Lee Burgess: Welcome to the Bar Exam Toolbox podcast. Today, we're talking about mortgages as part of our "Listen and Learn" series. Your Bar Exam Toolbox hosts are Alison Monahan and Lee Burgess, that's me. We're here to demystify the bar exam experience, so you can study effectively, stay sane, and hopefully pass and move on with your life. We're the co-creators of the Law School Toolbox, the Bar Exam Toolbox, and the career-related website CareerDicta. Alison also runs The Girl's Guide to Law School. If you enjoy the show, please leave a review on your favorite listening app, and check out our sister podcast, the Law School Toolbox podcast. If you have any questions, don't hesitate to reach out to us. You can reach us via the contact form on BarExamToolbox.com, and we'd love to hear from you. And with that, let's get started.

Lee Burgess: Welcome back! In this podcast, we're going to discuss one of the most feared topics on the bar exam: real property. Real property on the bar exam is typically divided into five different areas: one, ownership of real property; two, rights in real property; three, real estate contracts; four, titles; and five, mortgages and security devices. Real Property is tricky because it's heavily rule-intensive and, unlike in other topics like Evidence or Con Law, each of the five categories we just noted are tested equally on the MBE.

Lee Burgess: Today we're going to dive directly into the particularly tricky subtopic of mortgages and priorities. To fully understand our rules and how they operate, let's start with a hypothetical that we adapted from the February 2014 California bar. If you can, take notes on the following hypothetical as you listen, and also remember that you can read the hypo in the linked transcript on our website. Okay, here we go:

Lee Burgess: "Bob purchased a candy shop from Sally for $500,000. Bob gave Sally $50,000 in cash, as well as a promissory note for an additional $50,000 secured by a deed of trust. To pay the full half million dollars, Bob borrowed the other $400,000 from First Bank. First Bank promptly recorded its mortgage. Prior to closing escrow and making the loan, First Bank had been aware of Sally's promissory note and deed of trust.

Lee Burgess: Unfortunately, Bob's candy store collapsed after a neighbor let her retaining wall go. When Bob applied for a permit to rebuild his candy store, the town government refused the permit. Bob was unable to sell any candy, defaulted on his loans to both Sally and First Bank. First Bank has now filed a foreclosure suit against Bob. Sally has now demanded a proportionate share of the proceeds from any foreclosure sale. The jurisdiction is a notice jurisdiction. How is the court likely to rule on Sally's claim for a proportionate share of the proceeds from the foreclosure sale?"

Lee Burgess: To answer this question, we need to cover our rules regarding mortgages and priorities. By knowing and understanding these rules, we can figure out who has priority when a foreclosure happens. So, let's start with some basic terminology that you heard in the question. First, what's a promissory note? A promissory note is nothing more than a legal promise to repay money borrowed.

Lee Burgess: Second, what's a mortgage? A mortgage is a security interest in real property intended to be collateral for repayment of a loan. In terms of players here, the debtor is the mortgagor, and the lender is the mortgagee.

Lee Burgess: When it comes to mortgages, let's talk about a special type of mortgage: the purchase money mortgage. A purchase money mortgage – or PMM – is used by the borrower to purchase the real property to begin with, and the lender secures the mortgage on the property. PMMs are important because the holder has priority over, one, all claims and mortgages against the mortgagor prior to the purchase of the property; and two, all subsequent claims and mortgages unless they're defeated by a recording statute.

Lee Burgess: Finally, what's a deed of trust? A deed of trust, like a mortgage, is a security interest in real property that is intended to be collateral for repayment of a loan. Unlike a mortgage, the deed of trust involves three parties: the borrower, the lender, and a third-party trustee who holds title to the property until the loan is paid off.

Lee Burgess: Now that we've got our terminology down, let's talk about foreclosure. Mortgages and deeds of trust will operate similarly on foreclosure. Foreclosure occurs when a debtor fails to make the loan payments and ends up in default. At that point, the lender – the one who holds the security interest – can initiate public foreclosure proceedings.

Lee Burgess: As you noticed in our question, foreclosure can get complicated when we have multiple security interests on the same piece of real property. Because of that, we have specific rules that determine who has priority to get the proceeds from the sale of the real property during foreclosure. Priority is determined by two key things: first, whether the mortgage was a PMM – as we just discussed, and second, whether the mortgage was recorded and our jurisdiction's recording statute.

Lee Burgess: So, let's take note of what happens when we record and what happens when a subsequent lender takes a loan knowing there's already a mortgage, like here. Typically, the court is not going to protect the subsequent mortgagor lender when they already have notice of the prior interest. A bona fide purchaser – also known as a BFP – is a person (or entity, like the bank) who takes real property without notice and pays consideration.

Lee Burgess: Knowing this, we can look at the recording process in different jurisdictions. In a notice statute jurisdiction, a subsequent BFP will prevail over a prior grantee that failed to record. In a race statute jurisdiction, notice is irrelevant, and whoever records first will win. In a race-notice jurisdiction, we need a BFP – again, someone who took the real property without notice – but who also records first.

Lee Burgess: Finally, how is the money from a foreclosure distributed? Critically, foreclosure destroys what we call "junior mortgages" – those mortgages that were recorded after the mortgage being foreclosed on. Those mortgagees, if their junior mortgages are destroyed, become unsecured creditors. And when the junior interest initiates the foreclosure, the senior interest remains intact on the property. Upon foreclosure, the proceeds pay off debts first to the attorneys' fees and expenses related to the sale; next to the debts owed to the mortgagees (lenders); and, finally, any remaining amount left goes to the mortgagor (or borrower).

Lee Burgess: Now that we've got the terms down, let's take a look at how these priority rules apply to our hypo. First, do you have a purchase money mortgage? Remember, our PMM is the loan used by the borrower to purchase the property to begin with. Here, both our deed of trust from Sally and the mortgage from First Bank were used to purchase the property, so we actually have two PMMs. As a result, we need to look at the order in which Sally and First Bank recorded, and what type of jurisdiction we're in to determine who has the senior interest.

Lee Burgess: Here, we're in a notice jurisdiction. That means that, to have priority, our subsequent purchaser must take without notice. In looking at Sally's interest, her deed of trust was executed first, and although she didn't record, First Bank was aware of the deed of trust before it provided its mortgage. Because of this, First Bank isn't a BFP, and Sally does not have a junior interest to First Bank. In other words, First Bank's decision to file for foreclosure will not extinguish Sally's interest.

Lee Burgess: But Sally wants a proportionate share of the proceeds. As we noted, the mortgagee doesn't get a proportionate share of the proceeds; they'll simply receive the debt owed. So, Sally won't get a proportionate share, but she can get her $50,000 back.

Lee Burgess: Now, let's take a look at one more hypothetical, so we can review the rules we just learned again. This hypothetical is adapted from the [California bar exam from July 2002]:

Lee Burgess: "Claire bought Blueacre for $15,000 and recorded her deed. To make the purchase, Claire borrowed $10,000 from First Bank and gave First Bank a note secured by a deed of trust on Blueacre naming First Bank as beneficiary under the deed of trust. First Bank recorded its deed of trust.

Lee Burgess: After experiencing a leaky sink, Claire decided the kitchen at Blueacre needed an upgrade, and secured a $5,000 mortgage from Second Bank for the kitchen. Second Bank, never having completed a title search and unaware of First Bank's loan, recorded the mortgage. The jurisdiction is a race jurisdiction. Claire subsequently defaulted on both loans. A few months later, First Bank lawfully foreclosed on Blueacre. What rights does Second Bank have to proceeds from the foreclosure?"

Lee Burgess: To figure this out, remember that priority is determined by two key things: first, whether the mortgage was a purchase money mortgage; and two, when the mortgage was recorded and our jurisdiction's recording statute. PMMs are our all-powerful mortgages, and get priority. Do we have a PMM here? Yes, we do! The deed of trust secured by First Bank, which Claire used to purchase Blueacre, is a PMM.

Lee Burgess: The mortgage from Second Bank, on the other hand, is not a PMM. That money was simply used for a kitchen upgrade. Because it's a PMM, the only way it could be beat out is if it was defeated by another secured interest that followed the rules according to our jurisdiction's recording statute. Here, we're in a race jurisdiction, which doesn't present First Bank with any trouble, as First Bank had immediately recorded its deed of trust.

Lee Burgess: Now that we know First Bank has priority and is the senior interest, what happens to Second Bank when First Bank seeks foreclosure? First Bank's decision to foreclose extinguishes Second Bank's junior mortgage. As a result, Second Bank becomes an unsecured creditor, and would have to sue Claire instead of relying on the foreclosure dollars to receive any of its money back.

Lee Burgess: And with that, we're out of time! Hopefully you found these examples to be helpful reminders of how to tackle mortgages and priorities questions. If you're studying for the bar right now, I would definitely encourage you to practice these two California essay questions on your own, or you can use tools like our [Brainy Bar Bank] to look up California bar or UBE questions that also focus on mortgages, and more generally, real property. Also make sure you practice mortgages questions for the MBE.

Lee Burgess: I also want to take a second to remind you to check out our blog at BarExamToolbox.com, which is full of useful tips to help you prepare and stay sane as you study for the bar exam. You can also find information on our website about our courses, tools, and one-on-one tutoring programs to help you as you study for the UBE or California bar exam. If you enjoyed this episode of the Bar Exam Toolbox podcast, please take a moment to leave a review or rating on your favorite listening app. We'd really appreciate it. And be sure to subscribe so you don't miss anything. If you're in law school, you might also like to check out our popular Law School Toolbox podcast as well. If you have any questions or comments, please don't hesitate to reach out to myself or Alison at lee@barexamtoolbox.com or alison@barexamtoolbox.com. Or you can always contact us via our website contact form at BarExamToolbox.com. Thanks for listening, and we'll talk soon!

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