Hypothecated Security: Revisiting in Re Enderle

By Bernard "Rick" Richards, Jr., Esq.

Consider the following scenarios, the facts of which present one easily recognizable issue for real property practitioners, but which also, upon further consideration, present a more subtle issue which many attorneys and lenders are frequently failing to address.

Scenario #1: A nineteen year old college student wishes to obtain a loan from Lender. She executes a promissory note in favor of Lender. Since the student has no real property to put up as collateral for the loan, Lender requires that she and her parents execute a deed of trust encumbering a parcel of real property owned by her parents. The parents do not sign the promissory note and the loan proceeds are distributed directly to the student.

Scenario #2: Mr. and Mrs. Smith open a business and desire to obtain a loan from Lender for start-up costs. Lender and the Smiths agree that the loan will be made to the new corporation of which the Smiths are the only officers, directors and shareholders. The newly-formed corporation owns no property to serve as collateral for the loan. Although the Smiths sign a promissory note in their capacities as officers of the new corporation, the lender requires them to execute a deed of trust encumbering the residence they own as tenants by the entireties.

Real property practitioners would immediately recognize the obvious concern addressed by the lender in both scenarios; namely, that in order to encumber real property with a deed of trust, the record owner of that property must execute the deed of trust, even though the record owner is not the borrower. The more subtle issue raised by the facts presented in both scenarios is how a lender properly encumbers property owned by one party which is serving as collateral for the obligation of another. Such an encumbrance is frequently referred to as hypothecated or collateral security and is the precise issue discussed in the case of *In re Foreclosure of Enderle*, 110 N.C. App. 773, 431 S.E.2d 549 (1993). However, as is evident by the frequent questions posed to this title insurer by lenders and attorneys facing similar situations and the number of title opinions submitted which fail to address the issue at all, the holding of this case appears to have gone unnoticed or been forgotten.

As the court in *Enderle* acknowledges, the grantor of a deed of trust can put up his property as collateral for the obligation of another and the benefit to that third party can serve as consideration for the loan. Authorities noted in the case are G. S. Nelson & D. A. Whitman, *Real Estate Finance Law* 2-1 (2d ed. 1985); 59 C.J.S. *Mortgages* § 90 (1949); and 55 Am. Jur. 2d *Mortgages* § 146 (1971). However, unless the nature of the obligation is clearly defined, the grantor of a deed of trust in the hypothecated security situation can argue that he received no material benefit from the loan made to the third party.

In *Enderle*, the Court of Appeals reversed the order of the trial court which had affirmed the clerk of court's decision authorizing the foreclosure of property owned by the Enderles on these facts. A mortgage lender loaned $255,000.00 to the Tants who

executed a promissory note in that amount. The Enderles signed a pre-printed, form deed of trust encumbering property they owned as collateral for the loan to the Tants. However, the deed of trust did not reflect that the loan was to benefit the Tants. Instead, the deed of trust indicated that the Enderles were indebted to the lender for $255,000.00. The pre-printed language of the deed of trust reflected that it secured the payment of a debt evidenced by a note "made by" the Enderles. The Enderles, however, had not signed the note. The Tants subsequently defaulted and the lender proceeded to foreclose on the property owned by the Enderles pursuant to the power of sale clause in the deed of trust. The clerk of court conducted a hearing regarding the lender's right to foreclose and authorized the foreclosure. The Enderles appealed and argued that they were not indebted to the lender, but the superior court, in turn, issued an order authorizing the foreclosure.

The Court of Appeals disagreed with the trial court and the clerk of court. After acknowledging that one person's property can be mortgaged as collateral for the debt of another party, the Court held that the nature of the obligation must be "properly" identified on the deed of trust. The key to the Court's decision was the fact that the deed of trust asserted that the Enderles were indebted to the lender for $255,000.00, and no mention was made that the subject property had been pledged as collateral for the debt of the Tants. Due to this inaccurate description of the debt in the deed of trust, failure to clarify the obligation secured by the real property, the lender had no authority to foreclose on the Enderles. See also *Walston v. Twiford*, 248 N.C. 691, 693, 105 S.E.2d 62, 64 (1958). The Court did not address the issue of whether the deed of trust could be reformed because the issue was not raised on appeal.

As noted earlier, no real property practitioner would fail to have the actual record owner of the property execute the deed of trust under the circumstances presented by *Enderle* and the two scenarios previously discussed in this article. However, many attorneys either fail to recognize the more subtle issue or are uncertain how to address it. The lenders in these scenarios are obviously concerned that the borrower has little or no valuable property to put up as collateral for the loan. In turn, real property practitioners are frequently in the unenviable position of representing the lender's interests at closing as well as those of the borrower. As a result, the closing attorney must be able to recognize transactions involving hypothecated security and represent the lender's interests accordingly. Otherwise, the lender may look to the closing attorney in the even the deed of trust cannot be foreclosed.

Fortunately, once spotted, the issue can be easily addressed. The holding in *Enderle* requires only that the deed of trust "properly identify the obligation secured." *In re Enderle*, 110 N. C. App. at 775. If the lender requires the property of one party to be encumbered as collateral for the debt of another, the closing attorney can simply attach an addendum to the deed of trust similar to that shown on Exhibit A to this article. This addendum, which must be signed by the mortgagor, recites that the mortgagor is deriving a material benefit from the loan being made to the third party. As an alternative, the closing attorney can suggest to the lender that the mortgagor sign a deed of trust specifically prepared by the attorney for transactions involving hypothecated security. Pertinent excerpts from such a deed of trust are shown as Exhibit B to this article. The closing attorney faced with an *Enderle* situation, must clearly identify the nature of the

mortgagor's obligation. Of course, convincing the mortgage lender to alter or append to one of their pre-printed forms is another thing entirely. The most important matter is for the closing attorney to recognize that when requested to encumber one party's property to secure the debt of some other party, more must be done than simply searching title to that property and having the record owner execute the deed of trust.

The author would like to thank James K. Pendergrass, Jr., of Reynolds & Pendergrass, P.A. in Raleigh, North Carolina, for his permission to include Exhibits A and B which he drafted in light of In re Enderle.

EXHIBIT A

ADDENDUM TO DEED OF TRUST FROM
_ TO _, TRUSTEE
FOR _, BENEFICIARY.

This Deed of Trust is given in the form of hypothecated security in that it is given to secure the debt of another, to wit: the indebtedness evidenced by the Promissory Note dated _, in the amount of $_ which is made and delivered by _ (hereinafter referred to as "Borrower") to and for the benefit of Beneficiary. _ (hereinafter referred to as "Owner") will derive a material and direct benefit from the loan evidenced by the Note, and in accordance therewith, Owner agrees that such interest and benefit are sufficient consideration to support the Deed of Trust. In the event of a default by Borrower under the Note, Owner expressly acknowledges, covenants, and agrees that Beneficiary shall have all rights and remedies hereunder as set forth for default just as if Owner had executed the Note. Further, in the event of default under the Note, it shall likewise be deemed an event of default hereunder giving rise to all rights and remedies as set forth herein for default. Owner expressly agrees that, upon such default, Beneficiary may elect to enforce any rights and remedies which it may have under this Deed of Trust. The foregoing provisions are set forth and made by Owner as an inducement to Beneficiary to enter into the loan transaction secured hereby.

_ (Seal)
John Doe
_ (Seal)
Jane Doe

EXHIBIT B

NORTH CAROLINA
_ COUNTY

DEED OF TRUST AND
SECURITY AGREEMENT

THIS DEED OF TRUST AND SECURITY AGREEMENT is made and entered into this _ day of _, _, by and between _ ("Grantor"), whose mailing address is _; _, Trustee of _ ("Trustee"); and _ ("Beneficiary"), whose mailing address is _.

STATEMENT OF PURPOSE

_ ("Borrower") is justly indebted to Beneficiary for money advanced as evidenced by a Promissory Note ("Note") of even date payable to the order of Beneficiary in the principal sum of _ AND NO/100THS DOLLARS ($_.00).

Grantor has an interest in the economic well-being of Borrower and has requested Beneficiary make a loan in the above amount to Borrower and accordingly does hereby give this Deed of Trust as an inducement to Beneficiary, to make such a loan and as security for the present and future obligations of Borrower to Beneficiary, for sums advanced by Beneficiary to Borrower pursuant to the terms of the Note of even date between Borrower and Beneficiary.

Grantor has agreed to secure payment of the indebtedness of Borrower evidenced by the Note by conveyance of the real estate hereinafter described.

SPECIAL TRUST

This Deed of Trust is given in the form of hypothecated security in that it is given to secure the debt of another, to wit: the Note secured hereby is that of a Promissory Note of even date herewith in the original principal amount of _ AND NO/100THS DOLLARS ($_.00), which is made and delivered by Borrower to and for the benefit of Beneficiary. The grantor will derive a material and direct benefit from the loan evidenced by the Note and in accordance therewith, Grantor covenants and agrees that such benefit is sufficient consideration to support this Deed of Trust. In the event of default by Borrower under the Note, Grantor expressly acknowledges, covenants and agrees that Beneficiary shall have all rights and remedies hereunder as set forth for default just as if Grantor had executed the Note. In the event of default by Borrower under the Note, it shall likewise be deemed an event of default hereunder giving rise to all rights and remedies as set forth herein for default. Further, it is expressly agreed by Grantor that, upon such default, Beneficiary may elect to enforce any rights and remedies which it may have under this Deed of Trust.

NOTE: The aforementioned are excerpts only. A granting clause, habendum clause and other such clauses as needed should be added for a complete security instrument.