A man purchased a house that needed substantial repairs. The man financed the purchase of the house by borrowing funds from a bank. He signed a note to the bank and secured repayment of the loan with a mortgage. After purchasing the house, the man borrowed money from his credit union to make the repairs. The man signed a note to the credit union; this note was also secured by a mortgage on the house. Both mortgages were promptly recorded in the order granted. The man was personally liable on both loans.

The man moved into the house and made the necessary repairs. He later defaulted on the debt to the bank, and the bank initiated judicial foreclosure proceedings, naming both the man and the credit union as parties to the action. An outside party acquired the house at the foreclosure sale.

After the expenses of the sale and the balance due the bank have been paid, $5,000 remains in the sale proceeds. The outstanding balance of the credit union loan is $20,000. The man and the credit union both claim the $5,000.

There is no applicable statute.

Who is entitled to the $5,000?

A. The credit union, because the credit union has priority.

B. The credit union, because the man is personally liable on the debt.

C. The man, because of his equitable right of redemption.

D. The man, because the outside party received title to the house subject to the second mortgage.

Explanation:

Foreclosure is the process in which the creditor **forces the sale of the mortgaged property** to satisfy the debt. After the foreclosure sale, **proceeds are typically distributed** in the following **order of priority**:

Costs from the foreclosure sale (eg, attorneys fees, court costs)

Mortgage being foreclosed

Junior mortgages (or other junior liens), in the order of priority

Debtor, if any surplus remains

Here, the man mortgaged his house, first to the bank and then to the credit union. When the man defaulted on his debt to the bank, the bank foreclosed on his house. After the costs from the foreclosure sale and the bank's mortgage were paid, $5,000 remained. Since the credit union has the second (junior) mortgage and is still owed $20,000, it has priority over the man. Therefore, the credit union is entitled to the $5,000.

(Choice B) The fact that the man is personally liable on the remainder of the debt to the credit union is irrelevant to determining who is entitled to the $5,000. Instead, the credit union is entitled to the $5,000 because it is a junior lienholder with priority.

(Choice C) The equitable right of redemption allows a debtor who has defaulted on a mortgage to cure the default *before* the foreclosure sale by paying the full amount of the outstanding debt. But this right is irrelevant to determining who is entitled to the proceeds *after* the foreclosure sale.

(Choice D) Since the credit union was a party to the bank's foreclosure action, the purchaser took the house free and clear of (not subject to) the second mortgage. But had the credit union not been a party, the purchaser would have taken the house subject to that mortgage.

Educational objective:

The proceeds of a foreclosure sale are distributed in the following order of priority: (1) the costs from the foreclosure sale, (2) the mortgage being foreclosed, (3) junior liens in order of priority, and (4) the debtor.

References

55 Am. Jur. 2d Mortgages § 705 (2019) (distribution of foreclosure sale proceeds).

Distribution of foreclosure sale proceeds