

A homebuyer financed the purchase of a new home by executing a promissory note and purchase-money mortgage to his credit union. The mortgage was promptly recorded. The next year, the home developed foundation problems. The homebuyer was forced to take out a second mortgage with a bank to finance the repairs. The mortgage was properly recorded, and file-stamped copies were sent to the homebuyer and the credit union.

After making consistent payments for five years, the homebuyer defaulted on both mortgages. The homebuyer agreed to execute a deed in lieu of foreclosure to the credit union in satisfaction of the debt. The deed was signed, delivered, and properly recorded. The credit union then initiated foreclosure proceedings on its first mortgage in order to eliminate the second mortgage held by the bank.

Is the credit union likely to prevail?

- A. No, because the credit union had actual knowledge of the second mortgage when it accepted the deed in lieu of foreclosure.
- B. No, because the deed in lieu of foreclosure automatically eliminated the second mortgage under the doctrine of merger.
- C. Yes, because the credit union impliedly retained the right to foreclose on the mortgage to eliminate junior liens.
- D. Yes, because the doctrine of merger does not apply to mortgages and the lender retains the right to foreclose.

### Explanation:

The homebuyer (mortgagor) executed a **deed in lieu of foreclosure**, under which he conveyed all interest in the mortgaged property to the credit union (mortgagee) to avoid foreclosure. This gave the credit union the right to take immediate possession of the property without the formalities of a foreclosure sale. However, by accepting the deed, the credit union may have lost the right to foreclose on its mortgage to eliminate the bank's [junior mortgage](#), depending on the jurisdiction.

A minority of jurisdictions apply the doctrine of merger when the same person (here, the credit union) acquires the mortgagee's interest in real property and the mortgagor's interest in that same property (**Choice D**). When this occurs, the mortgage merges into the fee estate and is thereby extinguished. As a result, the mortgagee has no lien on which to foreclose and any junior liens are promoted in status.

However, **most jurisdictions** have adopted the Restatement's position that the **merger doctrine does not apply** to mortgages (default rule on the MBE). Instead, a mortgagee that receives a deed in lieu of foreclosure is treated as having **impliedly retained the right to foreclose** on its mortgage—**unless** it had **actual knowledge of a junior lien**. If so, then the mortgagee **cannot foreclose** on its mortgage to eliminate that junior lien (**Choices C & D**).

Here, the credit union received a file-stamped copy of the bank's mortgage, so the credit union had actual knowledge of this junior lien when it received the homebuyer's deed in lieu of foreclosure. As a result, the credit union is *not* likely to prevail in foreclosure proceedings on its first mortgage to eliminate the bank's junior mortgage.

**(Choice B)** Had the minority rule regarding merger applied, the deed in lieu of foreclosure would have automatically eliminated the credit union's first mortgage—not the bank's second mortgage.

### Educational objective:

A mortgagee that receives a deed in lieu of foreclosure generally retains the right to foreclose on its mortgage. But if the mortgagee had actual knowledge of a junior lien, then it cannot foreclose on its mortgage to eliminate that lien.

### References

Restatement (Third) of Property: Mortgages § 8.5 cmt. b (Am. Law Inst. 1997) (discussing deeds in lieu of foreclosure).

## Lien theory v. Title theory

Majority rule (merger doctrine does not apply)		
Fee holder	Deed in lieu of foreclosure	
	Homebuyer	Credit union
Senior mortgagee	Credit union	*
Junior mortgagee	Bank	

Minority rule (merger doctrine applies)		
Fee holder	Deed in lieu of foreclosure	
	Homebuyer	Credit union
Senior mortgagee	Credit union	Bank
Junior mortgagee	Bank	

\*Cannot foreclose to eliminate junior liens of which it had actual knowledge

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