St. Mary's Law Journal

Volume 21 | Number 4 Article 15

1-1-1990

Texas Adopts the Outstanding Balance Method of Determining Whether Monies Bid at a Foreclosure Sale Involving Wraparound Mortgages Generate Excess Proceeds or Constitute a Deficiency.

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CASENOTES

REAL ESTATE—Implied Covenants—Texas Adopts the "Outstanding Balance" Method of Determining Whether Monies Bid at a Foreclosure Sale Involving Wraparound Mortgages Generate Excess Proceeds or Constitute a Deficiency.

Summers v. Consolidated Capital Special Trust,
32 Tex. Sup. Ct. J. 473 (June 21, 1989).

Consolidated Capital Special Trust (Consolidated) purchased an apartment complex in Harris County, Texas, at a foreclosure sale after Robert Sill, the previous owner, defaulted on a loan from Consolidated.[1] Sill's note was a "wraparound note"[2] that included four prior loans[3] and was secured by a deed of trust.[4] English Village Apartments, Ltd. (EVA) was the holder of the fifth note, being Sill's note.[5] When Consolidated purchased the apart-

1. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). Consolidated, mortgagee, originally loaned Robert Sill $6,289,000 to purchase the apartments in Harris County, Texas. *Id.* After Sill defaulted on the note, Consolidated foreclosed and purchased the property. *Id.*

2. A wraparound mortgage is a note that includes the balance of the pre-existing obligations existing on the property as well as the "new" money advanced. 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY § 475[7] (1989). The new money advanced is known as the "true debt" and the mortgagor is personally liable for the true debt. *Summers*, 32 Tex. Sup. Ct. J. at 474.

3. *Id.* at 473. The principal balance of the first note was $2,450,000; the second was a "wrap" of the new first note totalling $2,775,000; the third note was a "wrap" of the prior two notes totalling $3,250,000; the fourth note was a single note for $500,000; and the fifth note was a "wrap" of the four prior notes totalling $4,700,000. *Id.*

4. *Id.* The trustee under the deed of trust was James M. Summers, the defendant. *Id.* Upon default of Sill, James Summers had the power as trustee to sell the secured property through a foreclosure sale. The deed of trust specifically stated that "the trustee shall first pay all expenses, . . . and shall next apply such proceeds toward the payment of the *indebtedness secured hereby* (principal, interest [and] attorney's fees if any), and the remaining balance, if any, shall be paid to Grantors, their heirs and assigns." *Id.*

5. *Id.* The fifth note included, or "wrapped," all of the four prior notes. *Id.*

ments at the foreclosure sale, it took "subject to" the four previously existing notes wrapped by the fifth note.[6] After Consolidated defaulted on October 1, 1983, EVA foreclosed on its note and purchased the property for $2,750,000 at the foreclosure sale on June 5, 1984, subject to all existing notes and liens.[7] Consolidated brought suit, alleging the EVA bid of $2,750,000 generated proceeds in excess of $500,000, which legally belonged to Consolidated.[8] According to the trial court, the bid price at the foreclosure sale should have been credited against the balance of the entire wrap-

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6. *Id.* When Consolidated purchased the property at the foreclosure sale, it basically stepped into the shoes of Sill and began paying on Sill's note. *See id.* By taking subject to the pre-existing notes, Sill acquired the property with all the prior encumbrances. *Id.*; *see also* Slaughter v. Morris, 291 S.W. 961, 963 (Tex. Civ. App.—Austin 1926, writ dism'd w.o.j.)("subject to" invokes implied liability assuming payment of value of prior notes); *accord* Cleary v. Leden, 365 S.E.2d 903, 905 (N.C. Ct. App. 1988)(taking subject to means purchaser acquires property with prior liens and notes against it). However, Sill was not personally liable to the pre-existing note holder(s) or to EVA for the specific notes constitution that prior indebtedness. *See* Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989)(purchaser not expressly liable for underlying debt), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990); *see also Slaughter*, 291 S.W. at 963 (taking subject to means purchaser not personally liable for prior notes); *accord* Rolph v. McGowan, 579 P.2d 1011, 1014 (Wash. Ct. App. 1978)(when taking subject to, grantee has no personal liability to that which was taken subject to). Even though a purchaser taking subject to some prior indebtedness is not personally liable for that indebtedness, he may lose the property for his failure to pay the installments as required in *his* note (his installments including the value of that prior indebtedness). Kendall House Apts., Inc. v. Dep't of Revenue, 245 So. 2d 221, 223 (Fla. 1971). Consolidated's failure to pay installments allowed EVA to foreclose and thereby eliminate Consolidated's interest in the property. *See Summers*, 32 Tex. Sup. Ct. J. at 473 (trustee foreclosed following Consolidated's nonpayment).

7. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). EVA owned the apartment complex originally and then sold it to Robert Sill. *Id.* Because EVA held the last note, it had to foreclose to avoid losing its secured interest in the property to *its* mortgagee. *Id.* If EVA were to default, *its* note holder could foreclose and EVA would have to resort to contract theory to recover the true debt from Consolidated because it would have lost its security interest in the property. *Id.* at 474. *See generally* 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY § 463[3] (1989)(discussing consequences of mortgagee default); R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 243 (1979)(foreclosure upon default of mortgagor maintains security interest in property). Consolidated claimed that because the property was purchased subject to Sill's note, and because the $500,000 note included in Sill's note had not been paid as of the date of foreclosure, EVA was responsible for its prior notes, including the $500,000 lien. *See Summers*, 32 Tex. Sup. Ct. J. at 474 (Consolidated contended EVA was liable for surplus).

8. *Id.* Consolidated's specific calculations were:

around note, which included the pre-existing debt[9] and, therefore, resulted in a deficiency against Consolidated.[10] The Court of Appeals reversed,[11] holding that the bid price at the foreclosure sale should have been credited against only the "true debt" portion of the wraparound note,[12] defined as that part of the note which exceeds the balance of the pre-existing notes.[13] Therefore, the Court of Appeals determined that a surplus resulted in favor of Consolidated.[14] The Texas Supreme Court granted writ of error to determine whether EVA's bid at the foreclosure sale generated excess proceeds

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$6,206,952 - Debt of the Sill note (principal and interest).

($3,994,266) - Amount of 4 prior notes still due and owing as of May 21, 1984.

$2,212,686 - Amount owed to EVA on 5th note.

$2,750,000 - Amount bid by EVA at the foreclosure.

$ 537,314 - Excess proceeds.

Id. Consolidated claimed that because EVA took the property subject to all existing notes and liens and because the fourth note of $500,000 had not been paid by the time of foreclosure, EVA was responsible for paying it. *See* Brief for Appellant at 5-6, Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327 (Tex. App.—Houston [14th Dist.] 1987)(No. 14-8-000873-CV), *rev'd on other grounds*, 32 Tex. Sup. Ct. J. 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990).

9. *Summers*, 32 Tex. Sup. Ct. J. at 473. The wraparound note includes the pre-existing debt plus the true debt. *Id.* In this case, the principal balance of the prior indebtedness was $4,700,000 and the true debt was $1,506,452 for a total wraparound note of $6,206,952. *See id.* at 473-74 (true debt calculated by subtracting principal balance less prior indebtedness).

10. *Id.* at 474. The effect of the trial court's holding is that a bidder at a foreclosure sale can bid as high as the total debt owed on the property without creating a surplus. *See id.* at 475. EVA could have bid up to $6,206,952, the total of the pre-existing debt owed plus true debt owed by Consolidated without creating a surplus. *See id.* (no surplus if bid does not exceed balance). EVA counterclaimed for the rents and security deposits that Consolidated collected prior to the foreclosure date, but covering the rent period following the foreclosure date. The court stated that in order for the mortgagee to recover the rents and security deposits he must take possession of the property. The court reasoned that because EVA did everything necessary to take possession of the property, it is entitled to the rents and security deposits. *Id.*

11. Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327, 328 (Tex. App.—Houston [14th Dist.] 1987), *rev'd*, 32 Tex. Sup. Ct. J. 473 (1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990).

12. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 474 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990)(effect is anything over true debt is surplus and would go to grantor of deed of trust).

13. *Id.* By following the appellate court's holding, a bidder at a foreclosure sale may bid an amount equal to what the defaulting party owes on the true debt without creating a surplus. *See id.*

14. *Consolidated*, 737 S.W.2d at 328. As stated in the deed of trust, surplus was to be distributed to the grantor of the deed of trust. *Id.* In this case, Consolidated was the mortgagor. *Id.*

due Consolidated or resulted in a deficiency in favor of EVA.[15] Held—*Reversed*. Texas adopts the "outstanding balance" method of determining whether monies bid at a foreclosure sale involving wraparound mortgages generate excess proceeds or constitute a deficiency.[16]

A deed of trust is a method of real estate financing that creates an obligation between a mortgagor (purchaser or borrower), a mortgagee (seller or third party lender) and a trustee.[17] A deed of trust places title in the control of an appointed trustee to hold in trust for the benefit of the mortgagor and the mortgagee.[18] The mortgagee maintains a secured interest in the property until the mortgagor fully performs the contractual obligation.[19] When a balance is owed, the contract creates a lien upon the property that allows the mortgagee, upon default by the mortgagor, to foreclose upon the secured property through the trustee.[20] The trustee must strictly follow the terms of the deed of trust when releasing title and when conducting foreclosure

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15. *Summers*, 32 Tex. Sup. Ct. J. at 473.

16. *Id.* at 475. The court implied a covenant to effectuate the outstanding balance method to distribute proceeds at foreclosure. *Id.* at 474-75. This implied covenant does not make the mortgagor personally liable to the mortgagee or the pre-existing note holders for the pre-existing debt. *Id.* at 474. However, it will not allow a defaulting mortgagor to recover proceeds from a foreclosure sale until the pre-existing debt has been completely extinguished. *Id.* at 474-75.

17. *See* Union Bank v. Kansas City Bank, 136 U.S. 223, 232 (1890); *In re* Sherman, 12 F. Supp. 297, 298-99 (W.D. Va. 1935); La Arcada Co. v. Bank of Am., 7 P.2d 1115, 1115 (Cal Dist. Ct. App. 1932); *see also* R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 3.03 (2d ed. 1981); R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 243 (1979).

18. Lucky Homes, Inc. v. Tarrant Sav. Ass'n, 379 S.W.2d 386, 388 (Tex. Civ. App.—Fort Worth 1964), *rev'd on other grounds*, 390 S.W.2d 473 (Tex. 1965); *accord Union Bank*, 136 U.S. at 232; *Sherman*, 12 F. Supp. at 299; *La Arcada Co.*, 7 P.2d at 1115; *see also* W. ATTEBERRY, K. PEARSON & M. LITKA, REAL ESTATE LAW 224 (3d ed. 1984); R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 243 (1979).

19. Pearce v. Stokes, 155 Tex. 564, 568, 291 S.W.2d 309, 312 (1956); Lusher v. First Nat'l Bank, 260 S.W.2d 621, 627 (Tex. Civ. App.—Fort Worth 1953, writ ref'd n.r.e.); Norriss v. Patterson, 261 S.W.2d 758, 761 (Tex. Civ. App.—Fort Worth 1953, writ ref'd n.r.e.); *accord* Smith v. Haertel, 244 P.2d 377, 379 (Colo. 1952); Citizens Loan & Sav. Co. v. Stone, 206 N.E.2d 17, 21 (Ohio Ct. App. 1965); *see also* R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 1.1 (2d ed. 1981); W. MILLIGAN & A. BOWMAN, REAL ESTATE LAW § 9.12 (1984).

20. *See* Ogden v. Gibraltar Sav. Ass'n, 640 S.W.2d 232, 233 (Tex. 1982); Slaughter v. Qualls, 139 Tex. 340, 346, 162 S.W.2d 671, 675 (1942); Shepler v. Kubena, 563 S.W.2d 382, 385 (Tex. Civ. App.—Austin 1978, no writ); Hensarling v. Southern States Life Ins., 269 S.W.2d 555, 560 (Tex. Civ. App.—Waco 1954, writ ref'd n.r.e.); *accord* Coursey v. Fairchild, 436 P.2d 35, 38 (Okla. 1967); *see also* 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY § 462 (1989); Comment, *Through the Looking Glass: Foreclosure by Sale as* De Facto *Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 852 (1985).

proceedings.[21]

At common law, if the mortgagor did not pay the mortgage by a specified date, known as "law day," the land securing the obligations would revert automatically to, and vest title in, the mortgagee.[22] The present judicial trend foregoes the harsh common law remedy in default situations[23] and replaces it with foreclosure proceedings.[24] In the United States, the two most common methods of foreclosure are "judicial foreclosure"[25] and "non-

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21. Houston First Am. Sav. v. Musick, 650 S.W.2d 764, 768 (Tex. 1983); Murchison v. Freeman, 127 S.W.2d 369, 372 (Tex. Civ. App.—El Paso 1939, writ ref'd), *accord Sherman*, 12 F. Supp. at 299 (follow obligations set forth in deed of trust); *see also* C. JACOBUS, TEXAS REAL ESTATE LAW 247 (4th ed. 1985); Howard, *Foreclosure-Nonjudicial Style*, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE K-10 (1983).

22. *See* Terrell v. Allison, 88 U.S. (21 Wall.) 289, 292 (1874); *In re* Agostini, 33 A.2d 306, 309 (Del. Super. Ct. 1943); Ward v. Lord, 28 S.E. 446, 446-47 (Ga. 1897); *see also* R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 1.2 (2d ed. 1981); Comment, *Through the Looking Glass: Foreclosure by Sale as* De Facto *Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 856 (1985).

23. *See Terrell*, 88 U.S. (21 Wall.) at 292 (court allowed mortgagor chance to regain property, after default, by fulfilling obligation within reasonable time). *See generally* J. DASSO, A. RING & D. MCFALL, FUNDAMENTALS OF REAL ESTATE 309 (1977)(after default, mortgagor has "equitable right of redemption" which can only be severed by foreclosure); R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 1.4 (2d ed. 1981)(after default, mortgagor may choose to redeem property); Durfee & Doddridge, *Redemption From Foreclosure Sale-The Uniform Mortgage Act*, 23 MICH. L. REV. 825, 825 n.1 (1925)(mortgagor lost land by not paying by "law day" but given another chance to redeem property). The equitable right of redemption requires the mortgagor to pay the debt plus any other resulting costs before foreclosure in order to redeem the property. J. DASSO, A RING & D. MCFALL, FUNDAMENTALS OF REAL ESTATE 309 (1977). Some states have a "statutory right of redemption" which even allows the mortgagor to recover the property after foreclosure. *Id.* Because courts would sometimes allow the mortgagor to pay the debt at a later time and recover the land, the mortgagee never knew if he really owned the property. Additionally, automatic reversion caused a harsh result to the mortgagor because of the injustice of forfeiture. *Id.*

24. *See* R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 1.4 (2d ed. 1981)(foreclosure bars equitable right of redemption). *See generally* Cotellesse, *Nonjudicial Foreclosure Under a Deed of Trust: Some Problems of Notice*, 49 TEX. L. REV. 1085, 1085 (1971) (under deed of trust, Texas employs nonjudicial sale to foreclose). A foreclosure sale allows for the property to be sold at a public auction to pay the debt, and any excess would go to the mortgagor. *Id.*

25. E. HOPKINS, HANDBOOK ON THE LAW OF REAL PROPERTY § 140, at 248 (1896); R. KRATOVIL, REAL ESTATE LAW § 440, at 286 (1974). A court grants a public auction (foreclosure sale) and an officer of the court such as a sheriff conducts the sale. *See* R. KRATOVIL, REAL ESTATE LAW § 440, at 286 (1974). The mortgagor, or any noteholder is allowed to pay off the mortgage prior to foreclosure and thereby end the foreclosure. *See id. See generally* G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES 661 (2d ed. 1970)(majority of states use judicial foreclosure).

judicial foreclosure."[26] Judicial foreclosure requires the mortgagee to initiate foreclosure proceedings in court to obtain an order allowing for a public auction of the defaulted property.[27] The court also provides an officer of the court to conduct the public auction.[28] In Texas, non-judicial foreclosure is generally the method of foreclosure employed.[29] A non-judicial foreclosure sale under a deed of trust involves a public auction for the sale of the defaulted property without the use of the judiciary.[30] At the foreclosure sale, bidders, including the mortgagee, are allowed to bid for the property.[31] Proceeds from the foreclosure sale are to be applied as expressed in the deed of trust.[32] The deed of trust generally requires payment of the debts first and

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26. *See* Swanson v. Grassedonio, 647 S.W.2d 716, 719 (Tex. App.—Corpus Christi 1982, no writ)(deed of trust grants power to trustee to conduct non-judicial foreclosure); E. HOPKINS, HANDBOOK ON THE LAW OF REAL PROPERTY § 140, at 248-49 (1896)(non-judicial sale conducted according to instrument creating power); R. KRATOVIL, REAL ESTATE LAW § 443, at 288 (6th ed. 1974)(deed of trust empowers trustee to initiate foreclosure proceedings without court proceedings). The deed of trust specifically instructs the trustee on notice requirements and other formalties necessary in conducting the foreclosure sale. R. KRATOVIL, REAL ESTATE LAW § 443, at 288 (1974).

27. E. HOPKINS, HANDBOOK ON THE LAW OF REAL PROPERTY § 140, at 248 (1896); *see also* R. KRATOVIL, REAL ESTATE LAW §§ 439-440, at 286 (1974). *See generally* G. OSBORNE, MORTGAGES 661 (1970)(discussing disadvantages of judicial foreclosure). Judicial foreclosure can be time consuming, costly, and complicated. *See id.* Some of the requirements of judicial foreclosure are: (1) title search, (2) notice, (3) service of process, (4) hearing to obtain order for sale, (5) notice of sale, (6) sale, (7) report of sale, (8) proceeding to determine surplus rights, and (9) decree for deficiency if necessary. *See id.* at 663.

28. E. HOPKINS, HANDBOOK ON THE LAW OF REAL PROPERTY § 140, at 248 (1896); *see also* R. KRATOVIL, REAL ESTATE LAW § 440, at 286 (1974).

29. Cotellesse, *Nonjudicial Foreclosure Under a Deed of Trust: Some Problems of Notice*, 49 TEX. L. REV. 1085, 1085 (1971); Rant, *ULTA and Non-Judicial Mortgage Foreclosure in Texas*, 12 ST. MARY'S L.J. 1104, 1115-16 (1981).

30. TEX. PROP. CODE ANN. § 51.002(a) (Vernon 1984); *see also* Odom v. Empire Bldg. & Loan Ass'n, 134 S.W.2d 1053, 1056 (Tex. Civ. App.—Dallas 1939, writ dism'd judgmt cor.)(auction at schoolhouse permitted because courthouse destroyed). *See generally* R. KRATOVIL, REAL ESTATE LAW § 355, at 205 (5th ed. 1969); R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 1.4, at 31 (2d ed. 1981); R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 243 (1979); G. OSBORNE, MORTGAGES § 340, at 732 (1970).

31. *See* Southern Trust & Mortgage Co. v. Daniel, 143 Tex. 321, 326 184 S.W.2d 465, 467 (1945)(mortgagee has right to purchase at sale); Dall v. Lindsey, 237 S.W.2d 1006, 1008 (Tex. Civ. App.—Amarillo 1951, writ ref'd n.r.e.)(mortgagee may purchase at own foreclosure sale); Doolen v. Hulsey, 192 S.W. 364, 368 (Tex. Civ. App.—Amarillo 1917, no writ)(previous owner of land may purchase at foreclosure); *see also* 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY ¶ 469.2[2] (1989)(mortgagee's purchase of own property at foreclosure has same result as third party's purchase at foreclosure sale); W. ATTEBERRY, K. PEARSON & M. LITKA, REAL ESTATE LAW 226 (3d ed. 1984)(mortgagee is usually sole bidder at foreclosure sale).

32. Houston First Am. Sav. v. Musick, 650 S.W.2d 764, 768 (Tex. 1983); Slaughter v. Qualls, 139 Tex. 340, 346, 162 S.W.2d 671, 675 (1942); First Fed. Sav. & Loan Ass'n v. Sharp,

any surplus paid to the grantor (usually the mortgagor).[33]

Deeds of trust are also used to secure wraparound notes.[34] A wraparound mortgage secured by a deed of trust is a financing arrangement in which the mortgagor's note "wraps" or includes the pre-existing debt encumbering the property.[35] The wraparound note is calculated by including the balance of the pre-existing debt plus the true debt.[36] The mortgagor usually finances the wraparound mortgage with an interest rate at or below the current market rate while the pre-existing debt is financed at the interest rate set at its inception, usually an even lower rate.[37] Installment payments on wrap-

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347 S.W.2d 337, 339 (Tex. Civ. App.—Dallas 1961), *aff'd*, 359 S.W.2d 902 (Tex. 1962); *see also* C. JACOBUS, TEXAS REAL ESTATE LAW 247 (4th ed. 1985); Howard, *Foreclosures-Nonjudicial Style*, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE K-10 (1983).

33. *See* Byers v. Brannon, 19 S.W. 1091, 1095 (Tex. Comm'n App. 1892, opinion adopted); *accord* Dupee v. Rose, 37 P. 567, 568 (Utah 1894); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988); Comment, *Through the Looking Glass, Foreclosure by Sale as* De Facto *Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 863 (1985).

34. *See* Western Fed. Sav. & Loan Ass'n v. Atkinson Fin. Corp., 747 S.W.2d 456, 460 (Tex. App.—Fort Worth 1988, no writ); Greenland Vistas, Inc. v. Plantation Place Assocs., 746 S.W.2d 923, 925 (Tex. App.—Fort Worth 1988, writ denied); *accord* Armsey v. Channel Assocs., Inc. 229 Cal. Rptr. 509, 511 (Ct. App. 1986); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1053 (1988). *See generally* Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 UCLA L. REV. 1529, 1529 (1974)(wraparound note is sometimes to referred to as "an all-inclusive deed of trust").

35. *Western*, 747 S.W.2d at 459; *Greenland Vistas*, 746 S.W.2d at 925; Lee v. O'Leary, 742 S.W.2d 28, 30 (Tex. App.—Amarillo 1987, writ granted); *see also* R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 348 (1979); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985).

36. *Western*, 747 S.W.2d at 459; *Greenland Vistas*, 746 S.W.2d at 925; *Lee*, 742 S.W.2d at 30; *accord* J.M. Realty Inv. Corp. v. Stern, 296 So. 2d 588, 589 (Fla. Dist. Ct. App. 1974); Mitchell v. Trustees of United States Mut. Real Estate Inv. Trust, 375 N.W.2d 424, 428 (Mich. Ct. App. 1985); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985).

37. *See* ICM Realty v. Cabot, Cabot & Forbes Land Trust, 378 F. Supp. 918, 923 (S.D.N.Y. 1974)(wraparounds generally used on older properties because of low interest rate charged on first mortgage); *Greenland Vistas*, 746 S.W.2d at 927 (mortgagee charged higher rate of interest on wraparound note than was charged on underlying note); *Mitchell*, 375 N.W.2d at 428 (mortgage includes principal balance of existing note at existing note's interest rate, plus new money advanced at some other interest rate); *see also* R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 24.11(d) (2d ed. 1981)(mortgagee receives difference in interest between pre-existing debt interest rate and true debt interest rate); R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 348 (1979)(ad-

around mortgages result in a chain reaction; the mortgagor pays the installment to his mortgagee, that mortgagee in turn pays his note to his mortgagee, and payment continues on with each mortgagee paying his installment until all of the installments have been paid.[38]

Wraparound mortgages secured by a deed of trust emerged as the preferred method of financing because of the advantages available to all contractual parties involved.[39] First, if the existing deed of trust does not contain a "due on sale" clause,[40] or the owner holding a due on sale clause consents to the selling arrangement, subsequent purchasers are able to purchase the property "subject to" the existing debt and therefore utilize a

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vantageous to use wraparound deed of trust in market with high interest rate because pre-existing debt is financed at lower interest rate).

38. *See Greenland Vistas*, 746 S.W.2d at 925 (Greenland Vistas was to pay pre-existing debt after receiving installment from Plantation Place); *Lee*, 742 S.W.2d at 32 (mortgagee to pay his preexisting note because mortgagor did not assume those notes); *accord J.M. Realty*, 296 So. 2d at 589 (mortgagee obligated to pay his pre-existing debt pursuant to receiving installment payments by mortgagor); *see also* Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 UCLA L. REV. 1529, 1531 (1974)(mortgagor makes payments to mortagee who pays his underlying notes); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985)(mortgagee remains responsible for paying his prior indebtedness).

39. *See* Greenland Vistas, Inc v. Plantation Place Assocs., 746 S.W.2d 923, 925 (Tex. App.—Ft. Worth 1988, writ denied)(buyer personally liable for pre-existing debt); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Consideration and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(interest rate advantages for mortgagee and financing advantages for mortgagor); Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 UCLA L. REV. 1529, 1531 (1974)(advantageous to use during high interest rate periods); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 148 (1985)(discussing interest rate and liability advantages).

40. A due on sale clause allows the pre-existing lien holder, mortgagee, to accelerate the balance of the note in advance of the date of maturity and if not paid, foreclose whenever the property is sold. Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 148 (1985); *see also* Sonny Arnold, Inc. v. Sentry Sav. Ass'n, 615 S.W.2d 333, 339 (Tex. Civ. App.—Amarillo, 1981), *aff'd*, 633 S.W.2d 811 (Tex. 1982)(court-enforced due on sale clause permitted mortgagee to increase interest rate upon transfer of property); Consolidated Capital Properties, II, Ltd. v. National Bank of N. Am., 420 So. 2d 618, 621-22 (Fla. Dist. Ct. App. 1982)(must prove impairment of security interest to invoke due on sale clause); Daugharthy v. Monritt Assoc., 444 A.2d 1030, 1034 (Md. 1982)(noteholder could not invoke due on sale clause because purchasers were bound under original deed of trust). If a note contains a due on sale clause and the mortgagor sells the property, then the mortgagee may declare the note due and payable before the date of maturity. R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 242 (1979). A due on sale clause must be stated in the mortgage to be effective. R. KRATOVIL & R. WERNER, MODERN MORTGAGE LAW AND PRACTICE § 14.08 (2d ed. 1981).

wraparound deed of trust.[41] The mortgagor in this instance only needs to obtain new financing for the difference between the pre-existing debt and the true debt.[42] Second, because the mortgagor is taking subject to the pre-existing debt, he is not responsible for its repayment.[43] Third, the mortgagee may take advantage of a difference in interest rates between what he owes on his pre-existing debt and that which he receives on the wraparound mortgage.[44] It is because the mortgagor is not directly responsible for the prior

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41. *See* Mitchell v. Trustees of United States Mut. Real Estate Inv. Trust, 375 N.W.2d 424, 428 (Mich. Ct. App. 1985)(underlying debt stays in place and therefore wraparound note may be utilized). The mortgagee is only advancing the amount of the true debt, but he is receiving installments from the mortgagor based on the entire wraparound note. *Id.* The purpose of a wraparound deed of trust is to take advantage of the lower interest rates on prior debt; therefore, if a due on sale clause were allowed, wraparound notes would be nonexistent. 3 R. POWELL & P. ROHAN, POWELL ON REAL PROPERTY ¶ 475.7-.9 (1989); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(due on sale clause is avoided in wraparound deeds of trust).

42. *See Mitchell*, 375 N.W.2d at 428 (interest rate on prior indebtedness stays in place while lender finances note to mortgagor with interest rate between market rate and pre-existing note rate); *see also* R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 349 (1979)(pre-existing note already financed; therefore, interest rate set); Kennedy, *Wraparound Mortgages Considered In the Context of the Commissioner's Temporary Installment Sales Regulations*, 65 TAXES 530, 531 (1987)(pre-existing notes left alone and buyer only has to finance new money advanced to seller). *See generally* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(discussing advantages of wraparound mortgages).

43. *See* Western Fed. Sav. & Loan Ass'n v. Atkinson Fin. Corp., 747 S.W.2d 456, 459 (Tex. App.—Fort Worth 1988, no writ)(mortgagor's note wraps pre-existing debt without making mortgagor personally liable for pre-existing notes); *Greenland Vistas*, 746 S.W.2d at 925 (mortgagor not personally obligated for pre-existing debt); Lee v. O'Leary, 742 S.W.2d 28, 31 (Tex. App.—Amarillo 1987, writ granted)(party taking subject to did not assume prior encumbrances); *accord* J.M. Realty Inv. Corp. v. Stern, 296 So. 2d 588, 589 (Fla. Dist. Ct. App. 1974)(mortgagee obligated for balance of own note); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(mortgagor not personally liable for pre-existing debt); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985)(mortgagee responsible for own notes included in pre-existing debt).

44. *See* Greenland Vistas, Inc. v. Plantation Place Assocs., 746 S.W.2d at 925 (Tex. App.—Fort Worth 1988, writ denied)(mortgagee may keep difference between balance on true debt and balance on pre-existing debt); *accord J.M. Realty*, 296 So. 2d at 589 (mortgagee extinguishes pre-existing debt subsequent to receiving installments by mortgagor). Because the mortgagee receives the installments, any difference paid on the note due to the mortgagee and the underlying note due on the prior liens will be pocketed by the mortgagee because he is disbursing the money to his mortgagee. *See J.M. Realty*, 296 So. 2d at 589; *Mitchell*, 375 N.W.2d at 428 (mortgagor able to receive difference between pre-existing obligation and new obligation); *see also* R. LIFTON, PRACTICAL REAL ESTATE: LEGAL, TAX AND BUSINESS STRATEGIES 348 (1979)(mortgagee makes payments on pre-existing debt may keep difference between what is owed on notes and what is due him by mortgagor); Annotation, *Validity and*

indebtedness that the question arises at foreclosure as to what constitutes a surplus.[45] A surplus can be interpreted as: (1) any amount in excess of the amount due on the true debt, or (2) any amount paid for the property in excess of the outstanding balance of the wraparound debt.[46]

The purpose of the wraparound note and deed of trust instruments is to give effect to the intentions of the purchaser and wraparound noteholder.[47] Absent express agreement, implied covenants are used in real property law to further effectuate the intentions of the parties as reflected in the terms used in the written instruments.[48] An implied covenant is based on the sur-

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Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage, 36 A.L.R. 4th 144, 148 (1985)(mortgagee leverages investment by retaining difference between interest charged on pre-existing debt and interest charged on wraparound note).

45. *See* Consolidated Capital Special Trust v. Summers, 737 S.W.2d 327, 328 (Tex. App.—Houston [14th Dist.] 1987)(court calculated surplus in favor of mortgagor by using true debt analysis), *rev'd*, 32 Tex. Sup. Ct. J. 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990); *Lee*, 742 S.W.2d at 31 (determining balance owed on note); *accord J.M. Realty*, 296 So. 2d at 589 (determining whether mortgagor owes on full wrap note or just "true debt" portion of note); *see also* Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 150 (1985)(although mortgagor not personally responsible for wraparound note, foreclosure maintainable against whole amount). *See generally* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(discussing problems associated with bidding at foreclosure sales).

46. *See Consolidated*, 737 S.W.2d at 328 (court used true debt analysis); *Lee*, 742 S.W.2d at 31 (court applied true debt calculation); *see also* Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 150 (1985)(courts disagree on which method to apply). *See generally* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(discussing advantages and disadvantages associated with both methods of calculations).

47. *See* Houston First Am. Sav. v. Musick, 650 S.W.2d 764, 768 (Tex. 1983)(deed of trust must be strictly followed); Murchison v. Freeman, 127 S.W.2d 369, 372 (Tex. Civ. App.—El Paso 1939, writ ref'd)(deed of trust effectuates intentions of the parties and must be expressly observed); *accord In re* Sherman, 12 F. Supp. 297, 299 (W.D. Va. 1935)(trustee must follow deed of trust); *see also* C. JACOBUS, TEXAS REAL ESTATE LAW 247 (4th ed. 1985)(trustee must adhere to powers conferred in deed of trust); Howard, *Foreclosures-Nonjudicial Style*, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE K-10 (1983)(trustee must strictly follow deed of trust).

48. *See* Saccomanno v. Farb, 492 S.W.2d 709, 713 (Tex. Civ. App.—Waco 1973, writ ref'd n.r.e.)(reciprocal negative easement may be implied by language, surrounding circumstances, or conduct of parties); *see also* Fannin Inv. & Dev. Co. v. Neuhaus, 427 S.W.2d 82, 87 (Tex. Civ. App.—Houston [14th Dist.] 1968, no writ)(implied warranty may be determined by express words or language); *cf.* Empire Oil & Ref. Co. v. Hoyt, 112 F.2d 356, 360 (6th Cir. 1940)(implied covenant in oil and gas lease to use reasonable diligence in conducting operations); Waggoner Estate v. Sigler Oil Co., 118 Tex. 509, 512, 19 S.W.2d 27, 29 (1929)(implied obligation to continue development and production of oil and gas leases with due diligence).

rounding circumstances,[49] the document as a whole,[50] and the terms expressed in the written instrument.[51] Implied covenants will only be invoked when legally necessary, not simply to make the contract fair.[52]

In *Summers v. Consolidated Capital Special Trust*,[53] the Texas Supreme Court implied a covenant in a wraparound deed of trust, in absence of an express agreement,[54] requiring the trustee to satisfy the pre-existing debt before disbursing any proceeds to the defaulting mortgagor.[55] The court defined this method of proceeds distribution as the "outstanding balance," as opposed to the "true debt" method of calculation.[56] The court noted that if Consolidated had not defaulted, it would have paid the entire pre-existing debt plus the true debt by the end of the contract date.[57] Therefore, the mortgagor should not have received any proceeds until the prior notes were paid.[58] The court also reasoned that a party who defaults on an obligation

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See generally M. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 3 (2d ed. 1940)(implied covenant in oil and gas leases for lessee to maintain operation for benefit of both parties).

49. Danciger Oil & Ref. Co. of Texas v. Powell, 137 Tex. 484, 490, 154 S.W.2d 632, 635 (1941); *Saccomanno*, 492 S.W.2d at 713; *accord* Anderson v. Britt, 375 S.W.2d 258, 260 (Ky. 1964); Fidelity-Philadelphia Trust Co. v. Forster, 29 A.2d 496, 498 (Pa. 1943).

50. *Danciger*, 137 Tex. at 490, 154 S.W.2d at 635; *Saccomanno*, 492 S.W.2d at 713; *accord Anderson*, 375 S.W.2d at 260.

51. *See Saccomanno*, 492 S.W.2d at 713 (instrument may contain language exemplifying intentions of parties); *Fannin Inv.*, 427 S.W.2d at 87-88 (in determining implied warranties, consider actual words of conveyance such as "grant, sell, and convey"); Palm v. Mortgage Inv. Co., 229 S.W.2d 869, 873 (Tex. Civ. App.—El Paso, 1950, writ ref'd n.r.e.)(implied covenant based on intentions of contractual parties); *accord Anderson*, 375 S.W.2d at 260 (infer implied covenant from surrounding circumstances and agreement as a whole); Johnson v. Missouri-Kansas-Texas R.R., 216 S.W.2d 499, 502 (Mo. 1949)(infer implied covenant by intention of parties and words used).

52. *See* Grimes v. Walsh & Watts, Inc., 649 S.W.2d 724, 727 (Tex. App.—El Paso 1983, writ ref'd n.r.e.)(implied covenant invoked to effectuate intention of parties, not to make contract fair); *Saccomanno*, 492 S.W.2d at 713 (implied covenant must be absolutely necessary); *Palm*, 229 S.W.2d at 873 (must look at instrument as whole); *accord Anderson*, 375 S.W.2d at 261 (implied covenants will not be enforced simply to arrive at equitable result).

53. 32 Tex. Sup. Ct. J. 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990).

54. *Id.*

55. *Id.* at 473-74. The deed specifically stated, however, that the trustee shall pay all expenses associated with the sale first, then apply proceeds toward payment of the debt secured with all remaining proceeds to be distributed to the grantors. *Id.* at 473.

56. *Id.* at 475. In true debt analysis, the mortgagor is not personally liable for the pre-existing debt. *See id.* at 474. True debt analysis requires the trustee to apply the proceeds to the debt for which the mortgagor is personally liable and any surplus resulting from that application is due to the mortgagor. *See id.*

57. *Id.* at 474.

58. *See id.* (should not be more advantageous for party to default than to keep property).

should not be rewarded for its breach.[59]

Conversely, the dissent stated that the parties should adhere to the express terms of the contract, which only rendered the mortgagor liable for the true debt portion of the wraparound note.[60] The dissent also stated that the deed of trust should be strictly construed and should not be changed solely to meet equitable considerations.[61] The dissent further pointed out that the purchaser does not assume primary liability for the wrapped indebtedness because it is the seller who remains liable for his underlying senior debt.[62] Upon foreclosure, it is only the inferior liens which are extinguished; therefore, at foreclosure, the purchaser should construct their bid to account for the balance remaining on the senior lien.[63] Under this method, the intent of the parties would be followed as evidenced in the instrument by the words "subject to" and by the wraparound mortgagee's personal liability on the remaining debt.[64]

The court in *Summers* implied a covenant in every wraparound deed of trust, absent express provisions, requiring the trustee to pay off the underlying notes with the proceeds from the foreclosure sale before disbursing any proceeds to the grantor of the deed of trust.[65] The court reasoned that the implied covenant would facilitate the bidding process at the foreclosure sale.[66] Furthermore, the court stated that the covenant avoids rewarding a defaulting party and instead effectuates the actual intentions of the parties while producing an equitable result.[67] The implied covenant avoids award-

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59. *Id.* For Consolidated to receive proceeds from the foreclosure sale when it defaulted would mean it would receive profits for its breach. *Id.*

60. Summers v. Consolidated Capital Special Trust, 33 Tex. Sup. Ct. J. 283, 283 (Feb. 28, 199)(Mauzy, J., dissenting). The express terms of the contract should dictate. *Id.* The express terms stated that the trustee should apply the proceeds from the sale only to those debts which the mortgagor secured. 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). The mortgagor only took subject to the pre-existing notes; therefore, the part of the wraparound note that was secured, that which he personally owed to the mortgagee, was simply the true debt. *See id.*

61. 33 Tex. Sup. Ct. J. at 283 (Mauzy, J., dissenting).

62. *See* 32 Tex. Sup. Ct. J. at 474 (mortgagor not liable for underlying debt).

63. 33 Tex. Sup. Ct. J. at 284 (Mauzy, J., dissenting).

64. *See id.*

65. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 474-75 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). The mortgagor will only receive proceeds from a foreclosure sale if the amount bid at the foreclosure sale exceeds the balance of the wraparound note, including the balance of the underlying obligations. *See id.* at 475.

66. *See id.* at 474. (bidders at sale will know essence of bid).

67. *Id.* at 475. The wraparound note included the value of the underlying notes. *See id.* If the mortgagor had completed his obligation, the wraparound note would have been paid in its entirety; therefore, a breach of that obligation should not benefit the defaulting party. *See id.*

ing a windfall profit to the mortgagee because the covenant requires the *trustee* to extinguish the underlying debts.[68] However, the dissent argues that the majority decision directly contradicts the express language in the deed of the trust.[69] Further, the court's decision does not address the fact that the value of the property may have increased, but instead differentiates between a foreclosure sale and a regular sale.[70]

In *Summers*, the Texas Supreme Court implied a covenant, absent express provisions to the contrary, in every wraparound deed of trust.[71] This covenant requires the trustee to extinguish the pre-existing debt using the proceeds from a foreclosure sale before disbursing any proceeds to the grantor of the deed of trust.[72] Application of the implied covenant facilitates the bidding process at a foreclosure sale because a bidder will know he is bidding on all of the outstanding debt, not just the true debt.[73] For example, if a bidder determines that the true debt is equal to $50,000 and the pre-existing debt is equal to $50,000 for a total debt of $100,000 encumbering the property, he can bid up to $100,000 without creating a surplus.[74] Without this covenant, if the bidder purchases the property for any amount over the true

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68. *Id.*

69. *Id.* Implying a covenant that requires the trustee to pay the pre-existing debt before paying the mortgagor goes directly against the language in the deed of trust. *Id.* at 473.

70. *See id.* at 474.

71. *Id.*

72. *Id.* at 475; *see also* Quality Inns Int'l, Inc. v. Booth, Fish, Simpson, Harrison & Hall, 292 S.E.2d 755, 761 (N.C. Ct. App. 1982)(surplus in favor of grantor occurs only if bid exceeds total indebtedness).

73. *See* Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 474 (June 21, 1989)(bidder at foreclosure does not have to pay twice to obtain clear title), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). A bidder may now bid more than the true debt without fear of having to pay that amount twice to clear pre-existing debt. J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 10 (July 13, 1989)(available at St. Mary's University Law Library). The implied covenant relieves the fear of the bidder at the foreclosure sale because the trustee must apply all proceeds to entire debt before disbursing them to the mortgagor. *See id.* at 10-11. Additionally, because the trustee is applying the proceeds, the mortgagee is not able to pocket the difference between that which he owes on his underlying debt and that which is due to the pre-existing noteholders for which he is not personally liable. *See id.* at 9-10. *Contra* S. Weiner & C. Hudgins, *Update & Selected Problems in Commercial Real Estate Property Foreclosure*, in STATE BAR OF TEXAS EMERGING ISSUES IN REAL ESTATE LAW: FOR LAWYERS AND LEGAL ASSISTANTS E-15 (1988)(follow express terms of contract to determine what constitutes surplus).

74. *See Summers*, 32 Tex. Sup. Ct. J. at 473-75 (EVA could have bid up to $6,206,952 without creating a surplus); *see also Quality Inns*, 292 S.E.2d at 761 (N.C. Ct. App. 1982)(surplus did not result because bid did not exceed outstanding indebtedness). *But see* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(mortgagor should receive proceeds in excess of true debt); Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1054 (1988)(bid true debt or less to avoid surplus); Bentley, *The Wrap-around Mortgage: Analyzing*

debt, he is in essence forced to pay that excess to the defaulting party at the time of foreclosure and to the pre-existing noteholder when the note becomes due.[75]

The use of the implied covenant avoids rewarding a defaulting party, and effectuates the actual intentions of the parties to produce an equitable result by requiring the extinguishment of all indebtedness prior to the mortgagor's receipt of any surplus at foreclosure.[76] Even though the mortgagor took subject to the pre-existing debt, the value of that debt was included with the true debt in calculating the actual installments to be paid to his mortgagee.[77] For example, if the pre-existing debt was $50,000 and the true debt was $50,000, the total wraparound note would be $100,000.[78] Even though the mortgagor is not personally liable to the prior noteholders for the pre-existing notes or to his mortgagee for those specific notes,[79] he is responsible to

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and Documenting, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE X-60 (1986)(bid value of true debt as conservative measure).

75. *See Summers*, 32 Tex. Sup. Ct. J. at 474 (amount over true debt applied to pre-existing debt and bidder need not additionally pay mortgagor); *see also* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 10 (July 13, 1989)(available at St. Mary's University Law Library)(pay excess to pre-existing debt until proceeds exceed entire debt).

76. *See Summers*, 32 Tex. Sup. Ct. J. at 474 (obligated to pay entire wraparound note including value of prior notes); *see also* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 8 (July 13, 1989)(available at St. Mary's University Law Library)(extinguishing prior debt before disbursing proceeds to mortgagor prohibits mortgagor from improving position by defaulting). *But see* S. Weiner & C. Hudgins, *Update & Selected Problems in Commercial Real Property Foreclosure*, in STATE BAR OF TEXAS, EMERGING ISSUES IN REAL ESTATE LAW: FOR LAWYERS AND LEGAL ASSISTANTS E14-15 (1988)(actual intentions are expressed in deed of trust).

77. *See* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(wraparound mortgage is based upon entire wraparound note); C. JACOBUS, TEXAS REAL ESTATE LAW 265 (4th ed. 1985)(payments made subject to pre-existing debt); Annotation, *Validity and Effect of "Wraparound" Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985)(wraparound deed of trust payments include value of pre-existing debt).

78. *See* Greenland Vistas, Inc. v. Plantation Place Assocs., 746 S.W.2d 923, 924 (Tex. App.—Fort Worth 1988, writ denied)(wraparound consisted of prior notes and new money advanced); *see also* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(similar example given); C. JACOBUS, TEXAS REAL ESTATE LAW 266-67 (4th ed. 1985)(gives similar example); Annotation, *Validity and Effect of "Wraparound" Mortgages Whereby Purchaser Incorporates Into Agreed Payments to Grantor Latter's Obligation on Initial Mortgage*, 36 A.L.R. 4th 144, 147 (1985)(wraparound deeds of trust include value of pre-existing debt plus new money advanced).

79. *See Greenland Vistas*, 746 S.W.2d at 925; Lee v. O'Leary, 742 S.W.2d 28, 32 (Tex. App.—Amarillo 1987, writ granted); *see also* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(mortgagee obligated to prior seller for balance of his note); C. JACOBUS, TEXAS REAL ESTATE LAW 266 (4th ed. 1985)(purchaser taking "subject to" not promising to pay pre-existing debt).

his mortgagee for his wraparound payments (which include the value of those pre-existing notes).[80] Because the mortgagor is responsible for his wraparound notes, calculated to include the value of the underlying notes, it is equitable that the mortgagor should only receive money bid at a foreclosure sale when those underlying notes are extinguished.[81]

The implied covenant also protects the mortgagor because the mortgagor is entitled to receive all proceeds, if any, in excess of the outstanding indebtedness derived from the foreclosure sale.[82] Having a trustee apply the proceeds is safer than those proceeds being paid to the mortgagee to disburse because the mortgagee is not able to receive a windfall profit.[83] If for example a trustee was not appointed to apply the proceeds, then the mortgagee could retain the difference between that for which he is personally liable

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80. *See Lee*, 742 S.W.2d at 32; *see also* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(purchaser pays on entire wrapnote); C. JACOBUS, TEXAS REAL ESTATE LAW 267 (4th ed. 1985)(mortgagor to pay installments on entire wraparound note).

81. *See Greenland Vistas*, 746 S.W.2d at 925 (installments of wraparound note comprised of underlying obligations and new money advanced); *see also* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(installment payments calculated to include balance of underlying debt); C. JACOBUS, TEXAS REAL ESTATE LAW 267 (4th ed. 1985)(mortgagor pays installments based on entire wraparound note).

82. *See* Byers v. Brannon, 19 S.W. 1091, 1095 (Tex. 1892)(residue of proceeds belongs to owner); *accord* Dupee v. Rose, 37 P. 567, 568 (Utah 1894)(trustee applies proceeds to pre-existing debt and any surplus to grantor); *see also* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(surplus proceeds favor mortgagor after foreclosure sale); Comment, *Through the Looking Glass: Foreclosure by Sale as* De Facto *Strict Foreclosure—An Empirical Study of Mortgage Foreclosure and Subsequent Resale*, 70 CORNELL L. REV. 850, 863 (1985)(if surplus results, distribute first to junior lienholders thereafter surplus to mortgagor).

83. *See* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 9-10 (July 13, 1989)(available at St. Mary's University Law Library). The implied covenant imposes a duty upon trustee to extinguish the underlying debt; therefore, neither the mortgagee nor the mortgagor may receive excess until that pre-existing debt is absolved. *Id.* However, once that obligation is fulfilled, then mortgagor may receive a surplus. *Id. But see* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1052 (1988)(assumed that mortgagee would get windfall profit from outstanding balance method of calculation). Goren & Meyer's article assumed that the mortgagee would obtain the surplus at the foreclosure sale and distribute the proceeds himself; therefore, paying only the debts for which he is personally liable and thereby receiving a profit. *See id. See generally* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 9-10 (July 13, 1989). However, because the court in *Summers* implied a covenant imposing that duty upon the trustee, neither the mortgagor nor the mortgagee receives a windfall profit. *See id.* Because of the implied covenant, the bidder now has equal bargaining power with the mortgagee because the excess will not go to the mortgagee. *See id. But see* Becker & Bingham, *Current Issues in Foreclosures*, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE H35-36 (1987)(bid over true debt should be given to mortgagor).

(true debt of his own note) and that which he receives from the foreclosure sale thereby receiving a windfall profit.[84] However, if the mortgagor had fulfilled the contract and paid the wraparound note in its entirety, then the mortgagee would have only received the amount due by the contract.[85]

The court's decision implied a covenant which contravened the express provisions of the deed of trust.[86] The deed of trust specifically stated that the trustee was to apply the proceeds to the indebtedness secured "*hereby*."[87] The pre-existing notes were not secured by the mortgagor because the mortgagor only took the property subject to the pre-existing debt.[88] Furthermore, because the trustee was only authorized by the deed of trust to foreclose and discharge the fifth lien, not to pay off the underlying indebtedness as required by the majority decision, the deed of trust was not strictly construed.[89] Although the mortgagor was not personally liable for the pre-existing debt, it was, however, the intention of the parties for the mortgagor to fulfill the obligation of his wraparound note, which included the value of those pre-existing notes.[90] Therefore, although the decision contradicts the

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84. *See* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 9-10 (July 13, 1989)(available at St. Mary's University Law Library)(neither mortgagee nor mortgagor may receive excess until pre-existing debt is absolved because implied covenant imposes duty upon trustee to extinguish).

85. *See id.*

86. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). The deed of trust stated that the trustee was to apply the proceeds to the debt secured hereby and then to the mortgagor. *Id.* By implying a covenant requiring the trustee to pay the pre-existing debt before paying the mortgagor, the covenant was inapposite to the clause in the deed of trust. *See id.*; *see also* Houston First Am. Sav. v. Musick, 650 S.W.2d 764, 768 (Tex. 1983)(trustee must adhere to terms of deed of trust); Slaughter v. Qualls, 139 Tex. 340, 346, 162 S.W.2d 671, 675 (1942)(trustee must strictly follow terms in deed of trust); First Fed. Sav. & Loan Ass'n v. Sharp, 347 S.W.2d 337, 339 (Tex. Civ. App.—Dallas 1961)(trustee must construe deed of trust strictly), *aff'd*, 359 S.W.2d 902 (Tex. 1962). *See generally* C. JACOBUS, TEXAS REAL ESTATE LAW 247 (4th ed. 1985)(trustee power conferred in deed of trust); Howard, *Foreclosures-Nonjudicial Style*, in STATE BAR OF TEXAS, ADVANCED REAL ESTATE LAW COURSE K-10 (1983)(trustee must strictly follow deed of trust).

87. *Summers*, 32 Tex. Sup. Ct. J. at 473.

88. *See* Summers v. Consolidated Capital Special Trust, 33 Tex. Sup. Ct. J. 283, 284 (Feb. 28, 1990)(Mauzy, J., dissenting); *see also* Greenland Vistas, Inc. v. Plantation Place Assocs., 746 S.W.2d 923, 925 (Tex. App.—Fort Worth 1988, writ denied)(mortgagor not personally liable for pre-existing debt); Lee v. O'Leary, 742 S.W.2d 28, 32 (Tex. App.—Amarillo 1987, writ granted)(subsequent mortgagors not personally responsible for pre-existing debt); W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(mortgagee obligated to prior seller for balance of his note); C. JACOBUS, TEXAS REAL ESTATE LAW 266 (4th ed. 1985)(purchaser taking "subject to" not promising to pay pre-existing debt). Because the mortgagors took the property subject to the pre-existing debt, they did not secure or personally assume that debt. *See Summers*, 32 Tex. Sup. Ct. J. at 473.

89. *See Summers*, 33 Tex. Sup. Ct. J. at 284 (Mauzy, J., dissenting).

90. *See* C. JACOBUS, TEXAS REAL ESTATE LAW 267 (4th ed. 1985)(mortgagor obligated

language in the deed of trust, it fulfilled the true intentions of the parties by extinguishing the underlying obligations that formed the basis of the wraparound note as due by the mortgagor.[91]

The court has differentiated between property sold on the market and property sold at a foreclosure sale.[92] Taking the following example, a third party bids $70,000 at a foreclosure sale and takes subject to the prior indebtedness on a piece of property that has a total encumbrance of $100,000 ($50,000 represents the defaulting mortgagor's true debt).[93] By following the majority opinion, the foreclosing mortgagee would receive $50,000 as a credit against the true debt, and the remaining $20,000 would go toward extinguishing the pre-existing debt.[94] However, if the defaulting mortgagor

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to pay entire wraparound note); *see also* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 8-9 (July 13, 1989)(available at St. Mary's University Law Library)(mortgagor obligated to pay entire wraparound note that included value of pre-existing debt). *But see* Goren & Meyer, *Foreclosing the Wraparound Mortgage: Practical Considerations and the Emergence of Texas Case Law*, 51 TEX. B.J. 1051, 1051 (1988)(mortgagor not responsible for indebtedness evidenced by pre-existing debt).

91. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 473 (June 21, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). The deed required the trustee to pay the debt secured by the wraparound note and then pay excess to the mortgagor. *See id.*, 33 Tex. Sup. Ct. J. at 284 (Mauzy, J., dissenting)(express terms of deed only allowed trustee to foreclose upon fifth note included in wraparound note and not entire balance of wraparound note). By implying the covenant, the trustee is violating the deed of trust. *See* Chapa v. Herbster, 653 S.W.2d 594, 602 (Tex. App.—Tyler 1983, no writ)(strictly follow express terms in deed of trust); Lockwood v. Lisby, 476 S.W.2d 871, 875 (Tex. Civ. App.—Ft. Worth 1972, writ ref'd n.r.e.)(equity plays no part with a case at law).

92. *See Summers*, 32 Tex. Sup. Ct. J. at 475. At the foreclosure sale, EVA's bid resulted in a deficiency against Consolidated because the bid did not exceed the total debt encumbering the property. *Id.* However, had the sale occurred on the market, Consolidated would have received a profit as evidenced by the following example.

> If Purchaser 1's remaining balance on his note was in the amount of $40,000 and the purchase price was $60,000, Purchaser 2 could pay $10,000 down and execute the second lien deed of trust to Purchaser 1 in the amount of $50,000. In this manner it encompasses the $40,000 indebtedness as well as the $10,000 difference which he owes to Purchaser 1 as part of the purchase price of the property.

C. JACOBUS, TEXAS REAL ESTATE LAW 267 (4th ed. 1985). It is shown here that the seller is receiving proceeds before the underlying debt is extinguished, because that purchaser took subject to the pre-existing debt. *See id.*

93. *See* Quality Inns Int'l v. Booth, Fish, Simpson, Harrison & Hall, 292 S.E.2d 755, 761 (N.C. Ct. App. 1982)(court applied outstanding balance method in similar example). The bid at the foreclosure sale was $585,000 and the total outstanding debt was $601,600. *Id.* at 757. The court concluded that a surplus did not result because the bid was less than the outstanding balance of the entire debt encumbering the property. *See id.* at 761; *see also* W. BAGGETT, TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(explaining *Quality Inns* decision).

94. *See Quality Inns*, 292 S.W.2d at 761. The *Quality Inns* court applied the proceeds to the true debt and the remainder to the pre-existing debt. *See id. See generally* W. BAGGETT,

had instead sold the property, using the same scenario as above, the defaulting mortgagor would have received a profit of $20,000.[95] The $20,000 represents an increase in the value of the property; therefore, a surplus has resulted.[96] Should there be a difference to the mortgagor when a party purchases at a foreclosure sale as opposed to a regular sale? The majority decision indicates that such a difference is acceptable because it would be inequitable for a defaulting party to receive a reward for its breach.[97]

Even though the mortgagor is not personally liable for the prior indebtedness, the court held it is only equitable that, if the mortgagor defaults, he should not receive any proceeds until the pre-existing debt is extinguished. Because it is the intention of the parties at the time of contracting that the mortgagor completely pay the wraparound deed of trust note (which includes the value of the pre-existing debt) the mortgagor should not be absolved of that duty simply because he defaults. However, the court has gone against the express terms of the deed of trust by implying the covenant, thereby functioning as a court of equity instead of as a court of law. In addition, because any amount bid over the defaulting mortgagor's true debt is evidence that the value of the property has increased, the defaulting mortgagor is deprived of the surplus that he otherwise would have received had the property been sold instead of foreclosed upon. Due to the decision in this case, a surplus at a foreclosure sale involving a wraparound deed of trust will result only if the sale produces monies in excess of the outstanding balance of the wraparound note. To determine whether a surplus or a defi-

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TEXAS FORECLOSURE LAW & PRACTICE § 2.87C (Supp. 1988)(explaining *Quality Inns* decision). The author interpreted the court's decision to mean that a surplus did not result because the bid was less than the outstanding balance of the entire debt encumbering the property. *Id.*

95. The calculations are: $50,000 of the $70,000 towards payment of true debt (that for which selling mortgagor is personally liable); and buyer takes subject to the remaining $50,000 of pre-existing debt; selling party receives the remaining $20,000.

$70,000	payment by purchaser
($50,000)	pay off true debt of selling party
$20,000	remaining for seller

See C. JACOBUS, TEXAS REAL ESTATE LAW 267 (4th ed. 1985)(purchaser takes subject to pre-existing debt). The purchaser's note is larger than the note owed by the seller because of the additional obligation on the part of the purchaser for any excess (usually increase in value from time seller purchased to time sold). *See id.*

96. *See id.* (as evidenced in its example, the debt of seller was $40,000, and purchase price to buyer was $60,000; therefore increase in value of property).

97. Summers v. Consolidated Capital Special Trust, 32 Tex. Sup. Ct. J. 473, 474 (June 31, 1989), *dissenting opinion withdrawn and new dissent substituted*, 33 Tex. Sup. Ct. J. 283 (Feb. 28, 1990). *See* J. Stewart, *Wraparound Mortgage Foreclosures Revisited*, Presented to the San Antonio Real Estate Discussion Group 8 (July 13, 1989)(available at St. Mary's University Law Libary)(party should not be able to improve position by defaulting).

ciency exists at that time, the Texas Supreme Court has implemented the "outstanding balance" method of calculation.

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