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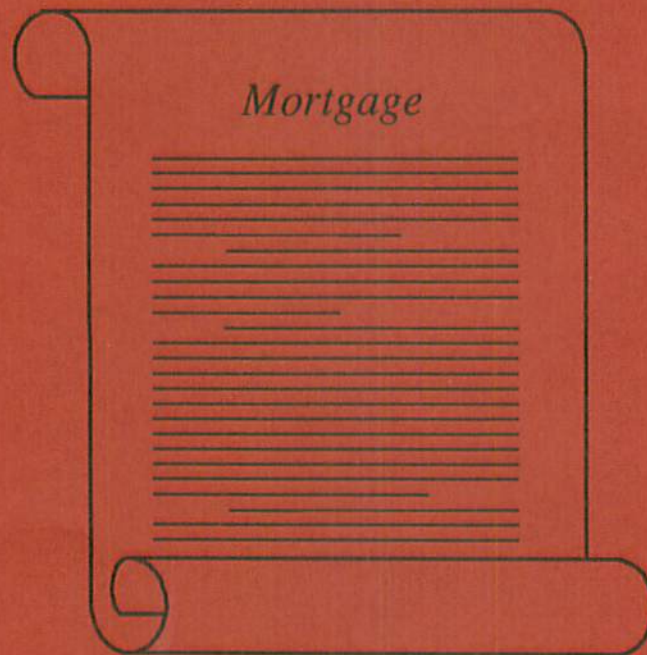
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# Legal Rights of Debtors and Creditors-- Enforcing Real Estate Mortgages

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## Joint Agricultural Law/Economics Research Report

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This publication is not intended to substitute for competent legal advice; instead, it provides general information to laypersons on real property mortgages. An attorney should be consulted if more detailed information is desired or needed.

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## Highlights

The agricultural industry for much of the 1980s has been characterized by financial stress among many farm operators. During this time, both debtors and creditors have arranged their business affairs to maximize the legal protection provided by law which includes judicial and legislative changes arising from this extended period of financial distress.

Creditors seeking to foreclose a real estate mortgage must closely follow state law as set forth in statute and by judicial decisions. Notice of intent to foreclose has to be provided 30 to 90 days before a creditor may initiate a foreclosure action. A creditor is required to foreclose by means of a court action unless it is a state agency and there is no disagreement as to the appropriateness of the foreclosure.

Debtors are protected by 1) limits on deficiency judgment, 2) a statutory redemption period which varies with the type of mortgage, and 3) statutes which exempt certain property from the reach of creditors. Recent cases have involved the confiscatory price defense which gives the court added discretion if the cost of production is greater than commodity prices.

Sellers on contracts for deed have several alternatives upon default by the purchaser. These include 1) statutory cancellation by notice, 2) cancellation by action, 3) action to foreclose, and 4) action to quiet title.

Creditors also must be aware of their rights and obligations if another creditor has a lien upon the same property of the debtor. In such cases, priority determines which creditor will have first claim against the collateral and which creditor bears the greater risk of nonpayment. Generally, the first to publicly record their mortgage without notice of prior liens will have priority, but exceptions are available for purchase money lenders as well as creditors who finance the acquisition and installation of fixtures.

All borrowers and lenders are impacted by credit laws even if every payment and obligation has been made on schedule. Although borrowers and lenders have broad discretion in setting the terms of their agreement, they must rely on the law to resolve questions they can not agree upon. Consequently, the likely outcome of litigation sets the parameters for negotiating a credit arrangement. Farm borrowers and their creditors, therefore, must be aware of applicable statutes and judicial decisions, and understand their impact upon the parties' negotiations.

LEGAL RIGHTS OF DEBTORS AND CREDITORS  
--ENFORCING REAL ESTATE MORTGAGES

Jeff Rotering, David M. Saxowsky, and Owen L. Anderson\*

Financial stress and high delinquency rates among many farmers have characterized the agriculture industry for much of the 1980s. Although no one factor can be identified as the cause of the financial difficulty, poor management techniques, low commodity prices, escalating costs, large debt obligations, high market interest rates, low real interest rates, optimism during the 1970s as to future prices, overproduction, and technology that expands output often are indicated as reasons for the current situation. A consequence is that numerous farm and ranch operations of all sizes and types have been reorganized or liquidated.

A farm business seldom is reorganized or liquidated when the borrower first recognizes an inadequate cash inflow for the operation. More frequently there is a default in repayment, followed by legal posturing by the creditor and borrower, culminating in either litigation or negotiation. Final resolution of the delinquent loan will depend upon the legal rights and obligations of both parties and their negotiating skills.

The bargaining position of an indebted farmer or an unpaid creditor (although it may not be readily apparent) directly reflects their legal rights. A relationship between a party's negotiating position and their legal rights arises because the alternative to negotiating is to litigate. Neither a lender nor a borrower is likely to accept a negotiated settlement unless the agreement places them in a position equal to or better than they would reach through litigation. Accordingly, an understanding of the legal rights of each person involved in the matter is necessary for the parties to quickly and inexpensively resolve their differences in a businesslike manner by negotiating. Such an understanding is important not only when the borrower is delinquent but also when the parties are initiating or amending their agreement. Therefore, it is critical that all borrowers and lenders understand their respective legal rights.

The law provides a balance between the right of a creditor to sell encumbered property and a debtor's right to retain certain property as well as defend against a creditor's action to possess or have the property sold. Legal rights of debtors and creditors depend upon 1) whether the debt is secured or unsecured, and 2) if the debt is secured, the type of property that serves as collateral. This publication examines the legal remedies for creditors and debtors upon the default of an obligation that is voluntarily secured by real property. Two legal proceedings that fit within this general category are 1) foreclosure of a real estate mortgage and 2) cancellation of a contract for deed. This report does not address

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involuntary liens (also referred to as statutory liens\*), debts that are secured by personal property, collection actions taken by Farmer's Home Administration under federal law, and the Agricultural Credit Act of 1987.\*\*

The first part of this report summarizes the events that lead to and comprise a foreclosure action. The following sections provide detailed explanations of these major foreclosure topics. Cancelling a contract for deed, priority conflicts among creditors, and negotiating a settlement are the last subjects to be addressed. A glossary of terms used throughout this publication has been included as an appendix.

This report is designed to provide general information about real property liens; it is not intended to serve as a substitute for competent legal advice. An attorney should be consulted if more detailed information is needed or if a legal proceeding has been instituted.

### Overview of a Real Estate Mortgage Foreclosure

The business relation between a borrower and credit institution begins when the borrower applies for and the lender agrees to make a loan. Creditors generally require that the borrower promise to repay the debt by executing a loan agreement (a *note*) and provide collateral for the loan in the form of a lien (*mortgage*) upon property owned by the borrower.

A real estate mortgage is *recorded* at the county register of deeds so any person can determine whether someone other than the owner has a legal interest in the land. Failure to repay the debt as promised in the note usually entitles the creditor 1) to sue the debtor for failing to abide by the promise or 2) to use the mortgaged land to satisfy the loan obligation. North Dakota law requires creditors to first enforce the land mortgage and to follow specific procedures for protection of the borrower. The procedure by which a mortgage is enforced is called foreclosure. There are various types of foreclosure; North Dakota permits *foreclosure by advertisement* and *foreclosure by action* but prohibits strict foreclosure. Each type of foreclosure is explained in subsequent sections.

Foreclosure, in North Dakota, involves selling the mortgaged land at a public auction. Proceeds from the sale are used to pay the sale's costs and repay the delinquent loan that led to the foreclosure. Any remaining proceeds are disbursed by the court to the debtor or other creditors holding a lien upon the land. Debtors also are granted a *statutory right of*

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\* North Dakota statutory liens relating to agriculture as they existed prior to the 1987 Legislature are discussed in Agricultural Economics Miscellaneous Report No. 101. A single copy is available free of charge from the Department of Agricultural Economics, North Dakota State University, Fargo.

\*\* A general description of the Agricultural Credit Act of 1987 is presented in Agricultural Economics Report No. 235. A single copy is available free of charge from the Department of Agricultural Economics, North Dakota State University, Fargo.

*redemption* which permits them to reacquire ownership of foreclosed property by paying the amount that was bid at the sale regardless of who was the successful bidder.

A foreclosing creditor is permitted to seek payment of the remaining obligation from the debtor if the sale proceeds are insufficient to pay selling costs and the foreclosed debt. The court proceeding for seeking an additional payment is referred to as a *deficiency judgment* and could be viewed as a lawsuit to enforce the note. This judgment will be paid from remaining assets owned by the debtor that are not *exempt* from the claims of creditors. Exempt assets are properties, defined by state law, as not available to a creditor seeking to satisfy a debt.

Each legal concept mentioned above is explained in detail, beginning with an explanation of a mortgage.

### Note and Mortgage

A loan agreement or note is a contract wherein the borrower promises to repay a loan at the times and in the amounts agreed to by the lender and borrower. In addition to this promise, lenders usually require borrowers to transfer to the creditor, a legal interest in property the borrower owns. This property interest helps secure repayment of the debt (should the borrower default) by giving the lienholding creditor a legal right to seize the borrower's property or have it sold to repay the debt. A lien generally refers to a property interest that secures payment of an obligation.

A voluntary lien results from an explicit understanding or agreement between the debtor and creditor.\* In such cases, the debtor not only agrees to repay the debt but also transfers a lien to the creditor in exchange for the loan or other credit. Borrowers may voluntarily grant a lien upon personal or real property. A voluntary lien that encumbers the debtor's land and other real property is a mortgage. This report addresses only real property mortgages.

North Dakota follows the lien theory of mortgages.<sup>1</sup> This theory allows the debtor to retain possession and ownership of the land while the creditor only has a right to take the property in the event of default.

In anticipation of a mortgage, many notes require that the borrower maintain the property that serves as security. Purchasing property

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\* An involuntary or statutory lien, by comparison, arises without the consent of the borrower. Instead, state statutes describe certain transactions which automatically give the creditor an involuntary lien, the property to be encumbered, and how the lien is made a matter of public record. As long as the statutory requirements are met, an involuntary lien will arise even if the borrower disapproves. In general, the purpose of statutory liens is to encourage merchants to sell products and services on credit and thereby improve the availability of financing. Consequently, most statutory liens encumber property that was sold or improved as a result of the credit transaction.



insurance, paying real estate taxes, and repairing improvements are only a few examples of additional obligations expected of borrowers who offer a land mortgage to secure debt. Failure to fulfill any of these obligations is a default upon the loan, similar to missing a scheduled payment.

A mortgage which transfers a legal right in real estate must comply with many of the requirements of any land transaction. For example, a real estate mortgage can be created, extended or renewed only in writing.<sup>2</sup> The written document has to be validated with the same formalities as when real estate is sold.<sup>3</sup> Mortgages may be, and usually are, acknowledged and recorded with the register of deeds.<sup>4</sup> State law requires that a mortgage not be recorded by the register of deeds unless it contains the post office address of the mortgagee (creditor) and a complete description of the secured debt including the principal amount, interest rate, and the time and place repayment is due.<sup>5</sup> Once recorded, this information allows any person who checks the public record to learn the identity of the mortgagee and the basic terms of the mortgage.

State law does not limit the type of obligation that may be secured by a real estate mortgage. Frequently, mortgages arise from the purchase of land, but a mortgage may secure a cash loan wherein the proceeds are used for a purpose unrelated to acquiring real estate. For example, a land mortgage may secure repayment of a loan used to purchase farm equipment. Another type of mortgage is the collateral real estate mortgage which secures a line of credit or other lending arrangement (such as a farm operating loan) wherein the amount owed will vary over time.<sup>6</sup> Collateral real estate mortgages are explained more fully in a subsequent section on priorities; however, the legal procedure for enforcing a real estate mortgage is the same regardless of how the loan proceeds are used.

A mortgage may encumber any transferrable interest in real estate,<sup>7</sup> including mineral rights, surface ownership of the land, or partial ownership interests such as a one-half undivided share. A debtor intending to grant the creditor a mortgage upon only the surface rights must include language in the mortgage reserving the mineral interest. This language would be similar to that required of a land seller desiring to retain ownership of the mineral estate.<sup>8</sup> Absent such language, a mortgage encumbers both the surface rights and the debtor's mineral interest in the real estate.

Upon repayment of the loan, a debtor is entitled to have the creditor file with the register of deeds a certificate of discharge or satisfaction of mortgage.<sup>9</sup> By comparison, should a debtor default, the creditor is entitled to liquidate the land which secures the obligation. Foreclosure may follow a loan default even though lenders and borrowers often attempt to avoid litigation and a forced sale by negotiating a work-out agreement, debt adjustment, or additional assurances.

#### Enforcement After Default

Repayment of a note secured by a real estate mortgage usually involves a series of payments that may extend over a number of years. In the event that the debtor misses a payment or otherwise defaults upon the

obligation, most notes or loan agreements permit the creditor to accelerate the debt; that is, the full amount owed will be considered immediately due. Creditors generally provide notice to a delinquent borrower that the debt will be accelerated unless the missed payments are paid. After a debt has been accelerated, the creditor may proceed to collect the full amount of the debt; not just the missed payment.

Creditors generally have more than one alternative for seeking payment from a delinquent borrower. Recall that a borrower, by signing a note, is entering into a contract to repay the obligation. Granting a mortgage, by comparison, is not an agreement to pay the debt. A mortgage transfers an interest in property of the debtor to the creditor to serve as security or collateral for the loan. Upon default by the borrower, a creditor may sue on the note for breach of contract (for example, failure to fulfill the promise to repay) or proceed to enforce (foreclose) the mortgage.

North Dakota law does not provide creditors with both alternatives in all cases. First, a creditor is not permitted to proceed against a delinquent borrower under both alternatives at the same time.<sup>10</sup> Second, the present deficiency judgment law (which is explained in a later section) has been interpreted by the Supreme Court as limiting creditors to foreclosing the mortgage rather than suing the debtor on the note;<sup>11</sup> however, the court has permitted a creditor to sue non-mortgagor debtors on the note.<sup>12</sup> An example of non-mortgagor debtors would be parents who co-sign a note with their adult child wherein the child is the mortgagor and primary borrower. In such a case, the creditor may sue the parents on the note but may only foreclose against the child's mortgaged property. This publication addresses foreclosure but does not explain the procedure for suing upon a note.

### Foreclosure

Historically, creditors were permitted to take possession of property which secured a delinquent debt. This practice, however, frequently caused the debtor to be treated unfairly. A debtor who had paid almost the total debt but failed to complete one of the last payments would have the entire tract of land seized by the creditor. The value of the land usually exceeded the amount still owed in such a situation, but the debtor had no means of retaining the equity in the land.

Courts attempted to ease this situation by granting the debtor a period of time after the default during which payment could be completed. This privilege is known as the *equity of redemption*. Uncertainty surrounded the length of time during which the debtor could correct the default, so legislatures permitted *foreclosure*; a legal proceeding wherein the creditor terminated the debtor's equity of redemption.

Early foreclosure actions (also called *strict foreclosure*) terminated a debtor's equity of redemption without assuring a debtor would receive the equity in the land. Legislatures (including North Dakota) again responded by limiting strict foreclosure and requiring the creditor to sell the mortgaged land, pay the cost of the sale, retain the amount needed to

fulfill the debt, and remit any remaining proceeds to the court for distribution.<sup>13</sup> With this practice, debtors theoretically receive the benefit of their equity in the land.

### Notice of Intent to Foreclose

An initial step to a foreclosure proceeding in North Dakota is for the creditor to provide Notice of Intent to Foreclose.<sup>14</sup> Written notice of a creditor's intent needs to be served on the record title holder of the mortgage property at least 30 days but no longer than 90 days before commencing any foreclosure proceeding. The notice must contain 1) a description of the real estate; 2) the date and amount of the mortgage; 3) a list itemizing the amount due for principal, interest, and taxes paid by the mortgagee; and 4) a statement that foreclosure proceedings will be commenced if the amount due is not paid within 30 days.\*

A debtor who pays the amount due within 30 days of the notice cures the default and forces the creditor to reinstate the mortgage as if no default had occurred.<sup>15</sup> The opportunity for a debtor to reinstate a mortgage is based on a rationale similar to the principal of equity of redemption mentioned above. A creditor is allowed to proceed with foreclosure if the debtor does not correct the default as specified in the Notice of Intent to Foreclose. North Dakota law permits two types of foreclosure; by advertisement and by action.

### Foreclosure by Advertisement

Foreclosure by advertisement is a legal "short cut" for enforcing a mortgage.<sup>16</sup> It includes 1) serving notice of intent to foreclose upon the record title owner of the property; 2) publishing notice of foreclosure in the county newspaper once each week for six weeks; and 3) an auction of the mortgaged property at the front door of the county courthouse.<sup>17</sup>

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\* The 1987 Legislature enacted two temporary provisions which affect the Notice of Intent to Foreclose. One provision requires the creditor to include, with the notice, information about state sponsored programs designed to assist financially distressed farmers. (See Act of April 4, 1987, Ch. 196, 1987 N.D. Sess. Laws 490; also see N.D.C.C. §35-22-03.) A list of such programs, as compiled by the Commissioner of Agriculture, has to be part of such information. This additional requirement does not apply to creditors who are individuals or farm corporations and will expire June 30, 1991.

The second temporary provision requires that the creditor notify the debtor that a foreclosure action is likely and that it may involve the debtor's homestead. Details of this notice are explained in the section on *Exempt Property*. This provision is effective until June 30, 1989. (See Act of April 1, 1987, Ch. 194, 1987 N.D. Sess. Laws 483; also see N.D.C.C. §35-22-03.)

Foreclosure by advertisement is limited in two important aspects. First, it is allowed only if the mortgage is held by the state or one of its agencies or departments.<sup>18</sup> The Bank of North Dakota, therefore, is the primary user of foreclosure by advertisement. All other mortgages must be enforced by action.

Second, state-held mortgages may be foreclosed by advertisement only if there is no question as to the appropriateness of the action. The mortgage must be foreclosed by action if the debtor alleges facts which, if proven, could prevent the state agency from obtaining everything it sought in the lawsuit.<sup>19</sup> For example, assume that the Bank of North Dakota commences a foreclosure by advertisement and serves the delinquent borrower with Notice of Intent to Foreclose. The debtor has 30 days to file an affidavit with the district court alleging a claim against the creditors or a defense to the foreclosure (that is, a reason why the creditor should not be allowed to foreclose).<sup>20</sup> Several defenses are explained in a subsequent section.

The court will issue an injunction preventing the creditor from continuing with the foreclosure by advertisement if satisfied that the affidavit states a defense or claim.<sup>21</sup> The creditor must then proceed to foreclose by action wherein the court will rule on the validity of the debtor's defenses.

A debtor who fails to file an affidavit within 30 days of the Notice of Intent to Foreclose may still seek an injunction;<sup>22</sup> however, a hearing must be held to determine whether the foreclosure by advertisement should be stopped. In contrast, a hearing is not required if the affidavit is filed within the 30 day period.

### Foreclosure by Action

Foreclosure by action is the only means of enforcing a mortgage available to private lenders such as banks, insurance companies, savings and loans associations, or Farm Credit Services. It also is the legal proceeding by which the state must foreclose if the debtor raises a defense or a claim against the creditor. Foreclosure by action involves a court proceeding brought and heard in a North Dakota District Court.

After the Notice of Intent to Foreclose, a foreclosure by action involves serving a summons and complaint upon each defendant in the case. Defendants in a foreclosure action include not only the mortgagor but also all persons having a subordinate lien on or other subordinate interest in the property. These additional persons are included in the lawsuit because a foreclosure will change the ownership of the land and thereby alter each person's legal interest in the property. Each person whose interest in the property will be affected must be part of the lawsuit to assure that no one's legal rights are adversely altered without an opportunity to be heard. A guarantor of the debt who has no interest in the mortgaged property need not be included as a defendant in a foreclosure proceeding.<sup>23</sup>

Service on defendants in possession of the property may be completed in person or by mail.<sup>24</sup> Other defendants can be served by mail, publication, or in person.<sup>25</sup> Service by publication must be followed by mailing copies of the summons and complaint to defendants whose addresses are known to the creditor.<sup>26</sup>

The plaintiff/creditor (mortgagee) will state in the complaint that the debtor is obligated to repay a loan and comply with others terms in the note, but has failed to do so. North Dakota law also requires that the creditor indicate in the complaint whether a deficiency judgment will be sought if the proceeds from the sale of the land are inadequate to repay the entire debt.<sup>27</sup> Deficiency judgments and their limited availability in North Dakota are explained in a subsequent section.

A debtor has several alternatives upon receipt of the summons and complaint. A debtor may do nothing in which case the creditor will most likely obtain a *default judgment* allowing foreclosure. An alternative would be to pay the amount of delinquent principal and interest plus costs, if possible. This payment would cause the court to dismiss the foreclosure action and reinstate the loan agreement.<sup>28</sup> A debtor is obligated to pay the full amount of the mortgage to have the suit dismissed if the creditor has accelerated the obligation.<sup>29</sup> Another option for the debtor is to file an *answer*.

A debtor has 20 days after receiving the complaint to file an answer with the court.<sup>30</sup> The answer contains the debtor's response to the creditor's allegations. Like an affidavit to defeat a foreclosure by advertisement, an answer will state the debtor's defenses to the foreclosure or claims against the creditor. A disagreement as to 1) the amount owed, 2) whether there has been a default, or 3) whether the debtor has a legal defense explaining why the payment is not due at this time are some issues that may be presented in the answer. The debtor also must admit in the answer which of the creditor's factual allegations are true.

Soon after an answer has been filed by the debtor, a common practice is for the creditor to file a motion for *summary judgment*. This motion requests that the judge enter a decision in the creditor's favor without a trial. A summary judgment will be granted after a hearing on the motion and a finding that "there is no genuine issue as to any material fact."<sup>31</sup> Generally, summary judgments are granted in foreclosure actions because there is no question as to the debtor's obligation and that it was not fulfilled. However, a summary judgment will not be granted if the debtor's answer asserts a defense that raises a question about an important fact.

### Defenses

A defense is a legal reason why the creditor should not be permitted to complete the foreclosure. An example of a defense to a foreclosure would be that the loan is not in default because the payment has been made, but the creditor failed to record the payment. In such a case, the debtor would have to substantiate the defense by proving that the payment had been made. Either a cancelled check or a receipt from the creditor would likely be adequate.

Another defense that a debtor may raise would be that no payment is due at this time so there could be no default. In such a case, the parties are admitting that there is a disagreement over terms of the loan. Most loan agreements clearly set forth when payments are due, thereby eliminating most uncertainty as to due dates and availability of this defense.

A creditor's failure to act in a timely manner also may constitute a defense. An action to foreclose a real estate mortgage must be commenced within 10 years after the default.<sup>32</sup> Likewise, a mortgage expires 10 years after the last payment is due; or 10 years after the mortgage is filed, if the due date of the last payment can not be determined from the mortgage.<sup>33</sup>

A more common defense is that the parties have, by their dealings, implicitly changed (or modified) the terms of the loan agreement.<sup>34</sup> For example, a creditor may initiate foreclosure after a payment has not been made. However, the debtor may argue that the creditor has accepted late payments in the past and should accept a late payment again rather than accelerate the loan and foreclose the mortgage. As a result, creditors often include a provision in the loan agreement that acceptance of a late payment does not prohibit them from enforcing the mortgage if there is a subsequent default. A similar argument is that the creditor, through its actions, has become so involved in the operation of the debtor's business and its management decision, that the arrangement is now a partnership rather than a debtor/creditor relation.<sup>35</sup> The idea is that the lender should share the business' loss rather than be paid in full. Other legal theories for imposing liability upon the lender include breach of a fiduciary responsibility, fraud, and breach of contract.

A defense that has arisen during the past several years addresses whether the creditor has taken all steps requisite to foreclosing. For example, some cases raise the issue of whether Farm Credit Services has followed its internal rules and regulations in dealing with a delinquent borrower before initiating foreclosure.<sup>36</sup> Borrowers also rely on rights and procedures set forth in federal legislation, such as the Agricultural Credit Act of 1987.<sup>37</sup> Consequently, debtors rely not only upon state statutes for protection from creditors but also Federal law and the creditor's own established rules and procedures.

One statutory defense that has received considerable attention during the past several years is the "confiscatory price law."<sup>38</sup> This statute was enacted in 1933 but was seldom used until 1984. Since then, the statute has been frequently interposed by delinquent borrowers as a defense to mortgage foreclosure.<sup>39</sup>

#### Confiscatory Price Law

The confiscatory price statutes grant North Dakota courts additional authority to delay legal proceedings when the price of agricultural commodities is below the cost of production, or when the debtor will lose equity in the property as the result of foreclosure.<sup>40</sup> The decision to delay the court action is in the discretion of the judge and is to be exercised in the "best interest of the litigants" or when "advisable and just."<sup>41</sup>

The mere attempt by a debtor to invoke the confiscatory price defense will generally delay a foreclosure proceeding. The North Dakota Supreme Court has determined that a mortgagee foreclosing by advertisement must proceed by action if the mortgagor asserts the confiscatory price defense.<sup>42</sup> Likewise, a debtor asserting the defense is entitled to a full trial on its merit; that is, a summary judgment is not available after the debtor raises the confiscatory price law.<sup>43</sup> The North Dakota Supreme Court has stated that the confiscatory price defense is not an absolute defense;<sup>44</sup> it does not reduce nor eliminate a debt, but it does postpone the collection process.

Creditors have presented a variety of arguments in attempting to overcome the confiscatory price defense but no argument has yet convinced the North Dakota Supreme Court that the statutes are ineffectual. Creditors have argued that the confiscatory price statutes self-repealed when the economic conditions of the 1930s improved. The Supreme Court has held, however, that the statutes remain in effect and are available whenever the specified economic conditions occur.<sup>45</sup>

Creditors also have argued that the confiscatory price statutes are preempted by federal law, and therefore, inapplicable to mortgages held by Farm Credit Services. The North Dakota Supreme Court has ruled to the contrary based on a finding that Congress intended state law to govern foreclosure of mortgages held by Federal Land Bank and Production Credit Association.<sup>46</sup>

The confiscatory price defense was designed to protect the farmer-landowner but the North Dakota Supreme Court has held that invocation of the defense is not dependent on a debtor actually possessing agricultural commodities.<sup>47</sup> Similarly, the defaulting debtor need not be farming the land that is subject to foreclosure to assert the defense.<sup>48</sup>

Creditors have argued that the confiscatory price law is unconstitutional due to vagueness, impairment of contract, and taking of property without due process. The North Dakota Supreme Court has not yet directly addressed these issues. Instead, it is awaiting a complete record of relevant facts and reasoning to be developed by a trial court before determining the constitutionality of the confiscatory price statutes.<sup>49</sup> At least four of the five justices of the North Dakota Supreme court must agree to declare a statute unconstitutional.<sup>50</sup>

Several questions remained unresolved by the statute. First, there is uncertainty as to what conditions must be met for the law to be triggered. For example, application of the law is complicated by issues such as determining the cost of production and the price of farm products. A second question is what may be required of a debtor during the period of delayed repayment. Certainly interest on the debt will continue to accrue, but the law does not clarify whether interest or some other payment will be required during that time.

Despite the defenses available to debtors, a court will grant judgment in favor of the creditor if the merits of the case so warrant. The next section explains the steps which follow a court decision to proceed with foreclosure.

### Enforcing the Judgment

A court decision in favor of the creditor will be followed by a judgment ordering the debtor to pay the judgment amount; that is, the amount owed to the creditor plus cost of the foreclosure proceeding.<sup>51</sup> This judgment is likely to be accompanied by an order for the mortgaged land to be sold, if the court determines that to be most beneficial to the parties.<sup>52</sup> The judgment also may order that possession of the property transfer to the purchaser at end of the redemption period (usually one year after the foreclosure sale).<sup>53</sup>

A court ordered sale of real estate involves the judge issuing a writ of execution instructing the sheriff to levy upon property of the debtor and conduct a sale.<sup>54</sup> The writ of execution cannot be issued by the judge until 10 days have passed since entry of the judgment.<sup>55</sup> A sheriff levies upon real property by filing a notice with the register of deeds in the county where the land is located.<sup>56</sup>

The property is sold at public auction by the sheriff after the sale has been advertised once a week for three weeks, with the last publication at least 10 days before the sale.<sup>57</sup> Notice is to be provided by posting the advertisement at the courthouse and five other public places in the county in the rare case that no newspaper is published in the county.<sup>58</sup> The auction will be at the courthouse in the county where the land is located.<sup>59</sup> Anyone may bid at the sale, including the debtor and creditor.<sup>60</sup> The property will be sold to the highest bidder who will receive a sheriff's certificate of sale.<sup>61</sup> This certificate is to be recorded with the register of deeds.<sup>62</sup>

The sheriff returns the writ of execution by informing the court of steps taken to levy upon and sell property of the debtor.<sup>63</sup> The selling price also is reported. The court reviews the sheriff's actions and, if satisfied that the proceeding conforms to the law, will confirm the sale.<sup>64</sup> Proceeds from the sale are retained by the sheriff until confirmation of the sale.<sup>65</sup> Upon confirmation, the proceeds will be used to pay selling costs and judgment amount; any remaining proceeds are disbursed according to an order of the court.<sup>66</sup> A debtor remains liable for the amount of the shortfall or *deficiency* if the proceeds are insufficient to pay both costs and the judgment. Deficiency judgments are explained in the next section.

Several statutory provisions offer some protection for the debtor. First, the foreclosure proceeding will be postponed (even after the judgment has been issued) if the debtor pays the principal, interest, and legal costs before the foreclosure sale.<sup>67</sup> However, a subsequent default by the debtor allows the court to reinstate the original judgment.<sup>68</sup> Second, the foreclosed property must be sold in separate parcels if the land consists of several known lots or parcels.<sup>69</sup> The debtor may direct the order in which the parcels are sold.<sup>70</sup> No more parcels will be sold once the proceeds are sufficient to pay all costs of the foreclosure plus the judgment amount.<sup>71</sup> Third, redemption statutes allow the debtor to temporarily retain possession of the property even though it has been sold.<sup>72</sup> *Right of redemption* is discussed after deficiency judgments.



### Deficiency Judgment

A borrower remains liable for the amount of debt that is not satisfied with proceeds from the foreclosure sale. For example, a bank enforces a mortgage securing a loan of \$100,000. Proceeds from the sale of the mortgaged property are sufficient to pay the cost of the sale, unpaid interest, and \$80,000 of the loan. The \$20,000 shortfall (or deficiency) remains an obligation of the debtor to the creditor. To collect the deficiency, the creditor has to obtain a second judgment from the court ordering the debtor to pay the unpaid balance.<sup>73</sup> This second judgment is known as a *deficiency judgment* and will be satisfied by selling other non-exempt property belonging to the debtor.

The 1933 North Dakota Legislature enacted a statute limiting the availability of deficiency judgments.<sup>74</sup> The original intent of the legislation was to permit creditors to recover only the value of collateral. The North Dakota Supreme Court, however, interpreted the statute to allow for deficiency judgments in some situations.<sup>75</sup> The 1937 Legislature responded by amending the statute and declaring its intention that:

no deficiency judgments [be] rendered upon notes, mortgages, or contracts given to secure the payment of money loaned upon real estate or given to secure the purchase price of real estate.<sup>76</sup>

Consequently, Federal Land Bank refused to provide loans secured by real estate.

The 1951 Legislature again amended the law but this time to permit a deficiency judgment following a real estate mortgage foreclosure only if a specified procedure was followed.<sup>77</sup> This change was sufficient to induce Federal Land Bank and other lenders back into the North Dakota credit market. The law has not been substantially changed since then.

The first step to obtaining a deficiency judgment must be taken by the creditor when the foreclosure is initiated. Recall the requirement that a creditor indicate in the foreclosure's summons and complaint any intent to collect a deficiency judgment;<sup>78</sup> the opportunity to seek a deficiency judgment is lost if this is not indicated at the start of the foreclosure action.<sup>79</sup> A creditor's second step to obtaining a deficiency judgment is taken only after the sale of the mortgaged property has failed to generate proceeds sufficient to pay costs plus the judgment. This step requires the creditor to initiate a separate legal action within 90 days of the foreclosure sale.<sup>80</sup> A deficiency judgment, once attained, may be enforced anytime within three years.<sup>81</sup>

The amount of a deficiency judgment generally is the judgment amount that remains unpaid after the sale proceeds are applied to cost of the sale and the judgment. However, North Dakota law permits a deficiency judgment following a real estate mortgage foreclosure only to the extent the *fair value* of the land is less than the judgment amount plus costs.<sup>82</sup> Furthermore, the statute requires that the fair value of the land be determined by a jury.<sup>83</sup>

Example. A bank forecloses a mortgage that secures a \$100,000 debt on which \$18,000 unpaid interest has accrued. The lender has incurred \$5,000 in legal fees. Cost of conducting the sale was \$1,500 while the selling price is \$104,500. After paying the cost, \$103,000 is applied against the \$123,000 judgment. This leaves a deficiency of \$20,000.

The jury must determine the land's fair value in a separate legal action brought by the creditor to obtain a deficiency judgment. The creditor will be entitled to a deficiency judgment if the fair value is placed at less than \$124,500; that is, \$123,000 judgment amount plus \$1,500 sale cost. The amount of the deficiency judgment will be \$124,500 minus the fair value, but it will never be more than \$20,000; that is, the judgment amount plus sale costs minus selling price. A determination that the land's fair value is \$124,500 or more will eliminate any deficiency judgment. In that case, the creditor will have either \$103,000 or, if it was the highest bidder at the sale, the land.

One issue with respect to North Dakota's deficiency judgment law was answered in June 1988 when the State Supreme Court defined "fair value."<sup>84</sup> In that case, a Walsh County jury awarded Federal Land Bank a deficiency judgment after the foreclosure sale of farmland failed to generate sufficient revenue to pay the borrower's entire land mortgage. This was one of the few cases in North Dakota where a jury granted a deficiency judgment following a mortgage foreclosure. The State Supreme Court reversed the trial court decision, however, reasoning that the judge did not give the jury complete instructions or guidance on what to consider in determining fair value.

The North Dakota Supreme Court explained that fair value is not the same as fair market value; and that market value is but one factor to consider. It then defined fair value to mean "the value of the property that will produce a fair and equitable result between the parties." Accordingly, a jury is to consider all circumstances affecting the intrinsic value of the property at the time of the sale and to balance the competing interests of the debtor and mortgagee. Information jurors should be allowed to hear include 1) the amount of the mortgage, 2) the amount of subsequent mortgages, 3) fluctuations in land values, 4) remaining amount claimed by the mortgagee, 5) the market value of the land, and 6) that a deficiency judgment will be the difference between the amount owed and the fair value of the property. Clearly, the North Dakota Supreme Court wants deficiency judgments granted on the basis of jurors' concept of justice and fairness rather than mathematical computations.

Several issues remain with respect to North Dakota's deficiency judgment statute. For example, state law does not impose the same limitation upon deficiency judgments following enforcement of liens against personal property. A resulting question is the availability of a deficiency judgment if the delinquent note is secured by liens on both personal and real property. Two alternatives are available for creditors. One, a creditor may enforce the lien against the personal property without first foreclosing the real estate mortgage. If the personal property is not

adequate to fulfill the obligation, the real estate mortgage may be enforced. However, the limitations upon a deficiency judgment would then apply.<sup>85</sup> Two, a creditor may first foreclose the real estate mortgage, but a jury trial is necessary to determine that land's fair value.<sup>86</sup> This valuation, in turn, determines the amount of the remaining debt that can be collected from the other collateral. Even though creditors who first foreclose the real estate mortgage still encounter the hurdle of a jury trial, the law is clear that the remaining collateral is accessible to the creditor.

Occasionally a third party personally guarantees repayment of money loaned to the mortgagor. For example, parents may co-sign a note of a son or daughter who wishes to begin a farm operation. The parents are personally liable for the debt even though it is secured with a mortgage upon the child's real estate. The Supreme Court has determined that a creditor may sue the third party without first foreclosing the mortgage<sup>87</sup> but the liability of the third party is limited to the difference between the total amount due the creditor and the property's fair value as determined by a jury. An alternative for the creditor is to first foreclose the mortgage without involving the third parties. This lack of involvement does not prevent the creditor from subsequently seeking a deficiency judgment against the third parties as long as they are provided at least 15 days advance notice of the hearing to determine the land's fair value.<sup>88</sup>

Three reasons explain why only a few deficiency judgments have been sought by creditors following a land foreclosure in North Dakota. The first two explanations are not unique to North Dakota whereas the third suggestion reflects the State's distinctive statute. First, a creditor is not likely to seek a deficiency judgment if the debtor has a limited amount of non-exempt equity with which to pay. Exempt property is explained in the next section. Second, generally increasing farm land values reduce the need for a deficiency judgment because the property's resale price is likely to exceed the amount of debt. The sale proceeds, in that situation, would be adequate to fully repay the creditor. As would be expected, the deflating land values of the 1980s prompted creditors to pursue more deficiency judgments.

A third reason why North Dakota lenders may not pursue a deficiency judgment is the unusual State statute. The time and cost of a separate jury trial plus the likelihood that the jury will find the fair value of the land to be greater than the foreclosure sale price combine to discourage creditors from seeking deficiency judgments. Consequently, mortgagors frequently satisfy a delinquent land debt by deeding the property to the mortgagee or by having the mortgagee foreclose, even though the indebtedness exceeds the land's selling price and the borrower has substantial non-exempt equity.

#### Exempt Property

Debtor-creditor law describes legal remedies available to creditors as well as protection for delinquent borrowers. A major protection provided by statutory law is that certain property is not available for creditors to seize in repayment of an obligation. These items are known as exempt

property and provide a debtor with sufficient resources to survive and financially rebuild.

North Dakota has a comprehensive statutory scheme detailing which property is exempt. A debtor is entitled to a number of absolute exemptions including family pictures, the family's clothing, and one year's supply of provisions and fuel for the family.<sup>89</sup> Insurance covering these items also is exempt. Furthermore, each debtor may exempt either crops from 160 acres or some alternatives which vary depending on whether the debtor heads a family or is not married.

The exemption which offers the greatest potential value to a debtor is the homestead; that is, the home and land upon which it is located up to a value of \$80,000.<sup>90</sup> Any debtor may substitute a mobile home or trailer for the homestead<sup>91</sup> whereas state residents have the additional option of claiming \$7,500 in place of a homestead.<sup>92</sup> This report focuses upon real property; therefore, only the homestead exemption is discussed in detail. The other exemptions are relevant to a mortgage foreclosure only if the creditor obtains and attempts to execute a deficiency judgment against the remainder of the debtor's property.

#### Homestead Exemption

A homestead in North Dakota consists of a home, the land upon which it is located, and all improvements attached to the land.<sup>93</sup> Total value of the homestead may not exceed \$80,000 more than the encumbrances and liens against that property. It may not consist of different tracts of land unless they are contiguous.<sup>94</sup> Anyone claiming a homestead must have an interest in the property being claimed.<sup>95</sup> Property claimed as the homestead of a married couple may be selected by either spouse from their joint or separate properties, with the consent of the other.<sup>96</sup>

State law allows any person to declare a homestead at any time; however, such a declaration is not necessary to preserve the exemption.<sup>97</sup> The declaration of a homestead needs to contain 1) a statement that the person making the declaration is residing on the property and claims it as a homestead, 2) a description of the property, and 3) an estimate of the cash value of the claimed homestead.<sup>98</sup> A homestead declaration needs to be executed, acknowledged, and filed with the register of deeds in the county in which the property is located.<sup>99</sup>

Several exceptions apply to the general rule that creditors may not seize a debtor's homestead. One exception allows a homestead to be used to satisfy a debt secured by a statutory lien that arose from work done or material furnished exclusively for the improvement of the homestead.<sup>100</sup> For example, a lien upon a home may be enforced and the house may be sold if the cost of an improvement to the property is not paid.

A second exception is that the homestead is not exempt to the extent its value exceeds \$80,000. If the property can be divided without materially harming it, the separated part will be subject to sale.<sup>101</sup> An entire homestead will be sold if the property is appraised at more than \$80,000 but can not be divided. No bids less than \$80,000 will be accepted

in that case, and the first \$80,000 will be paid to the persons claiming the homestead.<sup>102</sup> This cash is exempt from creditors as if it were the debtor's homestead. Any remaining proceeds are available to the foreclosing creditors.

Third, a homestead may be used to satisfy a debt that arose from the purchase of the home or that is secured by a lien on the home.<sup>103</sup> The homestead of a married person cannot be encumbered without the signature of both the husband and wife.<sup>104</sup> Requiring the signature of both is based on *one of the original purposes* of the homestead exemption which is to protect one spouse from becoming impoverished as a result of a sale or debt entered into by the other.

This exception is of major importance to many farm borrowers. Granting a mortgage on farmland to secure a loan often imposes a mortgage upon the house. The homestead exemption, consequently, provides limited protection should that debt become delinquent. Borrowers may avoid this outcome by not granting a mortgage on the farmstead or the house and surrounding yard. This is a matter of negotiation between the borrower and the lender; the proposal may be considered unacceptable by the lender if the buildings are of significant value. More frequently, borrowers and lenders do not consider the implication of mortgaging the homestead. A common situation is that few financially distressed farmers are able to take advantage of their homestead exemption because the farmstead has been mortgaged.

The 1987 North Dakota Legislature responded to this situation by enacting some additional protection for borrowers who encumber their homestead.\* The law requires that creditors provide a notice to borrowers

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\* The 1987 Legislature also enacted two temporary provisions to assist delinquent borrowers in retaining their mortgaged homestead in the event of foreclosure. One provision requires a foreclosing creditor to provide information to the debtor about state-sponsored programs to assist financially-distressed farmers. This provision will expire June 30, 1991. (Act of April 4, 1987, Ch. 196, 1987 N.D. Sess. Laws 490; also see N.D.C.C. §35-22-03.)

The second temporary provision permits a debtor who has mortgaged the homestead to designate lots and parcels, and thereby separate the homestead from the remainder of the land being foreclosed. Such designations must be set forth by accurate legal descriptions. A debtor also may specify the order in which the lots or parcels will be sold. The legal descriptions and order for sale have to be provided to the sheriff at least 10 days before the sale. If the first parcels sold generate sufficient revenue to pay the debt, no further sales will occur and the debtor will have retained some property; most likely the homestead. If all the land is sold, the debtor is permitted to separately redeem parcels rather than the entire tract. Overall, the law provides debtors an opportunity to redeem the portions of their land that are most valuable to them.

Creditors are required by this law to notify the debtor that a foreclosure is likely and that the debtor's homestead may be subject to that proceeding. The notice must explain the rights to designate parcels,  
(continued on next page)

who mortgage their homestead after June 30, 1987.<sup>105</sup> Purpose of the notice is to assure that the debtor understands that the homestead exemption is being waived. The following language must be used in the notice:

I understand that homestead property is in many cases protected from the claims of creditors and exempt from judicial sale, and that by signing this contract, I voluntarily give up my right to this protection for this property with respect to claims based upon this contract.

This notice is not required, however, if the debt resulted from the purchase of the property.<sup>106</sup>

Exemptions are intended to provide the debtor an opportunity to meet basic living needs while beginning to financially rebuild. Although exempt property is not a large dollar amount, some debtors may not be able to take full advantage of the state laws because their assets are encumbered. Debtors and lenders negotiating a settlement for a delinquent loan must be aware of how much the debtor can retain. A lender is not likely to benefit by asking the debtor to transfer exempt property if the debtor is aware that the assets are beyond the reach of the creditor's collection process.

#### Redemption of Real Estate

A debtor's right of redemption has been mentioned several times and is considered to be one of the most valuable rights provided a delinquent borrower. This right allows a debtor to temporarily retain possession of the property and possibly reacquire ownership of the foreclosed land by paying the successful bidder.

The period of redemption for most farmland is one year after the foreclosure sale.<sup>107</sup> A different period of redemption applies if the mortgage encumbers no more than 40 acres and the lender and borrower agreed, when the loan was initially extended, that the redemption period should be shorter.<sup>108</sup> *Short-term Mortgage Redemption* is discussed in the next section. Duration of the redemption period also may vary if the lender is an agency of the federal government, such as Farmers Home Administration (FmHA), because some state laws will not apply to agencies of the federal government. A federal judge ruled in 1986 that North Dakota's redemption law does not apply to foreclosures by FmHA; instead the judge set the time for redemption based on the equities of the case.<sup>109</sup>

A separate right of redemption exists for each tract of land sold through foreclosure. However, a debtor may not redeem only a portion of a

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(cont'd) specify order of sale, and redeem according to the parcel designation. Notice of these rights is to be included in 1) the Notice of Intent to Foreclose and 2) the summons and complaint if the foreclosure is by action, or in a separate notice provided 45 days prior to the scheduled sale day if foreclosure is by advertisement. This second temporary provision is effective until June 30, 1989. (Act of April 1, 1987, Ch. 194, 1987 N.D. Sess. Laws 483; also see N.D.C.C. §35-22-03.) The North Dakota Supreme Court demonstrated in Federal Land Bank v. Waltz, 423 N.W.2d 799 (N.D. 1988) that it expects creditors to strictly comply with this provision.

foreclosed tract. Consequently, selling an entire farm as one parcel may limit the chance to redeem because the debtor would need to pay the entire selling price and reacquire all the land. This amount of capital often is more than the debtor can accumulate. By comparison, a farm that is sold as several separate tracts offers the debtor more flexibility by providing an opportunity to redeem part of the foreclosed property.\*

A debtor must pay the sale price to the purchaser plus interest since day of the sale to redeem the property.<sup>110</sup> A redeeming debtor also has to pay expenses incurred by the purchaser in maintaining or protecting the property, such as taxes, assessments and insurance premiums, plus interest on these amounts from the day they were paid.<sup>111</sup> Interest will accrue at the rate specified in the original mortgage.<sup>112</sup> The right to redeem is the same whether foreclosure was by advertisement or by action.

The purpose of redemption is to assure that a debtor receives maximum benefit from sale of the land. The North Dakota Supreme Court reinforced this perception in stating that the redemption statutes:

are intended not only for the benefit of creditors holding liens subsequent to the lien being foreclosed, but are also for the purpose of making the property of the debtor pay as many of the debts as it can be made to pay and to prevent its sacrifice. To that end redemptions are encouraged.<sup>113</sup>

A right of redemption fulfills this objective by permitting a debtor to reacquire the property if the debtor decides it is beneficial to do so. A debtor benefits by redeeming if the value of the land is greater than the highest bid at the sale. Consequently, the foreclosing creditor (who is usually the purchaser at a foreclosure sale) bids, at least, the amount of debt or value of the land, whichever is less. The right to redeem also provides the debtor time to refinance.

The value of a redemption right can be significant because North Dakota law permits the debtor to occupy, use, and retain the income from the property during the redemption period.<sup>114</sup> A debtor receives the income from the land without an obligation to maintain the property or pay the real estate taxes.<sup>115</sup> The debtor's only responsibility is to not commit or permit waste of the land; that is, any activity or misuse which destroys the property or permanently reduces its value.<sup>116</sup> A debtor is not likely to improve the land during the redemption period because the purchaser is not obligated to pay the debtor for such investments. To protect the significant value of the right to redeem, state law does not allow loan agreements and other contracts to restrict the right of redemption.<sup>117</sup>

A result of the redemption right is that the purchaser at a foreclosure sale will not acquire possession of the property for at least one year after the auction, and may not own it, even then, if the land is redeemed. This delay and uncertainty in possessing the foreclosed land explains why the creditor often is the purchaser at a foreclosure sale.

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\* The temporary provision enacted by the 1987 North Dakota Legislature benefits farmers by allowing them to designate lots and parcels of land being foreclosed. These smaller lots must then be sold as individual tracts, thereby permitting a debtor to redeem some, but not all, of the farm. This provision is explained more fully in the footnote on page 16.

However, the creditor will bid the amount of debt or the land's value (whichever is less) to assure that the debtor can redeem only by paying the maximum amount the creditor could receive from the property. But this bidding strategy further diminishes the prospect of obtaining a deficiency judgment.

A question that arises is whether the debtor is entitled to retain the rent from the land if the original loan agreement includes an assignment of rent; that is, the note specifies that all rental income derived from the land be paid to the creditor. The North Dakota Supreme Court has ruled that assignments of rent are enforceable by the creditor before a foreclosure sale; but that after the sale and for duration of the redemption period, the rent is to be retained by the debtor regardless of the terms of the loan.<sup>118</sup> The public policy (as specified in the redemption law) of allowing the debtor one year's rent from the property after foreclosure prevails over an agreement to the contrary. The law is clear, however, that a crop growing upon the land when the redemption right expires becomes the property of the buyer.<sup>119</sup>

A debtor is not the only person granted the right to redeem land that has been foreclosed. Other creditors of the debtor also have the right to redeem if they hold a lien upon the foreclosed land that was subordinate to the mortgage that has been enforced.<sup>120</sup> These creditors are referred to as redemptioners. The debtor and each redemptioner is entitled to redeem; consequently, there may be a series of redemptions if the value of the land is adequate. Nevertheless, only the debtor is entitled to possession of the property or income earned from it during the redemption period.<sup>121</sup> Furthermore, the debtor's right to redeem expires after one year, even though a redemptioner may still have time to redeem.<sup>122</sup> Redemption by the debtor terminates the right of any redemptioner to redeem but the debtor remains liable to the redemptioner for the amount owed.<sup>123</sup> The rights of a redemptioner are explained more fully in a subsequent section entitled *Priorities Among Creditors*.

#### Short-Term Mortgage Redemption Act

Parties to certain real estate mortgages can agree when a loan is originated that a slightly different state law will apply in event of default.<sup>124</sup> This alternative statute is referred to as the Short-Term Mortgage Redemption Act and modifies some legal rights of the debtor and creditor.

A mortgage subject to this Act may encumber no more than 40 acres;<sup>125</sup> consequently, few farmland mortgages are affected by this law. The statute has greatest application to non-farm real estate and was intended to induce lenders to become involved in such loans.

The debtor and creditor need to agree that the short-term mortgage redemption law will apply. To assure the parties know that a different law is being applied, the mortgage instrument must be entitled in bold-face capital letters "MORTGAGE--SHORT-TERM MORTGAGE REDEMPTION."<sup>126</sup> Furthermore, the mortgage must contain language that makes it clear that the parties



intend to apply the Short-Term Mortgage Redemption Act. Suggested language is

[t]he parties agree that the provisions of the short-term mortgage redemption act shall govern this mortgage.

The Short-Term Mortgage Redemption Act is inapplicable absent such language; in which case, a foreclosure will proceed according to the general law.<sup>127</sup>

Major difference arising from application of the Short-Term Mortgage Redemption Act is that the debtor's period of redemption is shortened. If less than one-third of the original mortgage is repaid, redemption is permitted for only six months after foreclosure is commenced either by serving a summons and complaint (foreclosure by action) or publishing notice (foreclosure by advertisement).<sup>128</sup> This compares to one year from date of foreclosure sale for regular foreclosures. The redemption period is one year from time the foreclosure was commenced if more than one-third of the debt has been repaid.<sup>129</sup> In all cases, redemption must be available for 60 days after the foreclosure sale.<sup>130</sup> The shorter redemption period means the creditor will have to wait less time before receiving the sale proceeds or possession of the property.

A creditor foreclosing according to the Short-Term Mortgage Redemption Act must include, in the Notice of Intent to Foreclose, a statement as to the time for redemption after the sheriff's sale.<sup>131</sup> Failure to include such information places the redemption period at one year.<sup>132</sup> Although the statute is not clear, the legislature most likely intended the time for redemption to begin with commencement of the action.

A creditor is forbidden from seeking a deficiency judgment to compensate debtors for their limited right of redemption.<sup>133</sup> Recognize, however, that this prohibition may be inconsequential due to the already limited availability of deficiency judgments (as described in a preceding section). Perhaps more important is that the law's significantly expedites transferring possession of the land after a foreclosure sale. The period could be as short as 60 days rather than as long as one year. This is especially important if the court proceeding (from commencement of the action until the foreclosure sale) extends over a substantial length of time.

### Land Contracts

Prior discussion has focused on real estate mortgages and has assumed that the lender entered into a loan agreement with the borrower. A loan agreement and mortgage is the only means of extending credit and securing a loan when the borrower owns the land and intends to use it as collateral. However, if the land is in the process of being purchased and the seller is willing to extend credit to the buyer, their transaction can be accomplished in one of two ways. The seller could deed the land to the buyer and take back a note and mortgage from the seller, or the parties could enter into a land contract.

A land contract, also known as a contract for deed, is an agreement between a seller and purchaser of real estate whereby the purchaser makes periodic payments to the seller. The seller retains legal title to the

property as security for payment of the contract price. The deed is delivered to the purchaser only after payment of the total contract price. A third party (usually a bank) often is used as an escrow agent to hold the deed during the term of the contract and deliver it to the purchaser upon receipt of the final payment.

A land contract may be recorded with the county register of deeds since the agreement affects the title and possession of the property.<sup>134</sup> One purpose of the recording statute is to protect the purchaser. If the contract is not recorded and the seller transfers the land to another party after entering into the contract for deed, the later buyer will acquire ownership as long as the second transaction is recorded first and was made without knowledge of the first transaction. A land contract must be acknowledged (notarized) to be recorded;<sup>135</sup> therefore, buyers should enter into a land contract only if it will be notarized and recorded.

Land contracts have been criticized for permitting forfeiture of equity that a buyer may have accumulated. Most land contracts require that a defaulting buyer forfeit the property and permit the seller to retain all payments already made. Therefore, enforcement of a forfeiture clause, like strict foreclosure of a mortgage, can produce harsh results upon buyers. Accordingly, statutes<sup>136</sup> and court decisions limit the enforcement of forfeiture clauses to minimize this result.

Four methods of enforcement typically are available to the seller if a defaulting buyer on land contract refuses to voluntarily forfeit the property. These methods are 1) statutory cancellation by notice, 2) cancellation by judicial action, 3) termination by foreclosure, and 4) a quiet title action. Only termination by foreclosure will lead to a sale of the land; the other three methods return possession of the property to the seller.

#### Statutory Cancellation by Notice

North Dakota law requires that a person desiring to *cancel a land contract by notice* abide by and fulfill applicable statutory requirements, despite any contrary provisions in the contract.<sup>137</sup> The person seeking to cancel the contract must serve notice on the defaulting buyer. The notice needs to state that default has occurred, that the contract will be cancelled, and when cancellation will be effective.<sup>138</sup>

A defaulting purchaser has six months after service of notice to correct the default if less than one-third of the original indebtedness has been paid.<sup>139</sup> One year is allowed to correct the default if more than one-third of the original indebtedness has been paid or if the contract involves more than three acres of land.<sup>140</sup> The acreage provision assures most defaulting buyers of agricultural land a year to correct the default.

A buyer cures the default by paying the amount in arrears plus interest.<sup>141</sup> An attempt by the seller to accelerate the entire contract amount (and thereby demand full payment) is disregarded when cancellation is by notice.<sup>142</sup> This inability to accelerate the debt is considered a major disadvantage for sellers who seek to cancel a land contract by notice. A

seller who accepts a partial payment after serving notice of cancellation waives the notice and terminates the cancellation process.<sup>143</sup> Curing the default within the statutory time period reinstates the contract in full force and effect as if no default had occurred.<sup>144</sup>

Recording the cancellation of a recorded land contract is important to protect the seller from persons who subsequently claim to have acquired an interest in the land from the defaulting buyer. Items that need to be recorded with the register of deeds are a copy of the notice of cancellation along with an affidavit of service, and an affidavit that the purchaser's default was not corrected within the statutory period allowed for correction.<sup>145</sup>

Cancellation of a land contract by notice may be halted if a district judge believes the buyer has a legal counterclaim or another valid defense against the amount claimed as due by the seller.<sup>146</sup> The judge may then direct that the contract be cancelled only by court action. This is another disadvantage to the seller who seeks to cancel a land contract by notice; the time required for the return of the land to the seller may be significantly lengthened if a judge orders the cancellation to be by judicial action.

#### Cancellation by Judicial Action

*Cancellation of a land contract by judicial action* is commenced like any other lawsuit; that is, by serving a summons and complaint upon the defaulting buyer. Unlike a mortgage foreclosure, sellers are not required to notify buyers of their intent to cancel the contract before commencing the lawsuit.<sup>147</sup> The North Dakota Supreme Court, in deciding that the notice requirement does not apply to land contracts, explained that the statutory language requiring notice of intent to foreclose mentions only mortgages. The court declined to expand the language of the statute to implicitly include land contracts being cancelled.

Cancellation by judicial action is perhaps the most common remedy sought by sellers for several reasons. First, North Dakota law does not establish a mandatory redemption period or period to cure the default.<sup>148</sup> The length of the redemption period, if any, is left to the discretion of the court and will vary depending on the facts of the case. The North Dakota Supreme Court has approved a district court decision allowing no redemption period where the defaulting purchaser failed to appear in court and did not live on the property.<sup>149</sup> In another case, a one-year redemption period was set by the court when the purchaser claimed crop failure as the reason for the default.<sup>150</sup> A thirty-day redemption period was allowed to cure a default in a case where the purchaser had been delinquent for twelve years.<sup>151</sup>

Second, a properly drafted acceleration clause will be enforced in an action to cancel a land contract. A judge may order the defaulting purchaser to pay the entire balance due under the contract within the redemption period, the length of which is determined by the judge.<sup>152</sup> This is different than the amount that must be paid to cure a default when the contract is being cancelled by notice. Only the missed payments plus

interest need to be paid to reinstate the contract if cancellation is by notice.

The contract will be terminated if the balance is not paid as ordered. Alternatively, a judge may order the contract terminated with no opportunity for the purchaser to cure the default.<sup>153</sup> The potential for enforcing an acceleration clause coupled with a short, or perhaps no, redemption period are advantages to a seller.

### Termination by Foreclosure

Another alternative to a seller dealing with a defaulting buyer under a land contract is an *action to foreclose*. No North Dakota statutes specifically provide for foreclosure of a land contract, so applicable law has been developed by the courts. Foreclosure of a land contract was first approved by the North Dakota Supreme Court in 1930 and since then has been consistently accepted as a valid means of dealing with a defaulting purchaser.<sup>154</sup>

Part of the reason for allowing land contracts to be foreclosed by action is North Dakota's statutory law limiting deficiency judgments. Sections of the code which set forth availability of deficiency judgments refer to land contracts as well as mortgages.<sup>155</sup> These statutes require that the land be sold as part of the process of obtaining a deficiency judgment. The two methods already discussed (cancellation by notice and cancellation by action) do not provide for a sale; instead, the land is repossessed by the seller. Accordingly, the Supreme Court determined that a land contract may be foreclosed and that the proceeding will involve a sale of the land.<sup>156</sup> A deficiency judgment may be sought after the sale as if a mortgage had been foreclosed.

Consequently, *foreclosure of land contracts* contains some elements of *mortgage foreclosure* law and some features of *cancellation by notice* and *cancellation by action*. For example, foreclosing a land contract, like cancelling a land contract by judicial action, does not require the seller to provide the defaulting buyer with Notice of Intent to Foreclose.<sup>157</sup> Successful cancellation by action results in the return of the property to the seller whereas a successful action to foreclose results in a sale of the property to satisfy the judgment for the unpaid debt.

North Dakota law prescribes a one-year redemption period when foreclosing a real estate mortgage, but it is unclear whether a specified redemption period must be granted in foreclosure of a land contract. A North Dakota statute provides that a defaulting debtor must be allowed to possess property for one year after the land contract foreclosure sale; however, the right of redemption is not mentioned in this statute.<sup>158</sup> The North Dakota Supreme Court has implied that redemption rights after foreclosure of a land contract are left to the discretion of the court.<sup>159</sup> Consequently, while the deficiency judgment statutes and the provision requiring possession in the debtor for a year following foreclosure apply to the foreclosure of land contracts, no Notice of Intent to Foreclose is required and redemption rights are left to the discretion of the court.

### Action to Quiet Title

An *action to quiet title* is a fourth method by which a seller under a land contract can remove a defaulting purchaser's interest in the land from public record. A quiet title action is a legal proceeding to establish a person's title to real estate. Adverse parties are brought into court to substantiate their claims to the property. After reviewing all claims to the property, the judge will 1) decide who is the rightful owner of the property, 2) order the public record to reflect who is the rightful owner, and 3) declare all other claims to the property as invalid.

An action to quiet title is similar to cancellation of a land contract by action and was approved by the North Dakota Supreme Court as a means of terminating a land contract in 1897.<sup>160</sup> The court allowed the purchaser 30 days to correct the default; but if not corrected, the purchaser's interest in the property was to be terminated and the seller given immediate possession.<sup>161</sup> Quiet title actions are seldom used today to cancel land contracts. But when used, the requirements of North Dakota law dealing with cancellation of land contracts by notice must be followed, as well as all provisions of Chapter 32-17 of the North Dakota Century Code dealing with actions to quiet title.

Several thoughts may be beneficial in concluding this section. The current trend is to treat land contracts as mortgages so foreclosure of a land contract in the future will probably be treated more like foreclosure of a real estate mortgage. The advantage of a land contract diminishes as the differences between mortgages and land contracts are gradually eliminated. On balance, a seller of real property who furnishes financing may prefer to deed the property to the buyer and take back a mortgage on the deeded acreage and on other property of the buyer.

Regardless of which method of land contract termination is used, documentation of the action taken should be recorded with the register of deeds. Public record of the termination protects the seller from persons who buy from the defaulting purchaser without knowing that the contract had been canceled. Recording the termination of the land contract also eliminates a possible cloud on the title which would make future sale of the property difficult.

### Priorities Among Creditors

Prior discussion has focused upon the legal relation between a creditor and a defaulting debtor. The situation may be complicated, however, if another party (such as another creditor) claims an interest in the mortgaged property. A resulting question is which of the creditors will be paid by the debtor or have first right to the proceeds from sale of the debtor's property if the proceeds are insufficient to fully repay all creditors. This section addresses conflicts that may arise among creditors and the determination of priority.

The extensive limitation on the availability of deficiency judgment in North Dakota following foreclosure of a real estate mortgage places additional importance upon priority. Only mortgagees with priority can

expect to be paid if the amount owed by the debtor exceeds the value of the mortgaged land because the restrictions on deficiency judgments protects most debtors from having to pay more than that amount. Consequently, priority becomes an issue for mortgagees.

### Determining Priority

Some priority conflicts among creditors are resolved by the general rule that the creditor with a lien is the first lender to be paid from the proceeds of encumbered property. Therefore, a creditor holding a mortgage has priority over an unsecured creditor. The general rule does not determine, however, who has priority if more than one creditor claims an interest in the property or holds a mortgage on the same land. In that case, North Dakota law generally provides that priority among liens is determined according to the time of encumbrance; that is, the first lien to be recorded has priority.<sup>162</sup> A mortgage that is properly recorded with the county register of deeds notifies subsequent purchasers and lienholders that the land already is mortgaged and that any future liens or purchases will be subject to the mortgage. While recording a mortgage is not necessary to encumber the debtor's property,<sup>163</sup> it does provide notice of a prior interest, and thereby establishes an order for priority.

There are exceptions to the general rule that the first creditor to record a mortgage has priority. For example, a mortgage is valid against a third party only after the mortgage has been recorded or the third party has some other notice of the lien.<sup>164</sup> Therefore, a creditor who is granted a mortgage after one has already been granted to another creditor, may have priority if the later mortgage is recorded first and that creditor is unaware of the earlier mortgage. North Dakota's rule can be restated as: priority is granted to the mortgage holder who is first to record without knowledge of prior unrecorded mortgages.

A second exception applies when a debtor grants mortgages to more than one creditor on land that the debtor is in the process of buying. Although a creditor may be the first to obtain a mortgage and to have recorded it, a second creditor will have priority if it is the second creditor who provides the capital (that is, the purchase money) to acquire the land.<sup>165</sup> The second creditor would need to obtain and record a mortgage against the land as part of the loan arrangement in order to have priority in that situation.

### Altering Terms of the Agreement

The principal amount of an obligation and the rate of interest being charged must be indicated in the public record.<sup>166</sup> A second creditor can then compare the value of the land to the amount of an existing mortgage and decide whether to extend a loan secured by a second mortgage. The loan will be made if the creditor is satisfied that the debtor has adequate equity in the property and the ability to repay. A mortgage holder is not permitted to extend additional credit and secure it by expanding the first mortgage because this would diminish the position of an existing second mortgage. If the first lender extends credit beyond the amount specified in the recorded

mortgage, the additional amount is treated as secured by a mortgage subordinate to all other liens and mortgages upon the land.<sup>167</sup>

Two exceptions are available as to when the first mortgage holder may alter the terms of a note without adversely affecting a second mortgage holder and therefore not be forced to accept a subordinated position. First, the mortgage holder may renegotiate the terms of repayment as long as the principal amount and rate of interest is not increased.<sup>168</sup> Second, additional credit can be secured by an existing mortgage if the lender had made it clear that the mortgage would secure later loans;<sup>169</sup> however, the further advances (except if used to pay property taxes, assessments, or insurance) are subordinated to subsequent mortgages if the first lender has received written notice of the later mortgage before the additional credit was extended.<sup>170</sup>

North Dakota's legislature has enacted a statute to permit securing additional credit with an existing mortgage. The law authorizes *collateral real estate mortgages* to secure a line of credit wherein the loan amount will vary with time.<sup>171</sup> A collateral real estate mortgage constitutes a continuing lien against the mortgaged property. The lien has priority as of the date of filing for the total amount of cash advances made to the debtor during the term of the mortgage, plus interest. This mortgage will secure no more principal debt than is specified in the recorded papers. A debtor may demand in writing at any time the indebtedness is zero that the mortgage be released. The creditor must execute and record a satisfaction of the mortgage within ten days of the written demand.

### Real Estate Improvements

A conflict may arise between a real estate mortgage holder and a supplier who provides personal property on credit to the debtor for improving the debtor's land. These personal property items can be defined into two categories. One category is incorporated building materials; that is, personal property that becomes an integral part of the real estate. Such materials are considered part of the real estate and which creditor has priority in this property is determined according to the mortgages that encumber the land.

The second category is fixtures, which can be described as personal property that has been attached to real estate.<sup>172</sup> Fixtures generally are considered part of the real estate but may be treated as personal property. This dual-nature can be a source of priority conflicts between the real estate mortgage holder and the creditor holding a security interest in the fixture. The Uniform Commercial Code as adopted in North Dakota resolves most of these conflicts.<sup>173</sup>

The general rule is that a creditor with a mortgage on the land that is improved by a fixture has priority over the creditor who has a security interest (lien) in the fixture.<sup>174</sup> There are several exceptions to this general rule; only two are discussed here. First, a creditor with a security interest in the fixture must meet four conditions to have priority over an existing real estate mortgage. These four conditions are 1) that creditor either sold the fixture to the debtor or provided the capital for

the debtor to purchase the fixture, 2) the creditor acquired the security interest in the fixture before the fixture was attached to the real estate, 3) a financing statement covering the fixture is filed with the county register of deeds no later than 10 days after the fixture is attached, and 4) the debtor owns or possesses the real estate.<sup>175</sup>

Example. A bank has a mortgage on farmland upon which a farm shop is located. The indebted farmer purchases a furnace from the local supply company on credit. The furnace will be installed in the farm shop. The local supply company will retain priority in the furnace only if a lien is acquired before the furnace is installed. Furthermore, the supply company must file a financing statement with the register of deeds no later than 10 days after the appliance is installed.

A second exception provides that a creditor who holds a lien upon a fixture will retain priority over a subsequent real estate mortgage if two requirements are fulfilled. These are 1) the security interest in the fixture must be filed before the mortgage is granted, and 2) the debtor owns or possesses the real estate.<sup>176</sup> These two steps assure that the lien upon the fixture is public information before the mortgage is granted.

Creditors who provide a service or product to improve real estate may have priority over an existing mortgage even though the debtor does not voluntarily grant a lien. A creditor in that case may rely upon the appropriate statutory lien. The transaction frequently will give rise to a mechanic's lien upon the land; a mechanic's lien grants the worker or seller priority over unrecorded mortgages that the mechanic is unaware of.<sup>177</sup>

## Foreclosure

Priority is determined when a lien or mortgage is imposed, but it is after default by the debtor that priority becomes a practical issue. Three questions may arise when more than one creditor holds a lien upon property of a defaulting debtor. These would include 1) which creditor(s) may foreclose, 2) who receives the proceeds from the sale, and 3) who is entitled to redeem.

### Creditors Entitled to Foreclose

The answer to the first question is relatively straightforward. Any mortgage-holding creditor whose loan is in default is entitled to foreclose according to the rules explained in previous sections. In addition, most loan agreements permit a creditor to foreclose if another creditor is taking legal action against the mortgaged property. Therefore, any creditor holding a loan on which payments have been missed or the obligation is otherwise in default may initiate a foreclosure proceeding.

North Dakota law prohibits the holder of a subordinate mortgage from foreclosing its mortgage or suing on its note once a superior mortgage has been foreclosed.<sup>178</sup> Instead, a subordinated creditor's only remedy after foreclosure of a superior mortgage is to redeem the property. This



prohibition applies even though the debt secured by the subordinate mortgage is delinquent. The rule was derived from two basic ideas. First, the right to redeem the property fully protects a subordinated creditor's interest. A subordinated creditor may redeem the property and thereby obtain the full amount available to it if the value of the land exceeds the amount owed on mortgages with priority.<sup>179</sup>

A second reason to limit a subordinate creditor to redeeming the property stems from the restricted availability of deficiency judgments under North Dakota statutory law. The intent of the state's deficiency judgment law is to limit recovery by mortgage holders to the value of the land unless a jury determines that a fair value is less than the amount owed. This law would be circumvented if a subordinated mortgagee is allowed to sue on the note and enforce the judgment against other unencumbered property of the debtor after the mortgaged land has been foreclosed by a mortgagee with priority. Therefore, the North Dakota Supreme Court has ruled that once a mortgage with priority is foreclosed, subordinate mortgages may not be foreclosed. A subordinate creditor has its legal alternatives reduced to a right of redemption based on this judicial decision.<sup>180</sup>

A subordinate mortgage held by FmHA may need to be treated differently because it is not clear whether the limitation on deficiency judgments applies to that federal agency. If the law does not apply and FmHA can proceed to collect the continuing debt without complying with North Dakota law, the debtor may want to offer a partial payment in exchange for being released from the obligation.

Alternatives for a creditor holding a mortgage superior to the lien being foreclosed are similarly restricted. The prior mortgage holder may not foreclose unless its loan is delinquent; nor may it redeem from a sale foreclosing a subordinate mortgage. Furthermore, state statutory law clarifies that the first mortgage holder is not paid when a subordinate mortgage is foreclosed.<sup>181</sup> Instead, the buyer at the foreclosure sale purchases the land subject to mortgages that have priority over the lien being foreclosed. The bid price at the sale in such a situation will be the value of the property minus the amount of superior mortgages. The first mortgage holder may subsequently foreclose its mortgage if the necessary payments are not made.

#### Disbursing the Foreclosure Sale Proceeds

Applying the proceeds from a foreclosure sale is the second question. The cost of the sale is paid first, in all cases. If the foreclosing creditor is the highest bidder, the cost must be paid although no further cash outlays from the purchasing creditor are necessary (unless the highest bid is more than the mortgage plus sale costs). The full purchase price must be paid if someone other than the foreclosing creditor is the highest bidder. The debt which led to the foreclosure in that case is paid after sale costs are met.

The foreclosing creditor not only receives the principal, but also accrued interest. Although the amount of interest is not specified in the

mortgage, the rate of interest is. Consequently, subordinate mortgage holders have been provided notice as to the possible claim of the superior mortgage holder. If the principal amount of the debt is more than the mortgage amount, the foreclosing creditor will take a lower priority as to the extra amount.

Any cash proceeds remaining after the cost of the sale and the foreclosed mortgage are paid, will be divided according to an order of the court.<sup>182</sup> Creditors secured with liens subordinate to the foreclosed mortgage will be paid next. The debtor receives the balance of the sale proceeds after the sale's cost, foreclosed mortgage, and subordinated debt against the property are paid. Since most foreclosures result in a sale of the property to the foreclosing creditor at a price equal to the amount owed that creditor plus the cost of the sale, there seldom are additional proceeds available for distribution. A creditor holding a superior mortgage will not be paid from the proceeds of the sale; instead, the buyer acquires ownership subject to liens with priority over the foreclosed mortgage.<sup>183</sup>

#### Exercising Redemptioner's Rights

As mentioned in a previous section, secured creditors of a borrower who is being foreclosed have the right to redeem the property if their liens are subordinate to the foreclosed mortgage.<sup>184</sup> The rights of these redemptioners differ slightly from the redemption rights of a debtor. For example, all redemption rights terminate once the debtor redeems.<sup>185</sup> However, a redemptioner's right is not altered if other redemptioners exercise their right to redeem.<sup>186</sup>

Example. Davis' land has been foreclosed by First Bank which held the first mortgage against the property. Second Bank holds a second mortgage on the land and Third Bank holds a third mortgage. If Davis redeems after the foreclosure sale, Second Bank's and Third Bank's redemption rights terminate.

Example. Same facts as preceding example except Davis does not redeem. Second Bank or Third Bank may redeem from First Bank. If Second Bank redeems the property from First Bank, Third Bank may nonetheless redeem from Second Bank. Likewise, Second Bank may redeem from Third Bank if that institution redeems from First Bank.

The amount that needs to be paid to redeem the land varies depending on whether the debtor or a redemptioner is involved. Likewise, the amount also varies for redemptioners depending on whether they redeem from the purchaser, a superior redemptioner, or a subordinated redemptioner. Each of these points will be explained separately.

To redeem from the purchaser, the debtor must pay the purchase price, any amount paid by the purchaser to protect the property (such as taxes and insurance) plus interest.<sup>187</sup> A redemptioner must pay the same amount if the buyer is the foreclosing creditor. If the buyer is another creditor with priority over the redemptioner, the redemptioner also needs to pay the amount of the superior lien.<sup>188</sup>

Example. Facts are the same as the preceding example. Davis, Second Bank, or Third Bank must pay the purchase price bid by First Bank, costs of protecting the property since sale date, plus interest.

Example. Same as previous example except that Second Bank is the buyer at the foreclosure brought by First Bank. To redeem, Third Bank must pay purchase price, costs of protecting the property, amount of Second Bank's lien not reflected in the purchase price, and interest.

The debtor may redeem even though another redemptioner has already exercised its right of redemption.<sup>189</sup> In that situation, the debtor only needs to pay the sale price, cost of protecting the property, plus interest.<sup>190</sup> The redemptioner's original debt plus any other debt it paid becomes a lien upon the land in favor of the redemptioner.<sup>191</sup>

Example. First Bank forecloses and buys for the amount of its mortgage. Second Bank redeems from First Bank but Davis subsequently redeems from Second Bank. The amount Davis must pay to Second Bank to redeem is the sale price, the costs of protecting the property, and interest. Second Bank continues to hold a lien on the property by reason of its mortgage which now is a first mortgage since First Bank has been paid off.

Example. First Bank forecloses its mortgage but Second Bank buys at the sheriff sale by bidding the amount of First Bank's lien. Third Bank redeems from Second Bank by paying sale price, costs of protecting the property, Second Bank's lien, and interest. Davis subsequently redeems from Third Bank but is not required to pay the amount of Second Bank's lien. Third Bank now holds a mortgage on land for the amount of the Second Bank's and Third Bank's liens. Third Bank's mortgage is now a first mortgage because First Bank's and Second Bank's mortgages have been satisfied.

A redemptioner who wants to redeem after another redemptioner has done so, must pay the sale price, cost of protecting the property, interest, *plus* the amount of the lien held by the first redemptioner.<sup>192</sup> There is an exception. The second redemptioner need not pay the amount of debt owed to the first redemptioner if the second creditor to redeem has priority over the first creditor to redeem.<sup>193</sup>

Example. First Bank forecloses and buys the land for the amount of its mortgage. Second Bank redeems, but Third Bank may subsequently redeem from Second Bank by paying the sale price, costs of protecting the property, the Second Bank's lien, and interest.

Example. First Bank forecloses and buys the land for the amount of its mortgage. Third Bank redeems from First Bank by paying sale price, costs of protecting the property, and interest. Second Bank may subsequently redeem from Third Bank by paying the same amount.

Third Bank in the preceding example is protected by the law that permits redemptioners to redeem more than once if it is in their best interest to do so.<sup>194</sup>

Example. Same Facts as preceding example except that Third Bank is first to redeem from First Bank. Subsequently, Second Bank redeems by paying Third Bank the same amount. Third Bank again has the right to redeem but this time would need to pay the amount owed to Second Bank plus the foreclosure sale price and costs. Second Bank will own the property free from all liens if no further redemptions occur after Second Bank redeems.

A redemptioner's right may extend beyond one year even though the general rule is that the right of redemption expires one year after the foreclosure sale. The law provides that a redemptioner (other than the debtor) always has at least 60 days to redeem after another redemptioner has done so, even if that period extends beyond the one year limitation.<sup>195</sup>

Example. First Bank brought foreclosure proceeding to enforce its mortgage and was the successful bidder for the amount of its mortgage. The redemption period will extend for 12 months. Eleven and one-half months after the sale, Second Bank redeems from First Bank. Davis has only one-half month left to redeem, but Third Bank has 60 days from date of Second Bank's redemption even though this would extend beyond one year after the foreclosure sale.

Rather than waiting to redeem after a foreclosure sale, an alternative for a second mortgage holder is to pay the first mortgage holder the amount it is owed before it is foreclosed. The second mortgage holder would then be in a first position with a mortgage totalling the two outstanding liens. This action is prudent only if the value of the property exceeds the amount secured by the first mortgage.

#### Negotiations

Most missed payments and loan defaults do not result in litigation as described in this report. More frequently, the parties recognize their dispute and negotiate a settlement. A thorough understanding of each person's relevant legal rights is a vital part of a successful and satisfactory agreement. The lawful remedies and obligations of each party determine the parameters or limits of the settlement terms because, if the parties do not reach an agreement, they will proceed to litigate and the result will be as described in this report. Several generalities about negotiating a debt settlement can be stated despite significant differences among farm borrowers.

A missed loan payment usually indicates an inadequate cash inflow and limited access to other sources of cash and credit. Delinquent borrowers seldom have significant savings or reserves with which to fulfill the obligation. Furthermore, borrowers with well-managed production enterprises and reasonable consumption practices may have little opportunity to improve

their cash position by increasing revenue or decreasing expenditures. Their alternative is to reduce the level of debt service.

Actions that reduce debt service include 1) reamortizing the loan by extending debt payments over a longer time period, 2) decreasing the interest rate, and 3) reducing the principal amount owed either through a write-off by the creditor or payment from the debtor. A criterion for successful debt restructuring is whether the borrower's remaining assets will generate the cash needed to service the reorganized debt. A farm operation that is unable to generate the necessary cash is not likely to financially survive. Both parties benefit by recognizing when a proposed plan of reorganization is likely to succeed, and when it is likely to fail. Additional revenue and expense projections as well as continuing communication are crucial in revising a settlement offer that imposes excessive cash obligations upon the debtor.

Failure to reach a settlement will likely be followed by legal action and foreclosure; this outcome alone may provide sufficient incentive to negotiate since both sides give up something by litigating. Foreclosure implies the mortgaged property will be sold for the benefit of the creditor and likely to the dismay of the borrower. Litigation also implies the debtor will exercise and exhaust all available legal remedies including 1) defenses such as the confiscatory price law, 2) the right to designate tracts for purpose of sale and redemption, and 3) possessing the property for one year after the foreclosure sale. Each remedy delays or lessens the creditor's payment. The alternative to litigation is an agreement that benefits both the debtor and creditor; neither party should expect the other side to grant concessions without receiving something in return.

Reamortizing the loan may not significantly improve the debtor's cash flow especially if the original debt specified payments over many years. Extending payments over a longer time only reduces the principal portion of each installment; it does not alter the amount of interest that accrues. A few creditors may be willing to accept payment of only interest for several years if temporary deferral of all principal would improve the viability of the debtor's farm business. Reducing the interest rate is another alternative but some creditors express a reluctance to accept a lower rate except for a short period of time.

Debtors can offer incentives to encourage a creditor to negotiate; these incentives are the benefits that creditors expect in exchange for settling rather than foreclosing. Additional security such as a first or second mortgage on another tract of land may be acceptable. Likewise, a Shared Appreciation Mortgage (SAM) could be sufficient incentive for some creditors to reduce the interest rate, postpone a foreclosure, or write-off a portion of the debt principal. A SAM entitles a lender to a lump-sum payment if, on a specified future date, the value of the land exceeds the current market value. Such an agreement offers the creditor an opportunity to share in increasing land values. In other cases, a balloon payment sometime in the future might be acceptable to the creditor. Lenders frequently request that the debtor agree to a "drop-dead" provision as part of the settlement. This provision has the borrower promising to not fight future collection actions if the debtor is unable to meet the terms of the settlement.

A debtor with unencumbered equity is likely to have more difficulty negotiating than a debtor without equity. A debtor with equity is perceived by creditors as having something to offer whereas an insolvent debtor has already depleted all financial resources.

The third option for decreasing debt service is to reduce the amount of principal owed. A borrower is unlikely to have cash for a significant payment and credit institutions indicate that a write-off of principal is considered only as a last resort. This indication by creditors may be somewhat overstated, however. For example, a creditor might be willing to retain the current borrower if there is no viable purchaser, renter, or alternate use for the property. Creditors that recognize the limited availability of deficiency judgments and the possibility a debtor will seek the protection of bankruptcy, may write-down debt to market value of the land since that is the amount they would likely receive if the mortgage is enforced.

Partial or total liquidation is the most common means of reducing debt principal but any liquidation can be handled in several manners. The debtor could arrange for a sale and pay the proceeds to the creditor, the property could be transferred to the lending institution for its sale or use, or the parties may agree to have a foreclosure sale conducted by the sheriff. The last approach assures the debtor will have a right of redemption.

An agreement whereby the debtor transfers or deeds land to a creditor provides the lender an additional benefit. Such an arrangement grants the creditor immediate possession of the land, rather than at least a minimum one-year delay if the lender has to foreclose. Consequently, debtors want to be compensated for consenting to an immediate resolution that does not force the creditor to expend time and money to litigating.

A creditor who agrees to accept mortgaged land in full satisfaction of the obligation is not providing much benefit to a debtor because that is all the creditor would have received in any case due to the limited availability of deficiency judgments. Equally important, debtors should recognize that by deeding property they are forgoing the opportunity to operate the land for at least one more year. An agreement to lease the land at a reduced rental rate, an extra reduction in the amount owed, or a cash payment are only three ways to compensate debtors who relinquish their redemption right by deeding the collateral to a creditor. Any agreement to compensate the debtor for voluntarily deeding land must be 1) reached before the property is transferred and 2) documented in writing.

Both parties should recognize that corporate creditors are subject to North Dakota's law restricting corporate ownership of farmland. The general rule is that a credit institution has three years in which to sell farmland acquired by collecting a debt or enforcing a lien.<sup>196</sup> The period of permissible ownership expands to five years if the credit institution agrees to lease the land back to the prior mortgagor.<sup>197</sup> The lease has to 1) be entered into before the redemption period expires, 2) include an option to purchase, 3) be recorded with the register of deeds, and 4) require an annual rental payment of no more than 7 percent of the land's appraised value. The three year disposition rule also does not apply to corporations

which contract to sell the land to the prior mortgagor. This exemption is for an unlimited duration but the contract must be recorded and the selling price cannot exceed the appraised value of the land.<sup>198</sup> Value of the land will be established by three independent appraisers.<sup>199</sup> This time restriction upon corporate ownership of North Dakota farmland may be critical if the parties anticipate the creditor will have difficulty finding a buyer within the specified time. In such a case, the creditor's first preference may not be to accept ownership of the land.

Details of a negotiated settlement should be specified in writing to minimize the risk of a later misunderstanding. Neither party should assume agreement on an issue that is not contained in the settlement contract. Amounts to be paid, amount of debt reduction, property to be transferred, and dates for these transactions should be delineated. Likewise, a written release should be obtained by the debtor for any debt the creditor writes off as part of a negotiated settlement. Competent legal counsel for both parties will assure the agreement is complete and properly documented.

#### Summary

State laws grant rights and impose limitations on all parties involved in a real estate mortgage. An awareness and understanding of each person's legal alternatives is crucial to resolving disputes over delinquent loans. Most defaults are settled through negotiation rather than litigation. However, the likely outcome of litigated foreclosure sets the parameters for negotiating because that will be the likely consequence if a settlement is not reached.

1. North Dakota Century Code (N.D.C.C.) §35-01-01.
2. N.D.C.C. §35-03-01.
3. Ibid.
4. N.D.C.C. §35-03-02.
5. N.D.C.C. §35-03-04.
6. N.D.C.C. §35-03-17.
7. N.D.C.C. §35-03-01.1.
8. See N.D.C.C. §§47-10-24 and 47-10-25.
9. N.D.C.C. §35-01-27.
10. N.D.C.C. §32-19-05.
11. Lorass v. Connolly, 131 N.W.2d 581 (N.D. 1964); First State Bank of Cooperstown v. Ihringer, 217 N.W.2d 857 (N.D. 1974); Northern Trust Co. v. Buckeye Petroleum Co., 389 N.W.2d 616 (N.D. 1986); and Mischel v. Austin, 374 N.W.2d 599 (N.D. 1985).
12. Bank of Kirkwood v. Mueller, 294 N.W.2d 640 (N.D. 1980); H & F Hogs v. Huwe, 368 N.W.2d 553 (N.D. 1985).
13. N.D.C.C. §32-19-10.
14. N.D.C.C. §§32-19-20 to 32-19-27; also see N.D.C.C. §35-22-03.
15. N.D.C.C. §32-19-28.
16. Folmer v. State, 347 N.W.2d 731, 735 (N.D. 1984); N.D.C.C. §35-22.
17. N.D.C.C. §§35-22-03, 25-22-06, 35-22-08, and 35-22-09.
18. N.D.C.C. §35-22-01.
19. N.D.C.C. §35-22-04. Also see Folmer v. State, 347 N.W.2d 731, 735 (N.D. 1984) and Heidt v. State, 372 N.W.2d 857 (N.D. 1985).
20. N.D.C.C. §35-22-04.
21. Ibid.
22. N.D.C.C. §35-22-04 and Heidt v. State, 372 N.W.2d 857 (N.D. 1985).
23. Liberty National Bank of Dickinson v. Daly, 96 N.W.2d 897 (N.D. 1959).
24. N.D.C.C. §32-19-29.



25. Ibid.
26. N.D.C.C. §32-19-32.
27. N.D.C.C. §32-19-04.
28. N.D.C.C. §32-19-12.
29. Metropolitan Building & Loan Association v. Weinberger, 275 N.W. 638 (N.D. 1937).
30. N.D.R.Civ.P. 12(a).
31. N.D.R.Civ.P. 56(c).
32. N.D.C.C. §28-01-15.
33. N.D.C.C. §35-03-14.
34. Shervold v. Schmidt, 359 N.W.2d 361 (N.D. 1984).
35. For example see A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981).
36. For example see Federal Land Bank v. Halverson, 392 N.W.2d 77 (N.D. 1986).
37. Pub. L. No. 100-233, signed by the President January 6, 1988. One right that Farm Credit Services borrowers have under the Agricultural Credit Act is the opportunity to reacquire farmland forfeited through foreclosure or a voluntary conveyance in lieu of foreclosure. Federal District Court for Minnesota has held that a farmer has an unconditional right to reacquire foreclosed farmland if the borrower offers to purchase the property at its appraised fair market value [Leckband v. Naylor, Civ. 3-88-167 (D. Minn. May 17, 1988)].
38. N.D.C.C. §§28-29-04, 28-29-05, and 28-29-06.
39. Folmer v. State, 347 N.W.2d 731, 735 (N.D. 1984); Heidt v. State, 372 N.W.2d 857 (N.D. 1985); Lang v. Bank of North Dakota, 377 N.W.2d 575 (N.D. 1985); Federal Land Bank v. Thomas, 386 N.W.2d 29 (N.D. 1986); Production Credit Association v. Lund, 389 N.W.2d 585 (N.D. 1986); Federal Land Bank v. Halverson, 392 N.W.2d 77 (N.D. 1986); Federal Land Bank v. Bagge, 394 N.W.2d 694 (N.D. 1986); Federal Land Bank v. Anderson, 401 N.W.2d 709 (N.D. 1987); Federal Land Bank v. Lillehaugen, 404 N.W.2d 452 (N.D. 1987); Prudential Life Insurance v. Butts, 406 N.W.2d 662 (N.D. 1987); and First American Bank v. McLaughlin Investments, 407 N.W.2d 505 (N.D. 1987).
40. N.D.C.C. §§28-29-04, and 28-29-05.
41. Ibid.
42. Folmer v. State, 347 N.W.2d 731, 735 (N.D. 1984); and Heidt v. State, 372 N.W.2d 857 (N.D. 1985).

43. Federal Land Bank v. Thomas, 386 N.W.2d 29 (N.D. 1986).
44. Folmer v. State, 347 N.W.2d 731, 735 (N.D. 1984).
45. Production Credit Association v. Lund, 389 N.W.2d 585 (N.D. 1986).
46. Federal Land Bank v. Lillehaugen, 404 N.W.2d 452 (N.D. 1987).
47. Heidt v. State, 372 N.W.2d 857 (N.D. 1985).
48. Federal Land Bank v. Thomas, 386 N.W.2d 29 (N.D. 1986).
49. Federal Land Bank v. Halverson, 392 N.W.2d 77 (N.D. 1986).
50. N.D. Const. art. VI, §4.
51. N.D.C.C. §32-19-06.
52. N.D.C.C. §§32-19-06, 32-19-14, and 32-19-16.
53. N.D.C.C. §32-19-06.
54. N.D.C.C. §§32-19-08 and 28-21-05; N.D.R.Civ.P. 69.
55. N.D.R.Civ.P. 62(a).
56. N.D.C.C. §28-21-08(1).
57. N.D.C.C. §28-23-04.
58. *Ibid.*
59. N.D.C.C. §28-23-05.
60. N.D.C.C. §28-23-07.
61. N.D.C.C. §§28-23-07, 28-23-11, and 32-19-09.
62. N.D.C.C. §28-23-12.
63. N.D.C.C. §28-23-14.
64. *Ibid.*
65. *Ibid.*
66. N.D.C.C. §32-19-10.
67. N.D.C.C. §32-19-13.
68. *Ibid.* Most loan agreements that specify a series of payments contain an acceleration clause which allows the creditor to declare the entire debt due. Without acceleration, the creditor would be forced to foreclose each payment as it is missed. The type of events which

trigger acceleration include late payment, failure to pay property taxes on the mortgaged land, failure to maintain insurance protection, or waste of the property. Courts have ruled that the entire debt must be paid by the debtor to dismiss or postpone a foreclosure proceeding.

69. N.D.C.C. §28-23-07. See also note in section entitled Homestead Exemption for discussion of temporary provision enacted by 1987 North Dakota Legislature whereby debtor is granted right to designate separate parcels if homestead is subject to the execution sale.
70. Ibid.
71. N.D.C.C. §28-21-11.
72. N.D.C.C. §28-24.
73. N.D.C.C. §32-19-06.
74. Act of March 7, 1933, Ch. 155, 1933 N.D. Sess. Laws 223.
75. Burrows v. Paulson, 254 N.W. 471 (N.D. 1934).
76. Act of March 1, 1937, Ch. 159, 1937 N.D. Sess. Laws 296.
77. N.D.C.C. §32-19-06; First State Bank of Cooperstown v. Ihringer, 217 N.W.2d 857 (N.D. 1974).
78. N.D.C.C. §32-19-04.
79. Schaff v. Kennelly, 61 N.W.2d 538 (N.D. 1953).
80. N.D.C.C. §32-19-06.
81. N.D.C.C. §32-19-06.
82. Ibid.
83. Ibid.
84. Federal Land Bank v. Bergquist, 425 N.W.2d 360 (N.D. 1988).
85. Bank of Killdeer v. Fettig, 129 N.W.2d 365 (N.D. 1964); McKee v. Kinev, 160 N.W.2d 97 (N.D. 1968).
86. Schiele v. First National Bank of Linton, 404 N.W.2d 479 (N.D. 1987), and United Bank of Bismarck v. Glatt, 420 N.W.2d 743 (N.D. 1988).
87. First State Bank of Cooperstown v. Ihringer, 217 N.W.2d 857 (N.D. 1974); and Bank of Kirkwood Plaza v. Mueller, 294 N.W.2d 640 (N.D. 1980).
88. N.D.C.C. §32-19-06.
89. N.D.C.C. §28-22-02.

90. N.D.C.C. §47-18-01.
91. N.D.C.C. §28-22-02.
92. N.D.C.C. §28-22-03.1.
93. N.D.C.C. §47-18-01.
94. Ibid.
95. Myrick v. Bill, 17 N.W. 268 (N.D. 1883).
96. N.D.C.C. §47-18-03.
97. N.D.C.C. §47-18-17.
98. N.D.C.C. §47-18-19.
99. N.D.C.C. §47-18-18.
100. N.D.C.C. §47-18-04.
101. N.D.C.C. §47-18-12.
102. N.D.C.C. §47-18-14.
103. N.D.C.C. §47-18-04.
104. Ibid.
105. N.D.C.C. §47-18-05.1.
106. Ibid.
107. N.D.C.C. §28-24-02.
108. N.D.C.C. §32-19.1-04.
109. United States v. Elverud, 640 F.Supp. 692 (D.N.D. 1986).
110. N.D.C.C. §28-24-02.
111. Ibid.
112. Ibid.
113. Mehlhoff v. Pioneer State Bank, 124 N.W.2d 401, 407 (N.D. 1963).
114. N.D.C.C. §28-24-11.
115. Farm Mortgage Loan Co. v. Pettet, 200 N.W. 497 (N.D. 1924).
116. N.D.C.C. §28-24-12.

117. N.D.C.C. §35-01-10.
118. Skinner v. American State Bank, 189 N.W.2d 665 (N.D. 1971).
119. N.D.C.C. §32-19-09; Tanous v. Tracy, 212 N.W. 521 (N.D. 1927); distinguished in Zeigler v. Blecha, 229 N.W. 365 (N.D. 1930).
120. N.D.C.C. §28-24-01.
121. N.D.C.C. §28-24-11.
122. N.D.C.C. §§28-24-02 and 28-24-04; State v. Herman, 161 N.W. 1017 (N.D. 1917).
123. N.D.C.C. §28-24-06.
124. N.D.C.C. §32-19.1-01.
125. Ibid.
126. N.D.C.C. §32-19.1-03.
127. Ibid.
128. N.D.C.C. §32-19.1-04.1.
129. N.D.C.C. §32-19.1-04.
130. N.D.C.C. §32-19.1-04.1.
131. N.D.C.C. §32-19.1-05.
132. Ibid.
133. N.D.C.C. §32-19.1-07. A creditor may seek a deficiency judgment after foreclosure of a Short-term Mortgage Redemption loan if the mortgage also encumbers other property and a jury determines the fair value of the foreclosed real estate is less than the amount of debt. See United Bank of Bismarck v. Glatt, 420 N.W.2d 743 (N.D. 1988).
134. N.D.C.C. §47-19-01; Rolette County Bank v. Hanlyn, 183 N.W. 260 (N.D. 1921).
135. N.D.C.C. §47-19-02.
136. N.D.C.C. §35-01-10.
137. N.D.C.C. §32-18-01.
138. N.D.C.C. §32-18-02.
139. N.D.C.C. §32-18-04.
140. Ibid.

141. N.D.C.C. §32-18-04; Johnson v. Gray, 265 N.W.2d 861 (N.D. 1978).
142. Ibid.
143. Sadler v. Ballantyne, 268 N.W.2d 119 (N.D. 1978) citing Babb's Inc. v. Babb, 169 N.W.2d 211, 214 (Iowa 1969).
144. N.D.C.C. §32-18-04.
145. N.D.C.C. §32-18-05.
146. N.D.C.C. §32-18-06.
147. Ryan v. Bremseth, 186 N.W. 818, 821 (N.D. 1922).
148. Bender v. Liebelt, 303 N.W.2d 316, 319 (N.D. 1981).
149. Ibid.
150. Jesz v. Geigle, 319 N.W.2d 481 (N.D. 1982).
151. Funderberg v. Young, 281 N.W. 87 (N.D. 1938).
152. Jesz v. Geigle, 319 N.W.2d 481 (N.D. 1982).
153. Bender v. Liebelt, 303 N.W.2d 316, 319 (N.D. 1981).
154. D.S.B. Johnston Land Co. v. Whipple, 234 N.W. 59 (N.D. 1930); Schaff v. Kennelly, 61 N.W.2d 538 (N.D. 1953); James E. Leahy, Cancellation of Land Contracts, 32 North Dakota Law Review 5 (1956).
155. N.D.C.C. §§32-19-06 and 32-19-07.
156. D.S.B. Johnston Land Co. v. Whipple, 234 N.W. 59 (N.D. 1930).
157. Schaff v. Kennelly, 61 N.W.2d 538 (N.D. 1953).
158. N.D.C.C. §32-19-06.
159. Bender v. Liebelt, 303 N.W.2d 316,319 (N.D. 1981).
160. Fergusson v. Talcott, 73 N.W. 207 (N.D. 1897).
161. Ibid.
162. N.D.C.C. §35-01-14.
163. For example, see Croak v. Witteman, 17 N.W.2d 542 (N.D. 1945); Armstrong v. Hustad (In re Flaten), 50 Bankr 186 (1985).
164. N.D.C.C. §47-19-41; Hunt Trust Estate v. Kiker, 269 N.W.2d 377 (N.D. 1978); Burlington Northern, Inc. v. Hall, 322 N.W.2d 233 (N.D. 1982).
165. N.D.C.C. §35-03-10.

166. N.D.C.C. §35-03-04.
167. Nelson and Whittman, Real Estate Finance Law, §9.2 (1985).
168. Ibid.
169. N.D.C.C. §6-03-05.1.
170. Ibid.
171. N.D.C.C. §35-03-17.
172. N.D.C.C. §47-01-05.
173. N.D.C.C. §41-09-34 (UCC 9-313).
174. N.D.C.C. §41-09-34(7).
175. N.D.C.C. §41-09-34(4)(a).
176. N.D.C.C. §41-09-34(4)(b).
177. N.D.C.C. §35-27-03.
178. National Credit Union Share Ins. Fund v. University Developers, 335 N.W.2d 559 (N.D. 1983).
179. Kulm Credit Union v. Harter, 157 N.W.2d 700, 707 (N.D. 1968).
180. National Credit Union Share Ins. Fund v. University Developers, 335 N.W.2d 559 (N.D. 1983).
181. N.D.C.C. §32-19-09.
182. N.D.C.C. §32-19-10.
183. N.D.C.C. §32-19-09.
184. N.D.C.C. §28-24-01.
185. N.D.C.C. §28-24-04.
186. Ibid.
187. N.D.C.C. §§28-24-06 and 28-24-07.
188. N.D.C.C. §28-24-02.
189. N.D.C.C. §§28-24-04 and 28-24-06.
190. N.D.C.C. §28-24-06.
191. Ibid.

192. N.D.C.C. §28-24-03.
193. Bank of Mowbray v. Kelland, 157 N.W. 291 (N.D. 1916).
194. N.D.C.C. §28-24-04.
195. *Ibid.*
196. N.D.C.C. §10-06-13(5).
197. N.D.C.C. §10-06-13(6).
198. N.D.C.C. §10-06-13(7).
199. N.D.C.C. §10-06-13(8).



## GLOSSARY

**Affidavit:** A written statement declared under oath and used to present evidence.

**Antecedent Debt:** A debt that arose more than 10 days before a lien was granted or more than 45 days before payment was completed.

**Attachment:** Refers to when a security agreement becomes effective; the point in time when a creditor legally acquires a security interest in the debtor's property. Attachment occurs after 1) there is a security agreement, 2) the creditor has given the debtor something of value (such as loan proceeds or sold an item on credit), and 3) the debtor has an ownership interest in the property that will be encumbered.

**Automatic Stay:** Once a debtor is declared bankrupt, creditors are prohibited by federal law from taking any further acts to reclaim property, perfect liens, collect judgments, or secure payments except as allowed by federal bankruptcy law. Restated, all proceedings under state law are stopped upon declaration of bankruptcy.

**Bankruptcy:** A legal proceeding in federal court wherein a debtor who is unable to pay debts on time is protected from further legal action by creditors seeking payment of their obligations. In exchange for this protection, the debtor will arrange to pay as many debts as possible either through liquidation (Chapter 7) or reorganization (Chapters 11, 12, and 13).

**Bankruptcy Estate:** Includes all property and interests in property held by the debtor at the time of filing the bankruptcy petition, as well as earnings, proceeds, and products of this property.

**Chapter 7:** Bankruptcy proceeding wherein nonexempt property of the debtor is sold (liquidated) with the proceeds used to satisfy unpaid obligations. Debts remaining after liquidation are usually discharged. Also referred to as straight bankruptcy.

**Chapter 11:** Bankruptcy proceeding in which debtors are allowed to continue operation of their businesses in exchange for developing and fulfilling a detailed plan as to how and when debts will be repaid. Reorganization plans often involve delaying payments, extending pay-back periods, reduction in amount of indebtedness or interest rate, and partial liquidation.

**Chapter 12:** Bankruptcy proceeding designed for "family farmers" wherein a farmer files a plan in which he proposed to turn over farm income to a trustee, who distributes the income to creditors. The goal is to rehabilitate (reorganize) the farm business rather than liquidate the operation.

**Chapter 13:** Bankruptcy proceeding which provides for the adjustment of debts of an individual with regular income. The debtor makes payments to a trustee who makes a distribution to creditors according to an approved plan.

Creditor: Person or entity that has loaned money, sold property, or provided a service on the basis that payment will be completed at a later time. Someone who is owed a payment.

Debtor: Person or entity that has borrowed money or purchased property or services but is not expected to complete payment until a later time. Someone who owes a payment.

Deficiency: The amount a debtor still owes to a creditor after property upon which the creditor had a lien has been sold and the proceeds used to pay the creditor. Deficiency arises only when proceeds from sale of encumbered property are less than the amount of the debt.

Deficiency Judgment: Recognition by a court that a deficiency remains after the encumbered property of the debtor has been sold and the proceeds paid to the creditor. After a deficiency judgment, the creditor may proceed against additional property of the debtor in an effort to collect the remaining indebtedness.

Discharge: Available only from a federal bankruptcy court; it relieves the debtor of all obligations that the debtor is unable to fulfill. Once discharged, the debt is no longer a legal obligation and the creditor cannot attempt to collect payment. Some debts, by federal law, cannot be discharged. Discharges can be granted no sooner than six years after an earlier discharge.

Encumbrance: A lien.

Encumbered Property: Property that has a lien imposed upon it.

Execution: Procedure to enforce a judgment whereby the sheriff is instructed to seize property of the debtor in order to satisfy the unpaid obligation. The seized property usually is sold with proceeds (minus cost of sale) remitted to the creditor.

Exempt Property: Property that, according to state law, cannot be seized to satisfy obligations of the debtor.

Financing Statement: A statement filed for public record in the office of the county register of deeds or the secretary of state listing property of the debtor upon which a creditor has imposed a security interest. Filing a financing statement perfects the security interest.

Foreclosure: A legal procedure to terminate a debtor's equitable redemption right. Generally, it is used in reference to a state court proceeding wherein the debtor is declared delinquent in making payments to a creditor and encumbered property is ordered sold with the proceeds used to satisfy the debt.

Guarantor: A person who obligates oneself to pay the debt of another if that other person (the primary debtor) fails to repay the debt.

**Appendix**

Involuntary Bankruptcy: A bankruptcy proceeding initiated by creditors of the debtor rather than by the debtor. Federal law prohibits farmers from being forced into an involuntary bankruptcy.

Judgment Lien: A lien automatically imposed upon all real property of the debtor after a state court determines that the debtor is indebted to the creditor. The lien encumbers only real property in the county in which the court is located, but the lien can be imposed on real property in other counties by recording the judgment in the other counties.

Lien: A right to have property sold or otherwise used in satisfaction of a debt. The right to have the encumbered property used to fulfill an obligation secures payment of the debt. Although the right is held, it can be exercised only if the terms of the obligation are not met by the debtor.

Lienholder: Any person or entity whose debt is secured by a lien on the debtor's property. Any creditor who has the right to have a debtor's property sold or otherwise used to satisfy a debt.

Liquidation: Converting noncash assets to cash by selling them. Also used to denote a Chapter 7 Bankruptcy.

Loan Agreement: An agreement between a debtor and creditor wherein the debtor promises to repay the debtor. The loan agreement contains the terms of the understanding; such as due dates for payments, rate of interest, obligation for the creditor to extend additional credit at a future time.

Mortgage: A voluntary real property lien that the debtor has granted to a creditor. Chattel mortgage (less frequently used today) refers to a lien upon personal property. Mortgages generally are used to secure repayment of a debt to a creditor who has sold land on credit or loaned cash to the debtor.

Mortgagee: A creditor who holds a mortgage upon real property of the debtor.

Mortgagor: A debtor that owns land which has been mortgaged to a creditor; a debtor/mortgagor grants a lien (mortgage) to a creditor/mortgagee.

Note: Same as a loan agreement.

Perfection: The act of a creditor providing public notice that the creditor has a security interest in property of the debtor and that the creditor is entitled to have the property or its proceeds returned to the creditor if the debtor fails to fulfill the secured obligation.

Preference: A transfer of property from the debtor to the creditor, or imposition of a lien upon property of the debtor 1) within 90 days before bankruptcy and 2) to satisfy or secure an antecedent debt. Preferences can be avoided by a bankruptcy trustee, rendering the creditor unsecured. Any payment considered a preference must be returned by the creditor to the bankruptcy estate.

Personal Property: All property that is not considered real property; property that is movable; includes both tangible and intangible.

Priority: Determining which creditor is first entitled to proceeds from sale of encumbered property. Creditors without priority will receive only the amount that remains (if any) after fulfilling obligations of creditors with priority.

Purchase Money Security Interest: A security interest that arises automatically for a person who sold on credit or furnished cash for the purchase of property. A purchase money security interest is considered perfected for 20 days after the debtor acquires possession of the property. It is an acknowledgement by the law that filing to perfect takes some time and that the person who extended credit for the purchase of the property will retain priority as long as the security interest is perfected within a reasonable length of time.

Real Property: Land, buildings, and all property attached to real estate.

Redemption: The right of a debtor (and subordinated creditors) to reacquire property that has been seized to satisfy the claim of a secured creditor. The right to redeem farmland generally expires one year after date of foreclosure sale. The right to redeem personal property terminates upon the sale or acceptance of the property as fulfilling the debt. The amount that must be paid to redeem land is the amount the property sold for but, for personal property, is all obligations secured by the property.

Redemptioner: Other creditors of the debtor who hold liens upon land that is being foreclosed but the liens are subordinate to the mortgage that is being enforced.

Reorganization: Refers to a Chapter 11 or Chapter 12 bankruptcy proceeding.

Secured Creditor: A creditor with a lien upon property of the debtor. Usually refers to creditors with security interest in personal property.

Security Agreement: A written contract between the debtor and creditor wherein the debtor grants the creditor a lien in some property. Usually used in reference to a security interest.

Security Interest: Refers to a lien granted by a debtor upon personal property such as livestock, equipment, crops, and inventory.

Statutory Lien: A lien that automatically arises according to state law rather than by agreement wherein the debtor grants a lien to the creditor. These liens generally arise when material or services, sold on credit, benefits or improves specific property of the debtor. The lien encumbers the improved property. State law usually requires the creditor to file a notice with the county register of deeds in order to establish a statutory lien. Examples are mechanic's lien, repairman's lien, agricultural supplier lien, and agricultural processor lien.

Straight Bankruptcy: Refers to a Chapter 7 bankruptcy.

Subordinated Mortgage: A mortgage that does not have priority relative to another mortgage upon the same land.

Superior Mortgage: A mortgage that has priority over another mortgage that encumbers the same land.

Voluntary Bankruptcy: A bankruptcy proceeding initiated by the debtor.

Voluntary Lien: A lien that arises from an agreement between the debtor and creditor wherein the debtor grants a lien to the creditor. The lien, in conjunction with a promise to repay a debt, is exchanged for the creditor providing a cash loan or otherwise extending credit. Also referred to as a consensual lien.



