CORE
Metadata, citation and similar papers at core.ac.uk
Provided by Cornell Law Library

Cornell Law Review
Volume 38
Issue 2 *Winter 1953*
Article 3

Transfer of Mortgaged Property

Frederic P. Storke

Don W. Sears

Follow this and additional works at: http://scholarship.law.cornell.edu/clr

Part of the Law Commons

Recommended Citation
Frederic P. Storke and Don W. Sears, *Transfer of Mortgaged Property* , 38 Cornell L. Rev. 185 (1953)
Available at: http://scholarship.law.cornell.edu/clr/vol38/iss2/3

This Article is brought to you for free and open access by the Journals at Scholarship@Cornell Law: A Digital Repository. It has been accepted for inclusion in Cornell Law Review by an authorized administrator of Scholarship@Cornell Law: A Digital Repository. For more information, please contact jmp8@cornell.edu.

TRANSFER OF MORTGAGED PROPERTY

Frederic P. Storke and Don W. Sears***

It has long been settled that a security debtor's interest, or equity of redemption, is transferable. This is true regardless of the type of security transaction or the kind of property involved. It is a criminal offense, however, for a chattel mortgagor to sell the chattels without notifying the mortgagee of the sale and the purchaser of the existence of the mortgage.[1] A security debtor may make an *inter vivos* transfer by way of sale, exchange, gift, or payment of a debt. On his death, his interest passes to his heir or devisee (next of kin or legatee in the case of personal property). His interest is subject to involuntary transfer by execution, levy, or attachment. This article is chiefly concerned with sale transfers of real property; some treatment of the other types of transfer will appear in connection with the various topics.

At the outset, the effect of a transfer on the liability of the mortgagor (security debtor), and the extent to which it creates a liability on the transferee, should be noted. The personal liability of the mortgagor generally remains intact. No arrangement between transferor and transferee can discharge the liability of the mortgagor to the mortgagee without the latter's consent.[2] If only part of the mortgaged property is transferred, the mortgagor also remains subject to a property liability—that is, his retained interest may be applied to the payment of the entire mortgage debt.[3]

The transferee does not become personally liable unless he agrees to assume the debt.[4] In sale transfers, either the contract or the deed frequently contains an assumption clause binding the purchaser to pay the debt.[5] Assumption is rare in other types of transfer.

* Professor of Law, University of Colorado. See Contributors' Section, Masthead, p. 213, for biographical data.

** Associate Professor of Law, University of Colorado. See Contributors' Section, Masthead, p. 213, for biographical data.

1 COLO. STAT. ANN. c. 32, § 18 (1935); N. Y. PENAL LAW § 940 (1944); N. Y. PERS. PROP. LAW § 75 (1944).

2 Woodward v. Molander, 92 Colo. 551, 22 P.2d 622 (1933); Campbell v. Clay, 4 Colo. App. 551, 36 Pac. 909 (1894); Friedman, *Discharge of Personal Liability on Mortgage Debts in New York,* 52 YALE L.J. 771, 773 (1943), citing the New York cases.

3 OSBORNE, MORTGAGES § 286 at p. 808 (1951).

4 Lloyd v. Lowe, 63 Colo. 288, 165 Pac. 609 (1917); Burbank v. Roots, 4 Colo. App. 197, 35 Pac. 275 (1894); People *ex. rel.* Banner v. State Tax Comm'n, 244 N.Y. 159, 155 N.E. 84 (1926).

5 By statute in New York, no mortgage assumption by deed is valid unless signed and acknowledged by the grantee. N.Y. CIV. PRAC. ACT § 1083-c.

Regardless of any assumption, the transferee comes under a property liability, unless the interest of the mortgagee is cut off by the operation of a recording act.[6] In this article, it will be assumed that all security transactions are duly recorded or filed unless the contrary is stated. The term "liability" will be used in the broad sense to include both personal liability and the possible subjection of property to payment of the secured debt.

Analysis of the relationships resulting from transfers of mortgaged property is greatly handicapped by the absence of accurate, generally accepted phrases describing certain recurring transactions and the legal rules and doctrines applicable to them. We have thought it advisable to introduce several phrases that may seem strange to the reader. They are either original or have not come into general use.

There are various reasons for rejecting the orthodox terminology. Some of the phrases in current use are cumbersome circumlocutions, employed because no short descriptive phrase is available. Others have a definitely false connotation, suggesting unreal ideas to the reader and having a tendency to lead to false conclusions. Some of the terms that are used—"transfer subject to the mortgage," for example—are fatally ambiguous. It is hoped that the new terms here suggested will be adopted, not only in judicial opinions and legal discussions, but also in sale contracts and other instruments, which are now greatly lacking in clarity.

BASIC BARGAIN PRICE AND EQUITY PRICE

The owner of incumbered property who wishes to sell it starts by placing a value thereon. He first estimates the amount for which the property would sell if it were not mortgaged. This is the *basic value*. Then he deducts the mortgage debt, arriving at a net figure called the *equity value*. Suppose *D* owns a house, and after consulting with a realtor places a value of $30,000 on it. If there is a mortgage for $10,000 on the house, the equity value is $20,000. This is the net amount which *D* hopes to realize from the sale after paying off the mortgage debt.

Property does not always sell for its full "value." Suppose the

[6] As explained in this article, the recording acts usually invalidate any transfer, including a mortgage, where the act is not complied with, and the property is transferred by the original transferor (or mortgagor) to a bona fide purchaser without notice of the unrecorded transfer. If the second transfer is itself a mortgage to a bona fide purchaser, the latter will have priority over the unrecorded senior mortgage. See Storke and Sears, *The Perennial Problem of Security—Priority and Recordation,* 24 ROCKY MT. L. REV. 180, 188 *et seq.* (1952).

best offer *D* is able to get is $25,000 and he decides to accept it. This amount, reached by the bargaining process between seller and buyer, is the *basic bargain price.* Again subtracting the mortgage debt from this figure, we have a net of $15,000. This is the *equity price.*

The idea of basic bargain price is an extremely important one. This article is built around the phrase as the central concept involved in a sale transfer. Unfortunately, neither this phrase nor any equivalent has come into general use. The courts are apt to say "full value" when they mean "basic bargain price." But value and price are two different things. Value is someone's opinion of what a piece of property ought to sell for, price is what it actually does sell for.

Whenever incumbered property is sold, there is an underlying assumption present, not always expressed and sometimes not clearly realized by the parties. The seller expects to receive the *basic bargain price* from the buyer, if he, the seller, pays off the mortgage. He is content to receive the *equity price* if the buyer pays off the mortgage. The courts constantly make use of this assumption in determining the equities which result from the sale.

Once the parties have agreed on the *basic bargain price,* it becomes necessary to make some arrangement for handling the mortgage. Different methods of adjusting these rights and liabilities will now be considered.

The Clean Method

When *D,* the owner, conveys the mortgaged premises to *G,* a buyer, he would naturally prefer to be free from any further personal obligation to pay the mortgage debt. Any device by which this can be accomplished will be called the "Clean Method" of handling the transfer. The desirability of using the clean method should be apparent after a study of the complications resulting from transactions in which the original mortgage is not cancelled, but remains as an incumbrance on the land in the hands of the purchaser. It is not always easy, however, and sometimes impossible, to use the clean method, and in many cases the mortgage is allowed to ride because that seems to be the easiest way. Unfortunately, the parties are inclined to ignore the difficulties that will result if the grantee defaults in his payments on the mortgage. A careful vendor-mortgagor, therefore, should canvass all the possible ways of terminating his own liability. Four of the common ones are (1) payment; (2) novation; (3) a new mortgage to the mortgagor; (4) a new mortgage to an outside lender (refinancing).

Few buyers are prepared to pay the entire *basic bargain price* in

cash at the time of the transfer. Even when the purchaser wishes to do so, the consent of the mortgagee is necessary unless the mortgage is due or there is a provision for optional payment before maturity.[7] Assuming that the mortgage is payable, the main requirement is that all parties exercise due care. The parties should all meet, so that the buyer can be sure that the mortgage is paid and released of record, and the seller-mortgagor may get the cancelled note and mortgage as evidence of the termination of his liability.

When the buyer has sufficient funds to pay only the equity price, the seller should consider the possibility of a novation. The mortgagee may be willing to release the mortgagor from liability in consideration of the assumption of the mortgage by the grantee. This arrangement is impossible, however, without the mortgagee's consent,[8] which is often withheld. The mortgagee is apt to feel that the mortgagor, for his own protection, will require the grantee to assume, and therefore in this case both will be liable if the request for a novation is refused. Novation is most likely to work if the mortgagee has business or personal reasons for wishing the sale to go through.

When the buyer has enough cash to discharge the mortgage, it is usually best to use the money for this purpose. The balance of the purchase price (equity price) will be owed by the buyer to the seller, secured by a new mortgage. The main disadvantage is that the seller receives no cash, when very often the need for cash is the chief motive for selling at all. But for a seller who can wait for his money, this method is greatly preferable to one that leaves him liable on the original mortgage.

In recent years, refinancing has been the most available and popular method for disposing of the original mortgage. The buyer borrows funds from an insurance company, bank or other lender to pay off the old mortgage, giving another mortgage to secure the amount of the loan. In this arrangement, the parties to the original security transaction drop out altogether and new ones take their place.

THREE TYPES OF SALE TRANSACTIONS

Once the parties have decided to let the mortgage ride, they have three standard methods[9] of handling the sale. We will call these

---

[7] FULLER, BASIC CONTRACT LAW 568 (1947).

[8] Campbell v. Clay, 4 Colo. App. 551, 36 Pac. 909 (1894) (judgment discharging mortgagor reversed, since evidence showed consent to the transfer only, not to the discharge).

[9] The three methods are explained, in different terminology, in OSBORNE, MORTGAGES § 248 (1951); FULLER, BASIC CONTRACT LAW 569 (1947).

Grantor-to-Discharge, Grantee-to-Discharge and Grantee's Option.

The characteristic feature of the Grantor-to-Discharge transaction is the payment of the full *basic bargain price* directly by the buyer to the seller.[10] A buyer who pays in this way, of course, relies on the seller to discharge the mortgage. In a Grantee-to-Discharge transaction and in a Grantee's Option, the buyer pays only the equity price to the seller. The former is distinguished from the latter by an assumption clause, a promise made to the seller that the buyer will pay the amount of the mortgage to the mortgagee.

A Grantor-to-Discharge transaction is extremely unsatisfactory to the buyer. He pays for an unincumbered title and does not get it. His only protection is the personal liability of the seller. For this reason, the arrangement is rarely used in transfers of an entire mortgaged tract.[11] It is common enough, however, in those cases where only part of the mortgaged property is sold,[12] and appears to be standard in subdivision financing. In a Grantor-to-Discharge transaction the seller sometimes makes an express promise to the buyer that he will pay the mortgage when it becomes due. Even without such a promise, however, he owes a legal duty to the buyer to make this payment: he would be unjustly enriched if he failed to pay off the mortgage after receiving the basic bargain price in full.

The term "Grantor-to-Discharge" transaction is used here because there is no generally accepted descriptive phrase available. It emphasizes the understanding of the parties that the seller (grantor) not the buyer (grantee) is expected to pay off the mortgage debt. The Grantee-to-Discharge transaction is the one usually employed when an entire mortgaged tract is sold. It strikes the fairest balance between the interests of the mortgagor-seller and the buyer, and reasonably careful parties, acting under sound legal advice, are most apt to choose this device. To the buyer, however, it has the disadvantage of making him personally liable for any deficiency that may result from a foreclosure. He does not normally anticipate a deficiency, or he would not be buying the property; he agrees to this contingent liability because a careful seller will not sell on any other terms. The grantor,

---

10 GLENN, MORTGAGES § 292.1 (1943).

11 FULLER, BASIC CONTRACT LAW 569 (1947). The author appears to overlook the use of grantor-to-discharge transactions in fractional sales.

12 GLENN, *op. cit. supra* note 10. The author states that the purchaser would never have gone through with the bargain if he had searched title and taken the advice of counsel. This is a false conclusion. Actually, the grantor-to-discharge transaction is probably the best all-around solution to the problem of fractional sales. See discussion of Subdivision Financing, *infra.*

on his part, must not make the mistake of supposing that he gets rid of his own liability by getting the grantee to assume. He gets only the degree of protection arising from the suretyship relation explained below.

This device does have a standard name, Assumption of the Mortgage. Use of the new term, Grantee-to-Discharge, is made here for the sake of a consistent terminology that calls attention to the difference between this transaction and Grantor-to-Discharge. In both of these arrangements, one party owes the other a personal duty to pay off the mortgage. In Grantor-to-Discharge, this duty runs from seller to buyer; in Grantee-to-Discharge, from buyer to seller.

The use of the terms "grantor" and "grantee" instead of "seller" and "buyer" is dictated by the consideration that the seller normally deeds the property to the buyer and the assumption clause is usually found in the deed. However, the relationships indicated by these terms may arise from an executory contract of sale before any deed has been delivered. They also occur in the sale of mortgaged chattels, although the terms "grantor" and "grantee" there are not technically appropriate.

The Grantee's Option is most favorable to the buyer. He incurs no personal liability. No personal duty to discharge the mortgage arises either from buyer to seller or from seller to buyer. The buyer has a choice, or option: he may pay off the mortgage and keep the land, or simply let the land go upon foreclosure, limiting his loss to the equity price.

This transaction is most often found in the sale of a "thin equity" where the property is mortgaged for about all it is worth. Both parties are acutely conscious of the possibility of a large deficiency judgment. The buyer wishes to control the property for a small cash outlay, but does not wish to incur any greater liability. The seller hopes that the buyer will be able to pay the mortgage, thus relieving him of his own liability.

This transaction is usually called "transfer subject to the mortgage," a phrase that is too ambiguous and insufficiently descriptive. Both Grantor-to-Discharge and Grantee-to-Discharge transactions are actually "subject to the mortgage," since the grantee in either case acquires an incumbered title. Use of the phrase "subject to the mortgage" without more, in a contract or deed, is likely to lead to a misunderstanding. The terms of such a sale should be precisely specified and the parties should have available a phrase which will make their arrangement entirely clear.

Justification of the new term "Grantee's Option" may be found by comparing a transaction of this type with an ordinary purchase option. Suppose *D* owns a tract of the fair value of $10,000 mortgaged to *C* for $10,000, the mortgage to fall due in six months. *G*, a corporate promoter, wishes to tie up the land pending organization of a company which will need it. He pays *D* $200 for his equity and receives a deed with no assumption clause. Now if *D* had owned the land outright, *G* might have paid him $200 for a six months' option to buy the land for $10,000. In either case, *G* then controls the land for a small cash outlay and incurs no further liability. The legal position is different, but for practical business purposes the two arrangements are identical. It will be seen that a Grantee's Option is often a desirable substitute for an ordinary purchase option when dealing with heavily mortgaged property.

Specifying the Terms of the Bargain

A well-drawn contract for the sale of incumbered property should be absolutely clear on the following points: (1) amount of the *basic bargain price* and (2) character of the transaction (Grantor-to-Discharge or otherwise). Many a lawsuit results from the use of a deed containing the phrase "subject to the mortgage" as the only written expression of the actual bargain. Deeds are usually only partial integrations, leaving some of the terms of the oral agreement unexpressed or ambiguously stated. A figure appearing in such an instrument may be either the *basic bargain price* or the *equity price*. The parties may have in mind any one of the three basic types of transactions, or a combination. It is not unusual for one of the parties to think he is dealing on one basis, when the other has a different intent. The use of a carefully considered written agreement goes far to eliminate these difficulties.

The writing may cover the two important points in recitals or by the wording of the promises. A specimen form might run as follows: "Whereas, Seller and Buyer have agreed to the sale and purchase of the following described property for the *basic bargain price* of $25,000; and whereas, such property is mortgaged to William Smith, herein called Mortgagee, to secure a note for $10,000 due March 1, 1955, and is otherwise unincumbered; whereas the *equity price* is $15,000 and the parties intend that this sale shall be on a Grantee-to-Discharge basis:

"Therefore, Buyer agrees to pay the *equity price* of $15,000 to Seller March 1, 1953, and to discharge the balance of the *basic bargain price*

by assuming the said mortgage and paying the same to Mortgagee; Seller agrees, upon such payment of $15,000, to convey the property to Buyer by warranty deed, free of all incumbrances, except the above mortgage, such deed to contain a clause by which Buyer assumes and agrees to pay such mortgage."

THE SURETYSHIP RELATIONS

The sale of mortgaged property almost invariably results in the creation of suretyship relations. Such a transfer makes two persons liable for the mortgage debt, either personally or as the owner of property that can be appropriated to its payment. It also normally creates a duty to pay the debt, or part of it. These two conditions, liability of two parties for the same debt and the existence of a duty owed by one to the other to pay it, constitute the essence of any suretyship relation.[13] The duty to pay may run from the grantor to the grantee or the other way around. Sometimes each party owes the other a duty to discharge part of the debt. As a result, either party may be a surety, or both may be sureties for a part of the debt.

There are two kinds of suretyship, personal and real. Personal suretyship is a familiar concept. It arises when *C* loans money to *D* and *S* guarantees payment of the debt. If *S* mortgages his house to secure *D*'s debt, without any personal guaranty, he is a *real* surety or property surety.[14] The term "real" does not mean "genuine." It is derived from the Roman law, and means "pertaining to a *res*, or piece of property." A *real* surety is one whose property may be taken in payment of the debt of another.

It may facilitate grasping the concept of real suretyship if we personify the land and say "The land is surety"[15] or "The land is the principal debtor." Of course, this is metaphor and legal shorthand. It is the owner of the land who is a surety, but his liability is limited to the application of the land to the payment of a debt for which another person, or his property, is primarily liable. The courts usually express the idea of a real principal or a real surety by saying that the land is the primary or the secondary fund for the payment of the mortgage debt.

---

13 RESTATEMENT, SECURITY § 82 (1941).

14 *Id.* § 83(b). The term "real surety" is rarely found in our legal literature. It is occasionally used by Osborne, e.g. OSBORNE MORTGAGES § 248 (1951). It is the belief of the present writers that use of the terms "real" and "personal" suretyship helps greatly in the analysis of the relationships arising out of the transfer of mortgaged property.

15 In Wilcox v. Campbell, 106 N.Y. 325, 329, 12 N.E. 823, 824 (1887), the court spoke of "the *land* bound as surety for the defendant." (Italics added.)

Before analyzing the suretyship relations arising out of the different types of sale transfers, a brief summary may be proper.

I. In Grantor-to-Discharge transactions, the grantor is a personal principal and the grantee is a real surety.

II. In Grantee-to-Discharge transactions, the grantor is a personal surety and the grantee a real and personal principal.

III. In Grantee's Option transactions, the grantor is a personal surety and the grantee a real principal.

These are the simple relationships resulting from a transfer of all of the mortgaged premises. Fractional transfers produce the same relationships and others that will be discussed later. Still further complications arise when the burden of the mortgage debt is prorated between grantor and grantee.

Perhaps the best known of these surety relations occurs when a grantee buys all of the mortgaged property and assumes all of the debt—Grantee-to-Discharge transaction. He becomes personally liable to the mortgagee, and the assumption is a promise to the mortgagor that creates a duty to discharge the debt. This clearly makes the grantee a personal principal,[16] and the transferred land becomes the primary fund for payment of the mortgage debt. The grantee is a real as well as a personal principal. The grantor, who remains personally liable, is remitted to the position of a personal surety. If the grantee does not pay the debt when it is due, the grantor (by the weight of authority) may sue him for damages for breach of contract without paying the debt himself.[17] If the grantor pays the debt he may sue the grantee for reimbursement. Upon his payment, the grantor is subrogated to the mortgage and may foreclose against the grantee.

The situation in a Grantee's Option is not much different. Here the grantee pays only the equity price, receiving credit for the mortgage debt as a deduction from the basic bargain price. If the grantor paid the debt and the grantee were allowed to keep the land, he would get it cheaper than he should by the terms of his bargain. Accordingly the land is treated as the primary fund for the payment of the debt.

---

[16] Cave v. Belisle, 117 Colo. 180, 184 P.2d 869 (1947); Woodward v. Molander, 92 Colo. 551, 22 P.2d 622 (1933); Smith v. Davis, 67 Colo. 128, 186 Pac. 519 (1919); Calvo v. Davies, 73 N.Y. 211 (1878).

[17] Burbank v. Roots, 4 Colo. App. 197, 35 Pac. 275 (1894); OSBORNE, MORTGAGES § 259 (1951); *contra,* Ayers v. Dixon, 78 N.Y. 318 (1879) *semble;* See Friedman, *Discharge of Personal Liability on Mortgage Debts in New York,* 52 YALE L.J. 771, 790, n. 115 (1943). The conflicting decisions are collected in 21 A.L.R. 504 (1922), 76 A.L.R. 1192 (1932), 97 A.L.R. 1076 (1935).

The grantee is a real but not a personal principal.[18] If the grantor pays he will be subrogated[19] to the mortgage. Both in a Grantee-to-Discharge transaction and in a Grantee's Option, the grantee is a principal and the grantor a surety. The important difference is that in the latter case the grantor has no *personal* right against the grantee. It is optional with the grantee to pay the debt or lose the land.

CREATION OF LIABILITY OF GRANTEES

A Grantee-to-Discharge transaction is normally evidenced by a clause in the deed from the mortgagor, stating that the grantee assumes the mortgage debt and agrees to pay it.[20] A similar clause is often found in the formal written contract that precedes the conveyance. It is frequently claimed, however, that the grantee has assumed in some other way, by an informal oral or written agreement or even by conduct evidencing an intent to incur a personal liability.[21]

At common law great informality is permissible.[22] Neither the Statute of Frauds nor the parol evidence rule prevents proof of a collateral promise to assume.[23] This rule, however, is modified by statute in New York and California. In New York, the assumption must be signed and acknowledged by the grantee;[24] California has a somewhat similar provision.[25] In Colorado, acceptance by the grantee of a deed containing the assumption clause imposes personal liability.[26] An oral

---

[18] Murray v. Marshall, 94 N.Y. 611 (1884), overruling Penfield v. Goodrich, 10 Hun 41 (N.Y. 2d Dep't 1877). The *Penfield* case shows how difficult it is for some judges to grasp the idea of *real suretyship*. The court stated that no suretyship relation could exist when only one individual was *personally* liable.

[19] Subrogation is the substitution of one person to the position of another. A subrogee steps into the shoes of another just as an assignee steps into the shoes of his assignor. Subrogation, however, is effected by operation of law while assignment is a transfer of rights by act of parties. OSBORNE, MORTGAGES § 277 (1951); RESTATEMENT, RESTITUTION § 162 (1937).

[20] The word "assumes" does not have exactly the same meaning as "assumes and agrees to pay." In Woodruff v. Germansky, 233 N.Y. 365, 135 N.E. 601 (1922), the court denied specific performance of a contract to *assume* a mortgage, intimating that an opposite result might have been reached if the defendant had promised to "assume and pay."

[21] OSBORNE, MORTGAGES § 254 (1951); Friedman, *Creation and Effect of Personal Liability on Mortgage Debts in New York*, 50 YALE L.J. 224, 226 (1940).

[22] Howard v. Robbins, 67 App. Div. 245, 73 N.Y. Supp. 172 (4th Dep't 1901), *aff'd*, 170 N.Y. 498, 63 N.E. 530 (1902).

[23] Enos v. Anderson, 40 Colo. 395, 93 Pac. 475 (1907); Mulvany v. Gross, 1 Colo. App. 112, 27 Pac. 878 (1891) (chattel mortgage); Taintor v. Hemmingway, 18 Hun 458 (N.Y. 1879), *aff'd*, 83 N.Y. 610 (1880).

[24] N.Y. CIV. PRAC. ACT § 1083-c.

[25] CAL. CIV. CODE § 1624 (7), CAL. CODE CIV. PROC. § 1973 (Deering 1949).

[26] Great Western Mfg. Co. v. Elledge, 68 Colo. 594, 192 Pac. 498 (1920). The agree-

promise to assume is effective, but must be proved beyond a reasonable doubt.[27]

A few jurisdictions impose personal liability on the grantee where the contract of sale recites the basic bargain price and the grantee promises to pay only the equity price directly to the mortgagor-grantor.[28] This provision is supposed to "imply" a promise to pay the amount of the mortgage debt to the mortgagee. Actually such recitals merely clarify the process that is typical of a Grantee's Option. The normal implication is that the grantee *refused* to assume, or the deed would have contained an assumption clause.

The Colorado courts have stated that the assumption must be express.[29] In New York prior to the statute, the courts sometimes held that there could be an assumption by implication.[30] California was inclined to favor the rule permitting implication of an assumption until a statute forbade that result.[31] In England, the implied assumption is effective to create a right in the grantor only, and not in the mortgagee.[32] Some of the American states impose personal liability toward the mortgagee.[33]

The grantee's promise to assume and pay the mortgage debt, characteristic of a Grantee-to-Discharge transaction, creates a double liability. Either the seller or the mortgagee can sue the grantee if he fails to pay.

Liability to the seller is based on ordinary principles of contract law. Since the seller-mortgagor is a surety, the grantee's liability is often considered a duty of exoneration or indemnity. The mortgagor may enforce this liability in a number of ways. He may bring an action for damages for breach of the assumption contract,[34] or a bill for exoneration.[35] He may first pay the mortgage debt and then sue the

---

ment to assume was held insufficient in the following cases: Elliott v. Denver Joint Stock Land Bank, 107 Colo. 231, 110 P.2d 979 (1941) (insufficient consideration, assumption clause inserted without knowledge of grantee); Home Builders Co. v. Reddin, 97 Colo. 232, 48 P.2d 800 (1935) (agent lacked authority); Crebbin v. Shinn, 19 Colo. App. 302, 74 Pac. 795 (1903) (promise by grantee to pay interest and taxes only); Kilpatrick v. Haley, 14 Colo. App. 399, 60 Pac. 361 (1900) (same).

27 Enos v. Anderson, 40 Colo. 395, 93 Pac. 475 (1907).

28 Osborne, Mortgages § 257 (1951).

29 Lloyd v. Lowe, 63 Colo. 288, 165 Pac. 609 (1917). There was an express assumption in the deed in this case but it was cancelled for a mistake.

30 Comment, 13 St. John's L. Rev. 215 (1938).

31 Hopkins v. Warner, 109 Cal. 133, 41 Pac. 868 (1895).

32 Osborne, Mortgages § 257 (1951).

33 *Ibid.*

34 See note 17 *supra.*

35 See note 42 *infra.*

grantee for reimbursement of the amount paid.[36] Upon payment, he is subrogated[37] to the mortgage and may foreclose against the land that he has transferred to the assuming grantee.

When the mortgagor sues the grantee without first paying the debt, there is a conflict concerning both the right of recovery and the measure of damages. New York denies recovery;[38] Colorado allows it.[39] Those states that permit recovery apparently hold that the mortgagor can recover the amount due on the mortgage,[40] although it has been argued that only nominal damages should be awarded.[41]

In New York, there is authority that a mortgagor who has not paid may have a decree against the assuming grantee ordering him to pay the mortgage debt to the mortgagee.[42] This proceeding is called a bill for exoneration. Apparently it is equivalent to specific performance of the agreement to assume, but Colorado has disallowed a proceeding in the latter form.[43] The case so holding is somewhat unsatisfactory, since the decree entered by the trial court was not an order that defendant pay the debt to the mortgagee, but a money judgment in favor of the plaintiff.

There is general agreement that a mortgagor who has paid the debt is entitled to reimbursement from an assuming grantee. In addition, he is subrogated to the mortgage and can foreclose it. Subrogation[44]

---

[36] Cave v. Belisle, 117 Colo. 180, 184 P.2d 869 (1947); Cooley v. Murray, 11 Colo. App. 241, 52 Pac. 1108 (1898); Friedman, *Discharge of Personal Liability on Mortgage Debts in New York*, 52 YALE L.J. 771, 791 (1943).

[37] Watts v. Bock, 80 Colo. 223, 249 Pac. 1095 (1926).

[38] Ayers v. Dixon, 78 N.Y. 318 (1879). However, in Adams v. Symon, 22 Abb. N.C. 469, 6 N.Y. Supp. 652 (Sup. Ct. N.Y. County 1889), it was held that a mortgagor against whom a personal judgment had been entered on foreclosure could recover the amount of the deficiency from the assuming grantee without first paying the debt. The court distinguished Ayers v. Dixon in a rather unsatisfactory fashion. This leaves the law of New York in some confusion, but it seems clear that the mortgagor cannot sue the assuming grantee when he has not paid and there has been no foreclosure. Woodruff v. Erie Ry., 25 Hun 246 (N.Y. 1881).

[39] Burbank v. Roots, 4 Colo. App. 197, 35 Pac. 275 (1894).

[40] Gustafson v. Koehler, 177 Minn. 115; 224 N.W. 699 (1929); OSBORNE, MORTGAGES § 259 (1951).

[41] SEDGWICK, DAMAGES § 790 (9th ed. 1913).

[42] Marshall v. Davies, 78 N.Y. 414 (1879); Rubens v. Prindle, 44 Barb. 336 (N.Y. 1864); Marsh v. Pike, 10 Paige 595 (N.Y. 1844). The rule of these cases was severely limited by Slauson v. Watkins, 86 N.Y. 597 (1881), which refused a decree of exoneration and attempted to distinguish the earlier cases. Perhaps a realistic view is that exoneration will be granted in New York only under rather exceptional circumstances.

[43] Woodward v. Molander, 92 Colo. 551, 22 P.2d 622 (1933). Woodruff v. Germansky, 233 N.Y. 365, 135 N.E. 601 (1922), also denied specific performance but on the narrow ground that the grantee merely "assumed" but did not "promise to pay" the mortgage.

[44] See note 19 *supra*.

is a neat technical device for enforcing the real principal liability of the grantee. Since the land conveyed is the primary fund[45] for payment of the debt, it should be collected out of the land. By use of this device the mortgagor who has paid gets his money back, to the extent of the value of the land. Even if the grantee has not assumed, he is under a real principal liability, and subrogation is therefore proper in a Grantee's Option.[46] The personal remedies of an action for damages or reimbursement or a bill for exoneration are not available against a non-assuming grantee. Sometimes equity will enter a decree ordering the application of the land to the payment of the debt before the mortgagor pays.[47] This may be called *real* exoneration, in contrast to a personal order directing an assuming grantee to pay. Neither type of exoneration is common in actual practice.[48]

In practically all states, a mortgagee has a direct right of action against an assuming grantee[49] (but not against one who has not assumed). He may sue the grantee in a personal action,[50] but in practice the personal liability is usually enforced by means of a deficiency judgment in the foreclosure action. This simple rule[51] has slowly won recognition because it works well in practice and often avoids circuity of action. The modern tendency is to regard this right as a special case of recovery by a third party beneficiary.[52]

The original grantee may transfer the land to another person and this process may go on indefinitely. If each grantee assumes, the result

[45] In New York the doctrine that the land is the primary fund for the payment of the mortgage debt has produced consequences not generally found in other states. The New York courts take the position that the grantor-mortgagor should resort to the real principal liability of the assuming grantee before enforcing the personal liability resulting from the assumption. This is the basis of the rule of Woodruff v. Erie Ry., 25 Hun 246 (N.Y. 1881), that there can be no recovery on the contract of assumption until the land has been sold and the deficiency ascertained. The cases applying this theory are collected in 21 A.L.R. 518 (1922).

[46] Murray v. Marshall, 94 N.Y. 611 (1884). This case overruled Penfield v. Goodrich, 10 Hun 41 (N.Y. 1877) on the existence of the suretyship relation but both cases recognize the right of subrogation. See note 18 *supra*. See also OSBORNE, MORTGAGES § 258 (1951).

[47] OSBORNE, MORTGAGES § 285 (1951).

[48] Friedman, *Discharge of Personal Liability on Mortgage Debts in New York*, 52 YALE L.J. 771, 795 (1943).

[49] OSBORNE, MORTGAGES § 260 (1951), pointing out that there is some doubt in Massachusetts.

[50] Stuyvesant v. Western Mortgage Co., 22 Colo. 28, 43 Pac. 144 (1895).

[51] The various theories of liability are fully discussed in OSBORNE, MORTGAGES §§ 260, 264 (1951). The same author lists the discussions of this problem in note 69, p. 721 of that work.

[52] Starbird v. Cranston, 24 Colo. 20, 48 Pac. 652 (1897); Burr v. Beers, 24 N.Y. 178 (1861).

is a "chain of assumption." The last grantee, as owner, is under a real principal liability (provided the mortgage is recorded) whether he assumes or not. Earlier grantees are freed from real liability when they part with all interest in the land, but their personal liability remains. Accordingly, the mortgagee may join all of the assuming grantees, as well as the mortgagor, in the foreclosure action, and can recover a deficiency judgment against them all. Payment of the judgment by any of the judgment debtors will discharge the right of the mortgagee; there can be no double recovery.

The relations between the successive grantees and the mortgagor may be expressed in terms of suretyship. If there are two transfers, the second grantee is a principal, the first grantee a principal-surety, and the mortgagor a subsurety.[53] That is, the first grantee is a surety for the second grantee, but a principal with respect to the mortgagor. In a longer chain, any grantee is a surety for subsequent grantees and a principal for earlier grantees.[54] The last grantee is always a principal and the mortgagor a surety.

If any grantee fails to assume, we say there is a "break in the chain" of assumption. Failure to assume by the last grantee leaves him a real principal, but not a personal principal. The land is the primary fund for the payment of the mortgage. A prior grantee who does not assume is under no liability, real or personal, after parting with all his interest.

The most important problem arising out of the break in the chain concerns the right of the mortgagee to recover from a grantee who assumes after a break. It is not clear why a grantor who is not himself personally liable should require his grantee to assume. It may be owing to excess of caution, or because the grantor has personal or business reasons for conferring a benefit on the mortgagee. At any rate it often happens, and the courts are split on the result. Colorado permits the mortgagee to recover from any assuming grantee, regardless of the break.[55] New York denies recovery against any grantee who assumes after the break.[56] If we regard the case as one of a contract for the benefit of third persons, the conflict is easily explained by the differing policies concerning such agreements. Colorado broadly favors

---

[53] This is the terminology used in the RESTATEMENT, SECURITY § 145 (1941).

[54] As Friedman expresses it "The Liability is cast upon the grantees in the inverse order of assumption". *Supra* note 48, p. 774, n. 13.

[55] Hastings v. Pringle, 37 Colo. 86, 86 Pac. 93 (1906); Cobb v. Fishel, 15 Colo. App. 384, 62 Pac. 625 (1900).

[56] Vrooman v. Turner, 69 N.Y. 280, 25 Am. Rep. 195 (1877).

recovery by nearly all types of third party beneficiaries;[57] New York narrowly restricts such recovery. The mortgagee is neither a creditor beneficiary nor the kind of donee beneficiary who can recover in New York.[58]

In a Grantor-to-Discharge transaction, the grantee is only a real surety, never a principal and never personally liable.[59] His main right is to recover the value of the land from the grantor if it is taken from him by foreclosure. He may also pay the mortgage before foreclosure and sue the grantor for reimbursement. Subrogation is not involved unless the sale is of only part of the mortgaged land. The fractional sale, however, is exactly the ordinary case in which we are apt to meet with a Grantor-to-Discharge transaction.

Fractional Sales and Assumptions

An owner of mortgaged property often makes fractional sales. He may sell a part of the land and retain a part. He may divide the land into tracts and sell them to a number of purchasers. He may execute junior mortgages on parts of the land, and the purchasers may do the same. The acme of this process is found in Subdivision Financing, in which dozens or even hundreds of lots in a mortgaged tract are sold to prospective home-owners. The complicated suretyship relations arising from such situations have occupied the attention of the courts in many famous cases.

The frequent use of Grantor-to-Discharge transactions in fractional sales is explained by the usual reluctance of the grantee to assume the *entire* mortgage when the amount of the debt is in excess of the value of the fractional interest that he has purchased. The alternative of pro-rating the debt leads to complications which make that method less desirable than a straight Grantor-to-Discharge transaction. For an illustration of the latter, suppose property valued at $20,000 and mortgaged for $16,000 is owned by *D*. He divides it into four lots, and sells them separately to four purchasers; the basic bargain price is $5,000 in each case. Each purchaser promises to pay the entire $5,000 to *D*, relying on him to discharge the mortgage from the proceeds of the sales. This puts the four grantees in the position of *real sureties*. The purchased tracts are liable for the mortgaged debts, but between the purchasers and *D*, this liability is secondary to the personal liability of *D* to discharge the mortgage; if the land is taken by the mortgagee

---

57 Restatement, Contracts, Colo. Annot. §§ 133, 136 (1936).

58 See note, 9 Cornell L.Q. 213 (1924).

59 Osborne, Mortgages § 248 (3) (1951).

upon foreclosure, the purchaser will be entitled to reimbursement from *D*. It should be noted that as long as any of the tracts have not been conveyed by *D*, he is a *real principal* with respect to those tracts.

When the amount of the mortgage is relatively small, *D* may deal with one of the purchasers on a Grantee-to-Discharge basis. In our last illustration, suppose the mortgage debt to be only $4,000. *D* might require the first grantee to assume all of this amount, and pay the balance of $1,000 to *D*.[60] After making such an arrangement with the first grantee, *D* cannot afford to deduct the amount of the mortgage debt, or any part of it, from the basic bargain price in subsequent sales. Such a deduction is profitable only when *D* can expect his total indebtedness to be paid in exchange for the deduction, and of course, *D* does not want the same debt paid more than once. This gives us a practical working rule: if the first fractional grantee assumes the entire debt, subsequent sales by *D* will all be on a Grantor-to-Discharge basis.[61]

If the mortgage debt is relatively large ($16,000), we can expect all sales to be Grantor-to-Discharge or on a pro-rata basis. Each of the four grantees may assume $4,000 of the mortgage debt and promise to pay $1,000 to *D*. The sale of the first lot to G_1 produces a combination Grantor-to-Discharge and Grantee-to-Discharge transaction. The Grantee is personally, and, between himself and the grantor, primarily liable to the extent of $4,000; the Grantor is personally and primarily liable for $12,000. The Grantor is a real principal and the Grantee a real surety for this latter amount, while the Grantee is a real principal and the Grantor a real surety for $4,000.[62] When all four tracts have been sold, the Grantor's real liability disappears. Complicated suretyship relations develop between all parties which will be discussed under the head of marshalling.

---

60 Illustrations of this arrangement are found in Skinner v. Harker, 23 Colo. 333, 48 Pac. 648 (1896); Cooley v. Murray, 11 Colo. App. 241, 52 Pac. 1108 (1898); Chancellor v. Towell, 80 N.J. Eq. 223, 82 Atl. 861, 39 L.R.A. (N.S.) 359, Ann. Cas. 1914A 710 (1912); Wilcox v. Campbell, 106 N.Y. 325, 12 N.E. 823 (1887).

61 Unfortunately, the cases do not generally state the basic bargain price of the fractional interests purchased by subsequent grantees after the first grantee has assumed the entire mortgage debt, nor do they make it clear whether such later grantees paid the entire basic bargain price directly to the grantor. It is submitted that specific findings of fact on these points would greatly clarify the situation. See, for example, Chancellor v. Towell, note 60, *supra.*

62 The customary analysis of these pro-rata assumptions is to say that each tract is primarily liable for its pro-rata share. The analysis usually stops short at this point and fails to give the reader any intimation that the land in the hands of the assuming grantee is *secondarily* liable for the balance of the mortgage debt, which he has not assumed. Of course, he has no *personal* liability for this part of the mortgage debt either as principal or surety.

Fractional sales are sometimes made on a Grantee's Option basis. Either the whole or a part of the mortgage debt is deducted from the basic bargain price, but there is no assumption. This arrangement results in a straight Grantee's Option when the whole debt is deducted, or a combination Grantor-to-Discharge and Grantee's Option when only a part is deducted. The real suretyship relations are the same as in the case of an assumption, but the Grantee does not become either a personal surety or a personal principal.[63]

These transactions suggest an ambiguity in the term "equity price" when used in connection with fractional sales. Do we mean the basic bargain price less the *entire* mortgage debt, or the basic bargain price less a *pro-rata share* of the debt? While the first is a possible meaning, the latter more nearly fits the thinking of the average purchaser. He regards his "equity" as the price for which the fraction should sell less a deduction for its share of the mortgage debt. This ambiguity added to the difficulties of the situation in *Hooper v. Capitol Life Insurance Co.*,[64] a case in which the parties differed about what the equity price really was. This difficulty was aggravated by the fact that the grantee did not pay cash, but transferred an equity in other land owned by him. This important case will be discussed in detail later on in this article.

MARSHALLING

When two tracts of land are mortgaged for the payment of the same debt, it is often necessary for the court, in a foreclosure action, to decide how the two funds realized from the sale of the tracts shall be applied to the payment of the mortgage debt. It is possible to pro-rate the debt, charging part of it on each fund, or to exhaust one of the funds before the other is used. The process of deciding what application should be made is called *marshalling*.[65]

Cases involving marshalling may be conveniently grouped under two heads, *suretyship marshalling* and *lien marshalling*. The first group is made up of cases in which there are *two owners* of separate

[63] In Hooper v. Capitol Life Ins. Co., 92 Colo. 376, 20 P.2d 1011 (1933), the grantee of part of the mortgaged premises accepted a deed containing an entire assumption clause. This was stricken out for mistake, the court concluding that the parties intended a transaction of the sort just described. Three-eighths of the mortgage debt was deducted from the basic bargain price to be paid by the fractional grantee, the balance being charged primarily on the retained tract. This produces a combination Grantor-to-Discharge and Grantee's Option.

[64] Note 63, *supra*.

[65] *Cf.* 1 BLACK, JUDGMENTS § 440 (1891): "Marshalling is the ranking . . . of several . . . parcels of land for the satisfaction of a . . . mortgage to which all are liable."

tracts liable for the same mortgage debt, with a real suretyship relation existing between the owners. The second group consists of cases in which there are *two mortgagees,* one of whom has a mortgage on two tracts, and the other a junior mortgage on one of these tracts. In the first group, there are always *two owners,* but there need be only one mortgage; in the second group there are always *two mortgages,* but there need be only one owner. Of course, there may be complex cases involving both suretyship marshalling and lien marshalling.[66]

The standard dichotomy classifies the cases according to either "sale in inverse order of alienation" or the "two funds doctrine."[67] This classification is highly inaccurate. The second term is roughly synonymous with "lien marshalling," but is confusing because "two funds" are involved in both types of marshalling. (By "two funds" the courts mean the proceeds of two tracts of land sold separately.) "Suretyship marshalling" is a much broader term than "sale in inverse order of alienation," since many cases involving two owners result in sale in a different order. To add to the confusion produced by the orthodox terminology, the usual order of foreclosure sale of separate tracts subject to junior mortgages is in inverse order of alienation.[68]

Suretyship marshalling is a judicial technique designed to protect the basic equities inherent in real suretyship relations. The fundamental doctrine is that the property of the real principal should be applied to the payment of the mortgage debt before the property of the real surety is resorted to. Another important rule is that any transferee of property subject to a real suretyship liability takes the land burdened with this liability unless he is a bona fide purchaser without notice of the facts on which the suretyship relationship is based.[69] Similarly, a transferee of property owned by a real surety automatically acquires the suretyship equities.

The basic principle of lien marshalling is that the singly-charged tract (the one incumbered by the senior mortgage only) should be applied to the payment of the mortgage debt before the doubly-charged tract, on which the junior mortgagee also has a lien.[70] The theory is

[66] Illustrations are Newby v. Fox, 90 Kan. 317, 133 Pac. 890, 47 L.R.A. (N.S.) 302 (1913); Steere v. Childs, 15 Hun 511 (N.Y. 1878).

[67] OSBORNE, MORTGAGES § 286 (1951); WALSH, MORTGAGES 244 (1934).

[68] OSBORNE, MORTGAGES § 290 (1951); Fassett v. Mulock, 5 Colo. 466 (1880). See the discussion of lien marshalling, *infra.*

[69] OSBORNE, MORTGAGES § 287 (1951). The rule of notice is correctly stated in the standard type on pp. 812-813. There is an unfortunate slip in the black letter type on p. 810 where the phrase "*without* notice" has been used instead of "*with* notice". The author undoubtedly intended to use the latter expression.

[70] OSBORNE, MORTGAGES § 290 (1951).

that application of the two funds in this order does not ordinarily hurt the senior mortgagee, while application in the opposite order is apt to deprive the junior mortgagee of his security. If actual prejudice to the senior mortgagee is shown, the court has a discretion to deny marshalling.[71]

It should always be remembered that marshalling is not an end in itself, but merely part of the process of adjusting all of the equities. Marshalling as such is concerned with real liabilities rather than personal liabilities; but if the real surety is also a personal principal, the order of liability may be changed.[72]

The real problem in marshalling is to determine the *order of liability*, not the *order of sale*. Suppose that four tracts have been sold in the order 1, 2, 3 and 4. Once it has been decided that Tracts 1, 2, 3 and 4 are liable in the order 4, 3, 2 and 1 (inverse order of alienation), the duty of the court is to apply the funds realized from the sale of the tracts in that order. Normally this result is most easily attained by selling the tracts in the order of liability. If the order of liability were 1, 4, 3, 2, the sale would be in that order.

Suretyship marshalling is part of a general policy of suretyship protection, which is subordinate to the policy of security enforcement. In other words, the equities of the surety against his principal are sacrificed when they come into direct collision with the mortgagee's claim on the security. This is the basis of the commonly stated rule that sale in the inverse order of alienation will not be decreed when this will injure the mortgagee.[73] Suppose Tracts 1, 2, 3 and 4 are liable in the inverse order for a $12,000 mortgage. The mortgagee files an affidavit stating that a named bidder will offer $12,000 for the entire tract, but that the best bids for the separate parcels total only $10,000. The court will direct that the sale in parcels will be on a tentative basis, permitting bids for the entire tract to be made, which will be accepted if the amount realized is more than the total bid for the parcels.

Liability in Inverse Order of Alienation

We are now ready to consider the application of the principles determining the order of liability to the various types of fractional

[71] Friedlander v. Fenton, 180 Ill. 312, 54 N.E. 329 (1899); Evertson v. Booth, 19 Johns. 486 (N.Y. 1822).

[72] This is the clue to the holdings in Chancellor v. Towell, 80 N.J. Eq. 223, 82 Atl. 861, 39 L.R.A. (N.S.) 359, Ann. Cas. 1914A 710 (1912), discussed *infra;* and Steere v. Childs, 15 Hun 511 (N.Y. 1878).

[73] See note 71 *supra.*

sales or mortgages. For convenience, all illustrations will relate to four tracts originally mortgaged as a unit by *D* to *C*, and sold in the order 1, 2, 3, 4 to G_1, G_2, G_3, and G_4 respectively, or incumbered in that order to J_1, J_2, J_3, and J_4, junior mortgagees of the separate tracts.

We will start with the sale of Tract 1 by *D* to G_1, *Grantor-to-Discharge*. *D* is a personal principal, and the retained tract 2-3-4 is the primary fund for the payment of the mortgage debt, so that *D* is a real principal with respect to these tracts. Order of liability is 2-3-4 as a unit, then 1. On foreclosure 2-3-4, the retained tract, will be sold first.

When G_2 buys Tract 2, Grantor-to-Discharge, he also acquires an equity that the retained tract (3-4) is liable before 2. The lot that he bought is burdened with the equity of its primary liability for the mortgage debt. If G_2 has *actual* knowledge of all the facts, he takes subject to this liability. He may insist that 3-4 be sold before 2, but must submit to having 2 sold before 1. His equities in the entire mortgaged tract are junior to those of G_1, and are therefore inferior; his acquisition of the legal title to Lot 2 does not cut off G_1's prior equity in that lot, since he has notice.

Continuing this process, we find that G_3 acquires Lot 3 subject to the prior equities of G_1, and G_2, and that G_4's title is subject to the equities of the three earlier grantees. This produces the famous rule of *"liability in inverse order of alienation,"* usually stated as a rule of order of sale on foreclosure. Until recently, statements of the rule were defective in failing to note that its application is confined to Grantor-to-Discharge transactions; a different order of liability is found in other situations. Pomeroy made a general statement that the rule did not apply where there was anything in the contract between seller and buyer which "disturbed the equities."[74] He noted particularly that an assumption of the mortgage would defeat the rule. Osborne notes the true basis of the rule, namely that it rests on the payment of the "full value,"—the *basic bargain price* of the fraction sold[75]—so that the grantee is a real surety.

What if the later grantees have no actual notice of prior sales, but the earlier deeds and the mortgage are duly recorded? The weight of authority holds that the grantees are charged with constructive notice

[74] POMEROY, EQUITY JURISPRUDENCE §§ 1224, 1225 (5th ed., Symons, 1941).

[75] OSBORNE, MORTGAGES § 287 (1951); the "full value" rationale is mentioned in Note, 131 A.L.R. 4, 62 (1941).

of sufficient facts to subject them to the rule of liability in inverse order of alienation.[76] There is little doubt that this view is correct.

LIABILITY WHEN ONE GRANTEE ASSUMES

We will now consider the situation in which the grantee of Lot 1 assumes the entire debt. As between grantee and grantor, everything is reversed. The grantee owes his grantor a real and personal duty of exoneration: he becomes a real and personal principal. It is unanimously agreed that the order of liability is first, the tract conveyed, and second, the retained tract.[77]

As we have seen, in all subsequent sales of the other lots the grantee will pay the *basic bargain price* to the grantor. The result is a modified Grantor-to-Discharge transaction. G_2, if he knows of the assumption, will expect G_1 to discharge the mortgage, otherwise he will expect D to do so. The courts will require D to protect G_2 by paying the mortgage if G_1 defaults. Both G_1 and D are real and personal principals with respect to G_2, though as between themselves D is a real and personal surety and G_1 a principal. Order of liability is 1, then 3-4 and finally 2.

Sale of the remaining lots produces relationships between G_2, G_3 and G_4 of exactly the same character as if all of the transactions were *Grantor-to-Discharge,* and the final order of liability is 1, 4, 3, 2.

It is not always the *first* grantee who assumes. There may be fractional *Grantor-to-Discharge* sales, with some later grantee assuming the entire debt.[78] In this case, the tract of the assuming grantee is liable first, regardless of the order in which the tracts are sold to the various grantees, while all other tracts are liable in the inverse order of alienation. Suppose that the fourth grantee assumes; we have liability in the order 4, 3, 2, 1, just as if all sales had been *Grantor-to-Discharge.* There is, however, this difference: the final grantee in this illustration becomes a personal principal, and if the other lots are applied in payment of the mortgage, the owners have a right of reimbursement.

---

[76] *Ibid.* See, however, a criticism of the rule in Note, 79 U. OF PA. L. REV. 782 (1931).

[77] Skinner v. Harker, 23 Colo. 333, 48 Pac. 648 (1896); Cooley v. Murray, 11 Colo. App. 241, 52 Pac. 1108 (1898); Wilcox v. Campbell, 106 N.Y. 325, 12 N.E. 823 (1887); see 131 A.L.R. 62 (1941); OSBORNE, MORTGAGES § 288 (1951).

[78] Lippert v. Wright, 71 Colo. 462, 208 Pac. 453 (1922). In this case the first fractional sale was a Grantor-to-Discharge transaction so that the retained tract became primarily liable. On a subsequent sale of the retained tract to G_2, the latter assumed the entire debt. This left the tract last sold primarily liable and G_2 became a real as well as a personal principal.

In Steere v. Childs, 15 Hun 511 (N.Y. 1878), the situation was similar except that both sales were to the same grantee. The court said that the grantee lost his right to have the second tract considered as primarily liable when he assumed the entire debt.

Some cases, including the decision of *Chancellor of New Jersey v. Towell*,[79] speak of "sale in *direct* order of alienation." This language creates the impression that there are frequently recurring situations in which the order of liability is 1, 2, 3, 4, just as there are many in which it is 4, 3, 2, 1. It is believed that liability in direct order of alienation is so rare that it can hardly be called a "rule."

In the *Towell* case, *D* sold Lots 1, 2, and 3 to the *same* grantee in separate sales, retaining Lot 4. All were covered by a mortgage which *G* assumed when he bought Lot 1. He presumably paid the basic bargain price for Lots 2 and 3. On foreclosure, the trial court decreed 1, 4, 3, 2 as the order of liability, but the Court of Errors and Appeals held that 2 and 3 were liable before 4. There was no question but that Lot 1 was primarily liable. When *G* assumed the entire debt, he became a personal principal. If the court had applied Lot 4 to payment of the debt, *D* would have had a right of reimbursement against *G* for the value of the land. He, a surety, would in effect have paid part of his principal's debt. As the court stated, circuity of action was avoided when it applied Lots 2 and 3 before resorting to 4, making the separate action for reimbursement unnecessary. This case shows the importance of considering the *personal* liabilities as well as the *real* liabilities in a situation that calls for marshalling.

The opinion in the *Towell* case, excellent as it is, fails to point out that the rule of liability in the order 1, 4, 3, 2, decreed by the trial court, is ordinarily correct and was departed from only because later sales were made to the *same grantee, who had already assumed.* Third persons who pay the basic bargain price are entitled to believe that their tracts will not be held primarily liable for the mortgage debt; a purchaser who has already assumed should not draw any such conclusion.[80]

Liability in Pro-rata Sales

We come now to the transactions in which each grantee assumes a share of the mortgage debt. If the mortgage is $16,000 and there are four grantees, each may assume $4,000. In that case each lot will be subject to a real primary liability for $4,000 and a real suretyship liability for $12,000. There is no order of liability so far as the $4,000 is

[79] 80 N.J. Eq. 223, 82 Atl. 861, 39 L.R.A. (N.S.) 359, Ann. Cas. 1914A 710 (1912).

[80] The view taken in the Towell case was foreshadowed by the New York courts in Steere v. Childs, 15 Hun 511 (N.Y. 1878). Here, there were two sales to the same grantee, the first a Grantor-to-Discharge transaction and the second, a Grantee-to-Discharge. The court held that the two tracts became a unit constituting a primary fund for the payment of the mortgage debt.

concerned. The lots are separately sold, and $4,000 must be taken from the fund produced by each sale and applied to the debt. If all lots sell for $4,000 or more, the application of the proceeds discharges the mortgage, but if any lot sells for less than $4,000 we must resort to the suretyship liability and apply any excess over $4,000 realized from the sale of the other lots to make up the deficiency. Is there any order of liability in this case?

It is submitted that application of the basic principles of real suretyship and constructive notice leads to the conclusion that the secondary liability is in *inverse order of alienation.* When G_1 bought Lot 1, he acquired an equity that the retained tract, 2-3-4, should be applied first to the payment of that part of the mortgage debt ($12,000), which G_1 had not assumed. *D* is a real principal and G_1 a real surety for this amount.[81] G_2 will have constructive notice from the recording of the deeds, and takes subject to G_1's equity. From here on, the analysis proceeds exactly as in a series of straight Grantor-to-Discharge transactions, with the result that the *real suretyship liability* is in the order 4, 3, 2, 1. To effectuate this, the tracts will be sold in inverse order of alienation.

The advantage of sale in inverse order of alienation in pro-rata transactions is brought out by the following illustration. *D* owned land mortgaged for $16,000. He divided it into four lots valued at $5,000 each and sold them to G_1, G_2, G_3 and G_4, each purchaser assuming $4,000 and paying *D* $1,000. G_1 and G_2 improved their lots. Upon foreclosure, G_1 paid $4,000 to the sheriff and requested sale in inverse order of alienation. Lot 4 sold for $3,000, Lot 3 for $2,000, Lot 2 for $7,000. As the sheriff now had a fund equal to the mortgage debt, Lot 1 was not sold. First the $4,000 paid by G_1, the full amounts realized from the sale of Lots 3 and 4, and $4,000 of the amount received from Lot 2 are applied to the debt. There is a $3,000 deficiency which must be made up out of the amounts due under the real suretyship liability. As to this, Lots 1

81 Ross v. Brown, 72 Colo. 561, 212 Pac. 835 (1923). The suretyship relationships arising out of partial assumption of a mortgage debt are discussed in Ayers v. Dixon, 78 N.Y. 318 (1879). The grantee of one-half of the land assumed three-quarters of the mortgage debt, so that the tract transferred became the primary fund for the payment of this amount, while the retained tract was the primary fund for the payment of the balance. As to this latter amount, the grantee was a real surety. The court points out that if the grantor's retained tract were used to pay part of the mortgage debt in excess of the one-fourth properly chargeable on that tract, the grantor would be entitled to reimbursement based upon the value of the land after deduction of his share. The judgment of the trial court in favor of the mortgagor was reversed because plaintiff had not sued on the theory of reimbursement but on the theory that failure of the assuming grantee to pay his share made him immediately liable for the amount assumed.

and 2 do not pro-rate. All of the amount realized from Lot 2 must be applied before Lot 1 is touched, since the order of suretyship liability is 4, 3, 2, 1. In this way G_1 saves his own lot by merely paying his proper share. G_2 must bear the loss because his equity is junior. He has, however, a personal right of reimbursement against G_3 for $2,000 and G_4 for $1,000, since they were personal principals for $4,000 each and only part of that liability has been satisfied by the sale of the land.

It is unnecessary to analyze, in detail, the order of liability in Grantee's Option transactions. Whether the entire debt is deducted from the basic bargain price paid by one grantee or pro-rated, the resulting real suretyship relationships are the same as in the corresponding assumption transactions.[82] Only the personal liability of the Grantee is missing. In marshalling, the order of real liability is the same as in the analogous Grantee-to-Discharge situations.

A very instructive case dealing with pro-rating is *Hooper v. Capitol Life Insurance Co.*,[83] in which the court reformed a deed purporting to assume the entire mortgage. *D* owned two adjoining apartments, No. 1 having a basic value of $15,000 and No. 2 of $25,000, both incumbered by a mortgage to *C* for $14,000. *D* conveyed No. 1 to *G*, with a *total* assumption clause, in exchange for a deed "subject to a mortgage" to a ranch owned by *G*, allegedly worth $40,000 and mortgaged for $11,000. On foreclosure, *D* and *G* each claimed that he was a real surety, with the primary liability falling on the other property. The trial court decided that the parties had intended to pro-rate the debt, three-eighths on No. 1 and five eighths on No. 2—in the same ratio as that of the value of the apartments. The assumption clause was stricken, so that the transaction became a combined *Grantor-to-Discharge* and *Grantee's Option*. The Supreme Court affirmed.

This case shows the importance of a clear specification of the bargain and illustrates the judicial technique of determining the real intent of parties whose written expressions are incomplete or erroneous. Although

[82] OSBORNE, MORTGAGES § 288 (1951). The rule of liability in inverse order of alienation does not apply to gift conveyances or judicial sales. When a donor makes a gift of part of the mortgaged land, he is presumed to have intended to give the "equity" to the donee, and his fractional interest is therefore charged with a pro-rata share of the debt. Stephens v. Clay, 17 Colo. 489, 30 Pac. 43 (1892). By custom, the purchaser at a judicial sale is regarded as paying only for the equity, so that the amount of his bid is the equity price and not the basic bargain price. Accordingly, if a mortgaged tract is sold in two fractions at separate judicial sales, the amount of the mortgage debt is pro-rated on the two tracts regardless of the order of sale. Carpenter v. Koons, 20 Pa. 222 (1852). In both of these transactions the position of the fractional grantee is similar to that of the purchaser in a fractional Grantee's Option.

[83] 92 Colo. 376, 20 P.2d 1011 (1933).

the basic value is not necessarily the basic bargain price, it is at least some indication of the deal intended by the parties. If *G* were charged with the $14,000 mortgage, he would acquire only a $1,000 equity in the apartment in exchange for the $29,000 equity in the ranch. This result is too much out of line, and the court was quite justified in concluding that no such exchange was contemplated. Actually, *G* had an excellent argument for a straight *Grantor-to-Discharge* transaction, since the equity in the ranch was apparently worth more than the basic value of the apartment. The court must have felt that the ranch was greatly overvalued. If its true value was $20,000, the equity was $9,000, a fair exchange for the equity in the apartment after deducting three-eighths of the debt.

Lien Marshalling

Lien marshalling, usually called the "two funds doctrine," is often invoked when *D* mortgages two separate properties to *C* to secure the same debt, and later gives a junior mortgage to *J* on one of these properties. A situation more closely resembling fractional sales occurs when the senior mortgage covers an entire tract and the junior mortgage is on part of the tract. Here, *J* has an equity that the part of the land not covered by his mortgage shall be first applied to the debt. If *D* again divides the singly-charged tract and sells or mortgages a part of it, the purchaser or mortgagee acquires an interest burdened with *J*'s equity, provided that the mortgages are recorded.

In spite of this reasoning, a few courts that accept the rule of liability in inverse order of alienation in the case of fractional sales, reject its application to junior mortgages and substitute a rule of pro-rata liability.[84] This minority rule is sometimes based on a generalization that the equity of marshalling does not come into existence until it is invoked at the time of foreclosure.[85] Such reasoning merely begs the question. There is more color to the argument that the junior lienor's equity is weaker than the suretyship equity, and that it is not socially desirable to enforce it against intervening interests. The majority of the courts disagree with this view.

The leading case in Colorado is *Fassett v. Mulock*,[86] which is too

[84] OSBORNE, MORTGAGES § 290 (1951).

[85] Bronaugh v. Burley Tobacco Co., 212 Ky. 680, 280 S.W. 97 (1926).

[86] 5 Colo. 466 (1880); *accord*, Steere v. Childs, 15 Hun 511 (N.Y. 1878). There is a full discussion of the principles of lien marshalling in Ross v. Duggan, 5 Colo. 85 (1879), although no relief was given to the junior mortgagee. In a dictum the court pointed out that if the senior mortgagee were to release his mortgage on the singly charged fund, this would defeat his priority over the junior mortgagee on the doubly charged fund.

complicated for complete analysis. *D,* owning four lots, executed a senior mortgage to *C* and fractional junior mortgages to J_1, J_2, and J_3, the last one covering Lots 3 and 4. The court ruled that liability was in the inverse order of incumbering, qualified by the fact J_3 was a bona fide purchaser entitled to priority over the first mortgage. This result followed because the mortgage had been wrongfully released of record by *C,* after he had assigned to *CX* by an unrecorded instrument, and before the mortgage to J_3. The controversy now narrowed down to Lots 1 and 2 and the latter was held to be primarily liable.

This case is sometimes cited as an illustration of suretyship marshalling rather than lien marshalling. At the time of the foreclosure, Lots 1 and 2 had been deeded to J_1, and J_2 in discharge of the mortgage. Such conveyances are not sale transfers. They do not create any new order of liability but leave undisturbed the order arising out of the previously executed junior mortgages.

The following is a summary of the *order of liability* in the case of fractional sales and mortgages, where all parties have notice of the situation. The figures indicate the order of liability where there are four sales or mortgages.

1. In a series of fractional Grantor-to-Discharge sales, liability is in the inverse order of alienation. Order 4, 3, 2, 1.

2. If the first grantee assumes the entire mortgage and all other grantees pay the basic bargain price, the first grantee's tract is primarily liable and the others are liable in inverse order of alienation. Order 1, 4, 3, 2.

3. If all grantees assume a part of the mortgage, the primary liability is equal and the secondary (suretyship) liability for the balance of the mortgage is in inverse order of alienation. Order of secondary liability 4, 3, 2, 1.

4. If the first sale is a Grantee's Option, with the entire mortgage debt deducted from the basic bargain price, the result is the same as 2 above. Order of liability 1, 4, 3, 2.

5. If all sales are Grantee's Options, each grantee receiving credit for a part of the mortgage debt, the result is the same as 3 above. Order of secondary liability 4, 3, 2, 1.

6. In a series of junior mortgages on fractions of the land, the tracts are liable on the senior mortgage in inverse order of "alienation" (incumbering). Order 4, 3, 2, 1.

Subdivision Financing

The most important practical application of the rules discussed in this article is in the field of Subdivision Financing. There is a great industry, especially on the fringes of cities, devoted to the purchase of tracts of land, improving them and selling lots to prospective home-owners. In recent years, builders often erect large numbers of small homes on such tracts for sale to ultimate purchasers on the installment plan. Because of the large amount of capital required, any tract intended for subdivision is usually covered by a blanket mortgage. The sale of lots therefore is a typical example of fractional transfers of mortgaged property, and every sale involves a question of order of liability. Whether there is ever litigation or not, the purchaser should realize the legal situation in which he is entangled by his purchase of a mortgaged lot or home. It is doubtful if many buyers realize that their property is liable for the *entire* mortgage debt.

A special application of the "clean method" is available to the purchaser who wishes to avoid this liability. This procedure is the *release of lien.* It is customary for the parties to the underlying mortgage on a subdivision to insert a provision requiring the mortgagee to release any lot from the lien of the mortgage on payment of a specified amount, which may run from half to three-quarters of the retail price of the lot. The contract between the subdivision company and the purchaser should contain a clause requiring the former, upon full payment by the latter, to pay the mortgagee the required amount and procure the release of lien. It is unwise to purchase a lot in a subdivision without first checking the mortgage and contract to see that these provisions are present. If the buyer can pay cash in full, he should see that the lien is released at once. If he is buying on credit, it is much better to refinance the debt than to owe it to the subdivider. The buyer should be able to borrow enough from a bank, or other lender, to pay his debt for the purchase price and procure the release of lien. To secure this loan he gives a new mortgage which is a lien on his own lot only. No default on the blanket mortgage can injure him when this procedure is followed.

Since many buyers do not secure legal advice, there are always many transactions in which the lien is not released. In these cases default by the subdivider hangs over the head of the purchaser like a sword of Damocles, of which he is generally in happy ignorance. As long as the subdivision company is reasonably solvent, default is not apt to occur; the danger comes when the company is hard-pressed. Occasionally an unscrupulous promoter may be milking the company, but the real threat is a local depression or unemployment that destroys the ability

of many of the purchasers to pay for the lots and throws the subdivision company into bankruptcy. We have been so long in a period of inflation, with full employment and rising real estate prices, that most people are inclined to overlook this danger. It is precisely at such a time that more than usual care should be taken not to get into a vulnerable position.

To the subdivider, it seems natural to employ straight Grantor-to-Discharge transactions in all his sales. The purchaser cannot possibly assume the entire mortgage; it is too big. For the same reason a Grantee's Option is out of the question. There remains the possibility of a fractional assumption, but this is much too complicated to appeal to either party. The subdivider desires uniformity in all his transactions for bookkeeping reasons, and can be expected to refuse to sell to the occasional purchaser who insists on a fractional assumption.

Once a purchaser understands the legal consequences of fractional Grantor-to-Discharge transactions, he should be easily persuaded to follow the procedure of procuring a release of lien. It is worth noting that this is of greater importance to the purchasers of the last few lots in a subdivision than to those who get in early in the game. The rule of liability in inverse order of alienation works to the disadvantage of the late comers. As we have seen, this is equally true of the *secondary* liability when the device of fractional assumption is used, so that even if a purchaser could persuade the subdivider to use it he would be little better off. Lawyers should be sufficiently familiar with the rules of marshalling so that they can give sound advice to a prospective purchaser as to the extent of the liability and the best way to avoid it.

The foregoing lines are a warning to purchasers and the lawyers who represent them; a closing word is in order to subdivision companies and *their* lawyers. These companies are taking the money of purchasers in payment of land to which the title is not clear. This is a transaction which calls for the highest good faith, so that the buyer who pays for the land will not be disappointed in his expectation that the lien will be released. Part of every payment should be segregated in a special fund for the reduction of the mortgage debt, and there should always be sufficient cash in this fund to enable the subdivision company to secure an immediate release of lien on all lots as they are paid for. Diversion of this fund to other purposes, particularly to the speculative purchase of additional land, is unsound business practice and should never be indulged in. Although the subdivider is probably not legally a trustee of these payments, he should consider himself subject to a standard of conduct approximating that which the law imposes upon fiduciaries.