In Brief

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Strict Foreclosure: The Newest Old Tool in the Box

Here is a scenario familiar to most of our lender clients: the customer owes a debt secured by real property, but cannot make payments on the loan and cannot sell the mortgaged property for enough to pay off the debt. The customer and the lender negotiate a deal where the lender takes a quitclaim deed to the mortgaged property in exchange for a forgiveness of the debt. This is the standard "deed-in-lieu of foreclosure" transaction where the lender recovers its loss only through its resale of the property. Unfortunately, when the lender obtains a title report on the property, several liens are found, all of which are junior to the mortgage lien of the lender.

So, the lender contacts the lien holders to request that they release their junior liens in order to free up the title to the property, and to avoid the need to file a foreclosure action to clear off those liens. Rarely in a foreclosure case will a junior lien holder bid at the foreclosure sale over the priority lien holder's debt to buy the property so it can be resold to recover the bid monies paid and then, hopefully, a surplus to apply to the junior lien holder's debt. Most properties are not worth significantly more than the debt on the first mortgage such that a junior lien holder will want to bid and buy.

But, upon inquiry to the junior lien holders, our lender finds that each wants to be paid for a release, and it looks like it will be cheaper to simply file a foreclosure action even though that process will take many months and a bit of expense to accomplish a foreclosure of liens. It also makes the lender wonder why it spent the time and expense of negotiating with its customer for the deed-in-lieu of foreclosure when the foreclosure looks to be necessary anyway at the end of the day. But there is a shortcut to this process in Indiana, the so-called "strict foreclosure," which lets the lender have it both ways.

The process of strict foreclosure has been a feature of the law in Indiana for over a hundred years. It was recently the subject of an Indiana Supreme Court decision clarifying when the remedy is available. The Court's June 29, 2011, decision in *Citizens State Bank of New Castle V. Countrywide Home Loans, Inc.*, 949 N.E.2d 1195 (Ind. 2011) describes this remedy as an action filed against junior lien holders, whose liens will simply be declared foreclosed if they choose not to exercise the "right and equity of redemption" to buy the property from the Plaintiff lender. In effect, the lawsuit invites the junior lien holders

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to a hypothetical foreclosure sale, where, if they do not bid over the senior lien holder to buy the property, their liens will be foreclosed and the property sold free and clear of liens to the Plaintiff lender. The benefit is that if the junior lien holders do not answer the strict foreclosure Complaint, or if they answer saying they will not buy the property from the Plaintiff lender, then there is no sale, only a Judgment for the lender that it owns the property free and clear of liens, and a decree that the junior liens are foreclosed. Of course, if any of the lien holders answer that they will buy the property for the amount of the Plaintiff lender's debt, then a sale occurs with proceeds that pay the debt in full.

The Indiana Supreme Court in the *Citizens State Bank* case let us know that in order to preserve the remedy of strict foreclosure, there must *not* be a "merger" of the lender's mortgage interest in the property with the fee simple title taken by the deed-in-lieu of foreclosure. If these interests are deemed to have merged, the mortgage becomes void and the lender loses the power of foreclosure altogether. Anti-merger language in the deed-in-lieu of foreclosure taken from the customer solves this problem.

The problem of a merged mortgage confronted the Supreme Court in the *Citizens* case where a lender took a deed-in-lieu of foreclosure from its customer then re-conveyed the property "free from all encumbrances" to a third party. Upon the later discovery of a lien on the title to the property, that lender brought a strict foreclosure action against the lien holder, but was barred from that remedy because, as the Court held, its mortgage had been extinguished by the second conveyance. The Court found that by conveying the property with a warranty of title, i.e., free and clear of liens, and no reservation of rights as to its own mortgage, that lender intended to merge its mortgage interest into the title of the property and thereby extinguished its mortgage remedies.

Recently, Morgan & Pottinger, PSC represented a bank client in Indiana in pursuing a strict foreclosure action in a scenario more or less identical to the case where our hypothetical lender took a deed-in-lieu of foreclosure from its customer, then found junior liens encumbering the title. The bank's *Complaint for Strict Foreclosure* was filed on September 19, 2011, and a *Judgment/ Decree of Strict Foreclosure* was entered on October 27, 2011, declaring the bank the owner of the property free and clear of two junior liens. A regular foreclosure action would have taken four to six months to complete, but this case took just thirty-nine days. If you have such a case or would like to discuss this remedy further, please give me a call at 502-560-6756.

Garret Hannegan
Shareholder

Happy Holidays!

At this time of year, we enjoy the opportunity to remember those whom we have had the personal and professional pleasure of working with during 2011. To each of you, we express our most sincere appreciation for the trust and confidence you have placed in our firm. Our goal for 2012 is the same as it has been for 37 years, to provide you with focused and efficient legal services that enhance the performance of your business. We are excited about 2012 and the opportunity to continue to work as part of your team.

It is also a time of year to be with family and friends. Our offices will be closed on Monday, December 26, and Friday, December 30.

From all of us at M&P

Duties of the Executor of an Estate

We are often asked for some sort of handout outlining the duties of a personal representative (e.g. Executor) of an estate. Here is a synopsis of the main steps to settling a "typical" Kentucky estate.

First, as the person named Executor by the will of the decedent, you must file sworn petition papers in duplicate (and pay filing fees) in the probate court of the county in which the decedent resided. A date will be assigned for you to be in court where you appear before a Judge with the *original* of the will, have it proved as lawful and admitted to probate, following which you will be appointed by the court as Executor, post bond (*surety* on your bond may have been waived by the will) and obtain copies of the Order appointing you and probating the will. The will itself is recorded in the county clerk's office. Under a new procedure allowed in some Kentucky counties, it is sometimes possible for the Executor to sign all filing papers in advance before a notary; then the attorney for the Estate files them and is the only person to appear in court.

Second, an inventory of the estate must be filed in duplicate within 60 days of your appointment as Executor. The values of the listed assets are the fair market value on the date of death. It may turn out that the list of assets shown on the inventory is no more extensive than what was initially listed on the petition for your appointment as Executor. On the other hand, there may be newly discovered assets listed, or the fair market values of previously identified assets might be more accurately determined.

Third, all assets must be gathered, life insurance proceeds, retirement accounts, and other benefits (e.g. Social Security) collected or accounted for, and proper debts must be paid–all entailing careful record keeping and documentation. This record keeping includes money and assets coming into the estate, and monies going out to pay bills and expenses. An estate checking account typically needs to be opened to facilitate this and to create a record.

Fourth, a Kentucky Inheritance Tax return may have to be filed. The deadline for filing is nine months from date of death to take the five percent discount; otherwise, eighteen months from date of death is the deadline. Often no inheritance tax return need be filed if the beneficiaries are spouse, parents, children, grandchildren or siblings, and if there is no federal estate tax return that has to be filed. In this instance, only an "Affidavit of Exemption" is filed with the probate court explaining, in essence, why no inheritance tax return was required to be filed.

Fifth, a federal estate tax return may have to be filed, if the estate is over $5,000,000 (under current law effective through 2012). Determining the size is a bit tricky, as decedent-owned life insurance proceeds and qualified plan monies (e.g. an IRA or 401k) are included in arriving at the size of the estate. If a federal return must be filed, it is due nine months from date of death.

Sixth, *if* the situation is such that you are the sole beneficiary and there are no significant debts owed by the estate, there is an advantage to distributing the majority of assets in a speedy manner, which will limit the amount of any income attributable to the estate, and thus avoid the estate having to file fiduciary income tax returns. The threshold income amounts for the estate having to file fiduciary income tax returns are $1,200 Kentucky and $600 Federal. *On the other hand*, you as Executor have personal liability for claims against, and debts of, the estate if you disburse assets sooner than six months of your appointment, the estate thereby cannot pay the claims or debts due to the earlier disbursement of assets, and the beneficiary(s) receiving the disbursed assets have spent/used up the assets received.

Seventh, final federal and state individual income tax returns will have to be filed for the year of death. These returns should have hand lettered in large print at the top of the first page the notation "FINAL – DECEASED xx/xx/xxxx." The returns will be due by April 15 of the year following death; however, if you wish to speed up the process, sometimes the tax return form for the *preceding* year is successfully used (since the return for the *year of death* may not yet be available) and filed early, so that the duty isn't hanging over the Executor's head for an undue length of time.

Eighth, a final settlement must be prepared and filed with the probate court in order to close the estate. An Order of the probate court approving the settlement is what relieves the Executor of further duties and concludes the entire probate process. Some estates will qualify to file an "informal" final settlement (which still requires an "acceptance" of inheritance tax return from the Kentucky Revenue Cabinet, or "Affidavit of Exemption" mentioned above). An informal settlement requires the signatures of each of the beneficiaries of the estate acknowledging that they have received their property under the decedent's will (or similar proof such as a cancelled check from the estate account); if this is not feasible, then a formal settlement (essentially a set of books for the estate) must be filed.

The preceding should help you envision what you'll be responsible for when you serve as Executor of an estate. But, keep in mind that the preceding is a *generalization* and is no substitute for determining what is required of you by law in a *specific* estate, for which you will need professional advice.

C. Edward Hastie
Of Counsel

Firm News

M&P is pleased to announce:

Melissa Miller has joined the firm as an associate. Miller is a 2009 graduate of the Indiana University Maurer School of Law. She obtained her bachelor's degree from the University of Evansville. Miller's practice will be concentrated in the area of commercial and retail collections. Miller is licensed to practice in both Kentucky and Indiana and is a registered patent attorney by the U.S. Patent and Trademark Office. Miller is located in M&P's Louisville office and can be reached at 502-589-2780 or mmiller@morganandpottinger.com.

Sarah Mattingly also has joined the firm as an associate. Mattingly is a 2011 graduate of the University of Kentucky College of Law where she was a member of the Kentucky Law Journal. She obtained her bachelor's degree from Centre College. Mattingly's practice will be concentrated in the area of commercial transactions, including commercial loan documentation, commercial litigation, real estate and banking regulations. Mattingly is located in M&P's Lexington office and can be reached at 859-226-5294 or ssm@morganandpottinger.com.

In other news:

Scott White was appointed by the Lexington-Fayette Urban County Council to the Board of Health.

Emily Cowles was named to the 2011-2012 class of Leadership Lexington through Commerce Lexington.

John T. McGarvey and **Thurman Senn** were presenters at the University of Kentucky College of Law's 31st Annual Conference on Legal Issues for Financial Institutions.

Tim Schenk and **Tom Coffey** obtained a favorable verdict in an employment law defense case in Jefferson County, which was summarized in Kentucky Trial Court Review, 15 K.T.C.R. 9, p. 6.

M&P had 100 percent participation from its associates for the Legal Aid's 2011 Justice For All Campaign.

Emily Cowles published an article in the September 2011 Equine Issue of Business Lexington entitled "Altered Landscape: Decline in foal crop could bring many repercussions in Bluegrass economy." The article is posted on M&P's website at www.morganandpottinger.com.

In *Frambes v. Nuvell National Auto Finance, LLC, et al.*, 454 BR 437 (Bankr. E.D.Ky 2011), **Tyler Powell** obtained a favorable verdict for M&P's client when the Bankruptcy Court for the Eastern District of Kentucky granted his motion to dismiss on all counts an adversary proceeding filed by the debtor.

Tyler Powell gave presentations on Lender Liability Issues and Forbearance Agreements at NBI's 'BOOT CAMP: Foreclosure and Loan Workout Procedures.'

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