because the Loan is made upon terms more favorable to Owner than terms currently available from other lenders where no such option is granted. Such favorable terms include a below-market interest rate and a loan-to-value ratio which is greater than that which is generally available for conventional mortgage loans. Owner is not willing to sell the Property or any percentage thereof at the present time, but is instead willing to grant the Option to permit the purchase of the Class B Limited Partnership Interest in Owner by Option Holder at a future date. Owner is further desirous of borrowing funds against the security of the Property and in partial consideration for the favorable terms of the Loan Owner has agreed to grant the Option to Option Holder.

5. Owner acknowledges that the ability of Option Holder to exercise the Option in accordance with its terms is a material benefit to Option Holder, bargained for and supported by the consideration to Owner described above, including the payment by Option Holder of the Option Fee upon execution of the Option Agreement.

Accordingly, Owner understands and agrees that any attempt to prevent Option Holder from enforcing the Option in accordance with its terms would deny Option Holder a material portion of the benefit of its bargain embodied in the transactions contemplated by Owner and Option Holder.

6. Owner has discussed with its legal counsel the doctrine of “clogging of the equity of redemption” and understands that such doctrine has sometimes been applied in certain cases to prevent enforcement of options or deeds given to secured lenders. Owner has been advised by its counsel that such doctrine should not be applied in circumstances such as those that exist in the transaction between Option Holder and Owner contemplated herein to invalidate the Option or prevent its exercise, and Owner understands and agrees that its counsel may rely upon this Certificate in rendering such advice. Owner represents and agrees that the Option is based on independent, bargained-for and significant consideration and its not intended to be a clog or other restraint on Owner’s equity of redemption or a contract for the forfeiture of property subject to a lien in satisfaction of the obligation secured thereby.

WITNESS the execution of this Certificate as of the date first above written.

_____ PARTNERSHIP,
a _____ limited partnership

By _____
General Partner

By _____
Name _____
Title _____