Financing the Farm

A law bulletin series on legal arrangements for farm financing

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Mortgages

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Mortgages serve a vital role in helping people buy, sell, and leverage their equity in real estate such as farmland. This bulletin explains mortgages and what a beginning farmer should understand when entering into a mortgage with a lender.

What is a mortgage?

A **mortgage** is a security interest in real estate that a debtor grants to a creditor in exchange for a loan. In the mortgage context, debtors and creditors take on new names. The debtor is the **mortgagor,** which is the party granting the mortgage. A creditor is the **mortgagee,** which is the party receiving the **security interest** in collateral in exchange for a loan. In a mortgage agreement, the mortgagor grants a security interest in real estate to the mortgagee, who then has the legal right to foreclose and claim title to the real estate in the event that the mortgagor fails to repay the mortgagee.

Mortgages are different than promissory notes, operating loans, and lines of credit. A promissory note documents a promise to repay a loan. Operating loans and lines of credit are for day-to-day operating expenses, and usually do not involve granting a security interest in real estate as collateral for the loan. Instead, banks may require the debtor to give a security interest in collateral such as growing crops, livestock, equipment and machinery for an operating loan.

When do farmers use a mortgage?

A farmer uses a mortgage when taking out a substantial loan with a lender who wants to protect its interests by securing the loan with collateral. Frequently, the collateral is the same real estate that the farmer is purchasing with the loan. However, a lender might want to take a mortgage interest in real estate to secure another loan for purposes other than purchasing the mortgaged real estate. This means that the mortgage tool not only enables the purchase of the real estate used as collateral, but also allows a farmer to leverage equity in real estate to obtain credit for other needs.

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How does a mortgage work?

As the mortgagor, you must **sign** a mortgage in order for the instrument to have legal effect. A mortgage serves as a claim of right in your property that goes against your own interest, and a signature signals your intent to be legally bound by the agreement. You may sign the mortgage yourself, or you may authorize an agent in writing to sign on your behalf.

Most states require a signature on a mortgage to be **notarized**. States register notaries who serve as official witnesses to signatures for important transactions. A notary's seal confirms that the person whose name appears on the document actually and voluntarily signed the agreement, but notary does not read the document.

A lender will **record** a signed mortgage in the public records. Filing the mortgage in the public record gives notice to others that the lender has a security interest in the property. Public recording plays an important role if you default on the loan or sell the property.

The date of the recording of the mortgage determines a creditor's **priority** in receiving payment if there is a sale or foreclosure on the property. In a sale or foreclosure action, interests filed at an earlier date have first priority over interest filed after that date and are repaid first. If there is money left over, interests with lower priority are paid in order of when their interests took effect. This makes filing of a mortgage an important step for the creditors.

Mortgages and promissory notes

When you grant a mortgage to a creditor, you will likely also sign a **promissory note** at the same time. Why? The promissory note documents your promise to repay the amount of the loan, with interest, to the creditor. It's a legally binding contract, but a creditor wants more assurance of repayment than a promise on paper. That's where the mortgage comes in. The promissory note is tied to the mortgage interest. If you violate your promise to repay the promissory note, the mortgage kicks in. Your creditor can act on the foreclosure rights granted in the mortgage to recover its financial interests. Read more about promissory notes in our second law bulletin in the *Financing the Farm* law bulletin series.

Rights granted to the mortgagee

When you sign a mortgage as the mortgagor, you give certain rights to your creditor, the mortgagee. One commonly exercise right is the right of **assignment,** which allows the mortgagee to sell or assign the mortgage to another party. This means that you might not always be dealing with the same lender as you repay the loan that is tied to the mortgage.

Another right is the right to prevent **waste** of the collateral by the mortgagor. A mortgage may contain covenants and rules on how the mortgagor must care for the property, such as paying property taxes and not making changes to the property that decrease the property's value. If the bank believes that the property owner is committing waste, it may seek judicial action to either stop the waste through an injunction, obtain monetary damages to compensate for the loss in the collateral's value, or even foreclose.

Perhaps the most important right given to the mortgagee is the **right to foreclose** on the collateral property if you fail to fulfill the terms of the promissory note, which we explain below.

Foreclosure on a mortgage

Foreclosure is a legal process through which a mortgagor can claim title to the collateral property in the event that you default on payments due under the promissory note. Upon foreclosure, the mortgagee may choose to sell the property. If so, the proceeds of a foreclosure sale are first used to pay off the debt that you owe the mortgagee. The mortgagor may receive money from the sale if the sale raised enough to first cover all mortgages and liens on the property.

The laws governing foreclosure vary from state to state. States have different rules on the type and timing of notice required, how long the redemption time frame lasts, and whether there are limitations on seeking additional payment from the mortgagor if there are remaining debts after the foreclosure sale.

If you are able to pay the missed payments and bring your account current before the foreclosure sale, your state law might stop the foreclosure from occurring. Known as **redemption**, this requires you to pay all missed payments along with fees and interest. Some states also grant mortgagors a statutory right to redemption after the foreclosure sale for a set number of months. The mortgagor essentially must pay the amount that the property was sold for at the foreclosure sale in order to redeem the property after the sale.

When the money raised through the foreclosure sale does not cover all of your debt, the mortgagee may seek a **deficiency judgment** against you to cover the difference. A deficiency judgment becomes a personal debt that you must pay to the mortgagee. States impose various limitations on deficiency judgments, which an attorney licensed in your state can help you navigate.

Mortgages and subordination

A lender might require you to obtain a **subordination agreement** from other mortgagees before granting a loan and receiving a mortgage on a property. A subordination agreement is a legal agreement between mortgagees that adjusts their priority positions when they have a security interest in the same collateral. When there are two mortgages on a property, the mortgagees may enter into a subordination agreement that allows one mortgagee to have first priority even if the other mortgagee holds an earlier mortgage.

Subordination agreements are often used in refinancing situations when the property owner wants to refinance the first mortgage. Refinancing effectively counts as a new loan with a new priority date. Having later priority would discourage the first mortgagee from refinancing, but by having a subordination agreement with the second mortgagee, the first mortgagee can retain first priority. A second mortgagee typically agrees to this type of subordination agreement without incident, as long as there is sufficient value in the collateral to address both mortgages.

Mortgage disclosure laws

When a residence is part of a mortgage transaction, mortgagors have certain protections under federal laws such as the Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act, and Homeowners Protection Act. These federal laws require brokers and lenders to provide a home buyer with certain information so that they may make an informed decision. The information includes a number of disclosures that explain the terms of the mortgage, along with closing and settlement costs.

When the mortgage does not involve a residence, but instead involves assets such as farmland, the government does not require lenders to provide as many disclosures. Purchases of farmland are treated as a business transaction by informed business parties, and therefore require fewer disclosures. This means that a farmer should take care to talk with the lender, know the terms of the mortgage, be aware of its costs, obligations and implications, and make sure that everything promised by the lender is in writing.

Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Promissory Notes, Installment Contracts, Leasing Arrangements*, and *Secured Transactions*.

Resources and References

"Finance and Credit," THE NATIONAL AGRICULTURAL LAW CENTER, https://nationalaglawcenter.org/research-by-topic/finance-credit/.

"Get answers to your mortgage questions," CONSUMER FINANCIAL PROTECTION BUREAU, https://www.consumerfinance.gov/mortgage/.

"Mortgages," *Office of the Comptroller of the Currency*, U.S. DEPARTMENT OF THE TREASURY, https://www.occ.treas.gov/topics/consumers-and-communities/consumer-protection/mortgages/index-mortgages.html.

Phillip L. Kunkel, Jeffrey A. Peterson, & Jason Thibodeaux, "Mortgages and Contracts for Deed," *Farm Legal Series*, UNIVERSITY OF MINNESOTA EXTENSION (June 2015) https://conservancy.umn.edu/bitstream/handle/11299/199838/mortgages-and-contracts-for-deed.pdf.