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North Carolina Extends Its Anti-Deficiency Statute: Merritt v. Edwards Ridge

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In 1933 the North Carolina General Assembly enacted an anti-deficiency judgment statute[1] that prohibited mortgagee-vendors from obtaining deficiency judgments upon foreclosure of purchase money mortgages and deeds of trust.[2] While the anti-deficiency statute expressly prohibits deficiency judgments only when the mortgagee foreclosing on the purchase money mortgage is also the original seller,[3] the statute does not limit the prohibition specifically to residential mortgages.[4] Because seller financing predominantly is used today to provide funds for commercial development,[5] the anti-deficiency statute primarily precludes deficiency judgments against sophisticated commercial investors. Yet, a commercial investor, unlike the ordinary home buyer, speculates in land expecting to assume the business risks associated with real estate investment. Because protecting these commercial mortgagors from deficiency judgments misallocates

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1. Act of Feb. 6, 1933, ch. 36, § 1, 1933 N.C. Sess. Laws 28 (codified as amended at N.C. GEN. STAT. § 45-21.38 (1984)). Historically, a mortgagee could obtain a deficiency judgment when the amount realized from the foreclosure sale of the mortgaged property was insufficient to satisfy the balance owed by the defaulting mortgagor. *See* G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 8.1 (2d ed. 1985). The anti-deficiency statute applies to both judicial foreclosures and foreclosures pursuant to a powers of sale clause in a deed of trust. *See* N.C. GEN. STAT. § 45-21.38 (1984).

2. N.C. GEN. STAT. § 45-21.38 (1984). A "purchase money mortgage" refers to the mortgage interest retained by a lender who provides the necessary funds for a buyer to purchase the land that serves as the underlying security. A purchase money "deed of trust" pertains to the situation in which a lender secures repayment of the purchase money loan by providing for a third party trustee to retain title to the property purchased. These instruments typically contain a "powers of sale" clause that permits either the mortgagee or trustee to foreclose and sell the property upon the buyer's default. *See* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 1, § 1.6. This Note will use the terms "purchase money mortgage" and "deed of trust" interchangeably.

3. The anti-deficiency statute provides:

> In all sales of real property by mortgagees and/or trustees under powers of sale contained in any mortgage or deed of trust executed after February 6, 1933, or where judgment or decree is given for the foreclosure of any mortgage executed after February 6, 1933, to secure to the seller the payment of the balance of the purchase price of real property, the mortgagee or trustee or holder of the notes secured by such mortgage or deed of trust shall not be entitled to a deficiency judgment on account of such mortgage, deed of trust or obligation secured by the same: Provided, said evidence of indebtedness shows upon the face that it is for balance of purchase money for real estate: Provided, further, that when said note or notes are prepared under the direction and supervision of the seller or sellers, he, it, or they shall cause a provision to be inserted in said note disclosing that it is for purchase money of real estate; in default of which the seller or sellers shall be liable to purchaser for any loss which he might sustain by reason of the failure to insert said provisions as herein set out.

N.C. GEN. STAT. § 45-21.38 (1984).

4. *Id.* Thus, when seller financing is involved, the statute shelters both sophisticated commercial developers and ordinary home buyers from deficiency judgments. Several factors contribute to the use of seller financing in both commercial and residential real estate transactions. First, if a buyer fails to qualify for third-party lending, then the seller must finance all or part of the purchase price to consummate the sale. Second, the parties may use seller financing to avoid the additional transaction costs generally associated with third-party lending. Finally, the seller may attempt partially to defer recognition of any realized gain by financing the sale and electing installment sales treatment for tax purposes.

5. *See* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 1, § 12.9.

the investment risk of declining property values to the mortgagee, some commentators argue that the present-day function of the statute fails to comport with commercial reality.[6]

Despite these criticisms, in the past decade the North Carolina Supreme Court has broadly construed the anti-deficiency judgment statute, thereby significantly expanding the protection provided to defaulting mortgagors.[7] Most recently, in *Merritt v. Edwards Ridge*,[8] the supreme court considered whether the anti-deficiency statute prohibits a mortgagee-vendor from recovering attorneys' fees and other costs associated with a foreclosure sale.[9] The promissory note at issue expressly provided that the defaulting buyer, a partnership formed to develop real estate, was to bear these costs. Nevertheless, the court concluded that the statute's elimination of deficiency judgments precluded any recovery of such costs by the mortgagee.[10] Once again, the court broadly construed the statute to deny mortgagee-vendors relief and to protect defaulting commercial investors.[11]

This Note examines the legislative intent behind section 45-21.38 and the extent to which the court's holding in *Merritt* is consistent with that intent. The Note also considers the potential impact of *Merritt* on seller financing, especially given that previous judicial interpretations of the statute have provided extensive mortgagor protection at the expense of mortgagee-sellers. Finally, the Note examines the negative effects and uncertainty in commercial seller-financed transactions created by broad applications of the anti-deficiency statute and concludes that the general assembly should amend the North Carolina statute to distinguish between commercial and residential seller-financed real estate transactions.

Plaintiff in *Merritt* sold defendant, a general partnership organized for real estate development, a large tract of undeveloped land. In return, defendant executed two promissory notes secured by a purchase money deed of trust. Each note provided "that upon default the maker would pay the holder fifteen percent of the outstanding balance for reasonable attorneys' fees and pay all other rea-

6. Note, *Mortgages and Deeds of Trust*—Ross Realty Co. v. First Citizens Bank & Trust Co.: *North Carolina Anti- Deficiency Judgment Statute Bars Personal Actions Against Purchase Money Mortgagors*, 59 N.C.L. REV. 855, 865 (1980) (questioning the "wisdom of permitting the statute to remain in force" because the North Carolina Supreme Court's "construction of the statute disrupts traditional allocation of risk concepts in commercial real estate transactions"); *see also* Leipziger, *Deficiency Judgments in California: The Supreme Court Tries Again*, 22 UCLA L. REV. 753, 755 & 776-77 (1975) (noting that supreme court in California, a state with an anti-deficiency statute similar to North Carolina's, adopted an "analytically sounder" approach by applying a "residential/commercial dichotomy" that permits deficiency judgments against mortgagors who accept real estate investment risks for a commercial purpose).

7. *See* Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 373, 250 S.E.2d 271, 275 (1979) (concluding N.C. GEN. STAT. § 45-21.38 limits mortgagee-vendor's relief to recovery of the security); Barnaby v. Boardman, 313 N.C. 565, 569-71, 330 S.E.2d 600, 602-04 (1985) (concluding mortgagee-vendor could not circumvent anti-deficiency statute by first releasing his security interest and then bringing an in personam action on the "newly" unsecured promissory note). For a discussion of *Ross Realty* and *Barnaby*, see *infra* note 38. In each case the court maintained that its broad statutory construction was consistent with the general assembly's intent.

8. 323 N.C. 330, 372 S.E.2d 559 (1988).

9. *Id.* at 331-32, 372 S.E.2d at 560.

10. *Id.* at 335-36, 372 S.E.2d at 562-63.

11. *See id.* at 337, 372 S.E.2d at 563.

sonable expenses incurred by the holder in the exercise of any of the holder's rights and remedies upon default."[12]

After making several payments on the note, defendant defaulted. Plaintiff purchased the property at a foreclosure sale conducted by the trustee and paid the foreclosure costs. Thereafter plaintiff sought judicial enforcement of the note provisions requiring defendant to repay plaintiff for any foreclosure costs and reasonable attorneys' fees incurred.[13]

Affirming the trial court's order granting summary judgment for plaintiff-seller, the court of appeals interpreted the anti-deficiency statute to prohibit only recovery of expenses constituting part of the unpaid purchase price owed on the note.[14] Thus, the court concluded that "insofar as attorneys' fees and expenses [after default] are not part of the balance owing on the note," recovery of these costs did not constitute a deficiency judgment within the meaning of the statute.[15] In an opinion by Justice Mitchell, the North Carolina Supreme Court reversed, stating that the appellate court's decision failed to uphold the legislative intent to protect mortgagors from oppression by mortgagee-vendors.[16] The *Merritt* court emphasized that "the purchase money creditor is limited strictly to the property conveyed" upon default by the mortgagor.[17] Furthermore, the court decided that "the proceeds of a foreclosure sale are, constructively at least, real property and stand in place of" the property conveyed. Therefore, upon foreclosure and sale of the mortgaged property, the mortgagee's sole relief is the amount of the proceeds in lieu of the property.[18]

In a brief dissent, Justice Whichard accused the majority of placing a "judicial gloss on the anti-deficiency judgment statute" that deprived plaintiff of the

12. *Id.* at 332, 372 S.E.2d at 561. These provisions were incorporated by reference into the deed of trust. *Id.*

13. The promissory notes executed by defendant were for $200,000. The foreclosure sale, however, brought only $115,000. Taxes and other foreclosure costs, excluding attorneys' fees, amounted to $7,000 and were paid with proceeds from the sale. Plaintiff initiated an action to recover the $7,000 and reasonable attorneys' fees of $17,000 (approximately fifteen percent of $115,000 foreclosure sale price). Plaintiff did not seek recovery of the $85,000 deficiency for the excess of the amount owed on the two promissory notes over the foreclosure sale price.

14. Merritt v. Edwards Ridge, 88 N.C. App. 132, 135, 362 S.E.2d 610, 611 (1987), *rev'd*, 323 N.C. 330, 372 S.E.2d 559 (1988). In permitting recovery of these costs, the court of appeals followed its earlier decision in *Reavis v. Ecological Dev., Inc.*, 53 N.C. App. 496, 281 S.E.2d 78 (1981). The court of appeals in *Merritt* stated that the promissory notes in *Merritt* and *Reavis* used identical language to allocate the attorneys' fees and foreclosure costs to the mortgagor. *Merritt*, 88 N.C. App. at 135, 362 S.E.2d at 611.

15. *Merritt*, 88 N.C. App. at 135, 362 S.E.2d at 611.

16. Merritt v. Edwards Ridge, 323 N.C. 330, 335, 372 S.E.2d 559, 562 (1988) (appellate court's decision failed "to give proper weight to the intent of the General Assembly as construed" in both *Barnaby* and Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 250 S.E.2d 271 (1979)).

17. *Id.* at 335, 372 S.E.2d at 562.

18. *Id.* at 336, 372 S.E.2d at 563. The court also cited section 45-21.31, which governs the distribution of foreclosure sale proceeds. This section requires payment of the foreclosure costs before the purchase money creditor may receive any proceeds from the sale. N.C. GEN. STAT. § 45-21.31 (1984). The court concluded that the mortgagee, whose remedy is limited by section 45-21.38 to either the property conveyed or the proceeds of the sale, bears the burden of all foreclosure costs because of the distribution requirements of section 45-21.31. *See Merritt*, 323 N.C. at 336, 372 S.E.2d at 563.

benefits of a bargain.[19] As the sole dissenter, he asserted that neither the express language of the statute nor public policy required the majority's result, and concluded that the court of appeals' restrictive definition of a deficiency judgment most closely approximated the general assembly's intent.[20]

Because the language of section 45-21.38 does not expressly deny recovery of attorneys' fees and other foreclosure costs, the soundness of the *Merritt* court's expansive application of the statute depends entirely on the correctness of its interpretation of the general assembly's intent. Because of the lack of conventional legislative history surrounding the statute's enactment,[21] the court resorted to other sources in deriving the legislative purposes for enacting section 45-21.38.

The enactment of the statute during the Great Depression reflected the general assembly's concern with widespread foreclosures and forced sales at depressed prices.[22] While the values of the property securing the debt depreciated, the likelihood of deficiency judgments upon foreclosure increased. In the absence of an anti-deficiency statute, foreclosure proceedings not only presented defaulting mortgagors with the potential loss of the purchased property, but also with the risk of judgments enforceable against their unmortgaged assets.[23] Thus, prior to 1933, defaulting mortgagors in North Carolina bore the entire risk of decline in property values.[24] Given the plight of mortgagors, one commentator concluded that the general assembly intended to "limit the creditor to the property conveyed,"[25] thus shifting the entire risk of declining property values to the mortgagee.[26]

The decision to shift the risk of declining property values only to mortgagee-vendors,[27] however, indicates that something more than debtor relief was involved.[28] This statutory restriction may reflect the general assembly's concern

19. *Merritt*, 323 N.C. at 338, 372 S.E.2d at 564 (Whichard, J., dissenting).

20. *Id.* (Whichard, J., dissenting).

21. *See* Note, *supra* note 6, at 857 (pointing out the complete absence of legislative history and scarcity of contemporary commentary).

22. *See* Currie & Lieberman, *Purchase-Money Mortgages and State Lines: A Study in Conflict-of-Laws Method*, 1960 DUKE L.J. 1, 13-14 (1960).

23. *See* Currie & Lieberman, *supra* note 22, at 14. A defaulting mortgagor potentially suffers a double loss—sacrificing both payments made toward the purchase of the property and any unmortgaged assets necessary to satisfy the deficiency judgment. *See* Note, *supra* note 6, at 857-58.

24. Note, *REAL PROPERTY—North Carolina's Anti-Deficiency Statute: Is Suing on the Note a Lost Option?*— Barnaby v. Boardman, 22 WAKE FOREST L. REV. 389, 393 (1987).

25. *A Survey of Statutory Changes in North Carolina in 1933*, 11 N.C.L. REV. 191, 219 (1933).

26. *See* Note, *supra* note 24, at 394 (noting that general assembly reallocated "the risk of a decline in property values [to] the seller-mortgagee").

27. In 1961 a legislative amendment to section 45-21.38 made explicit that the statute does not apply to third-party lenders. Act of June 2, 1961, ch. 604, 1961 N.C. Laws 793 (codified as amended at N.C. GEN. STAT. § 45-21.38 (1984)); *see* Childers v. Parker's, Inc. 274 N.C. 256, 263, 162 S.E.2d 481, 486 (1968).

28. *See* Currie & Lieberman, *supra* note 22, at 16. For reasons previously stated, the general assembly disliked deficiency judgments because of the inequities to defaulting mortgagors. *See supra* notes 23-26 and accompanying text. However, extension of credit by vendors typically occurs only when the necessary credit cannot be obtained from third-party commercial lenders. Currie & Lieberman, *supra* note 22, at 33. Because the anti-deficiency statute is inapplicable to third-party lenders, the general assembly's restriction of section 45-21.38 to seller financing indicates additional concerns other than a general dislike of deficiency judgments. *Id.* at 18-19.

with inequities that may result from amateur financing[29] involving a "seller-mortgagee [who] often has a disproportionately powerful position."[30] One significant inequity is the potential for unjust enrichment of mortgagee-vendors at the expense of defaulting buyers. Frequently the mortgagee-seller, like plaintiff in *Merritt*, is the successful bidder at the foreclosure sale. In addition to regaining possession of the land, the vendor also "keeps whatever payments the purchaser may have made."[31] Therefore, after foreclosure "the mortgagee has been made whole by being restored to his original condition, with compensation (by way of the installment payments) for the use of the property in the meantime."[32] To permit the vendor then to pursue a deficiency judgment would only aggravate any preexisting inequities.

A second potential inequity resulting from seller financing is the problem of overvaluation, because the seller usually establishes the terms of the sale.[33] First, because the seller establishes the purchase price, the general assembly may consider it equitable to deny him the opportunity to argue that the property has subsequently declined in value.[34] Furthermore, if a deficiency will result because of the "failure of the foreclosure sale to produce a bid resembling the true value,"[35] then the seller could avoid resorting to a deficiency judgment by submitting a bid at the foreclosure sale equal to the balance owed on the note.[36] Thus, absent an anti-deficiency statute, the seller can set a "high" purchase price and then speculate in land, knowing that the buyer theoretically bears any risk of decline in property value by way of a deficiency judgment.[37]

Given the losses that defaulting mortgagors may endure in the absence of anti-deficiency legislation, it is not surprising that the supreme court has construed section 45-21.38 broadly to thwart mortgagee-sellers' attempts to circum-

29. *See* Note, *supra* note 6, at 858.

30. Note, *supra* note 24, at 393.

31. Currie & Lieberman, *supra* note 22, at 30; *see also* Note, *supra* note 24, at 393 (observing that defaulting mortgagors relinquish the purchased property, any down payment, and any regular payments made on the note).

32. *See* Currie & Lieberman, *supra* note 22, at 30.

33. *See* Leipziger, *supra* note 6, at 760-61.

34. *See* Currie & Lieberman, *supra* note 22, at 30 (noting that seller is "estopped to deny" that property is worth the full amount of the debt). This interpretation of the general assembly's intent is further supported when one considers that sellers often set prices above the land's actual market value. *See id.*

35. *See* Washburn, *The Judicial and Legislative Response to Price Inadequacy in Mortgage Foreclosure Sales*, 53 S. CAL. L. REV. 843, 848 (1980) (noting that foreclosure sales often bring bids below market value because they involve forced sales rather than arm's length deals between willing sellers and willing buyers, and because these sales receive ineffective selling and promotional efforts).

36. *See* Currie & Lieberman, *supra* note 22, at 30. In order to create a deficiency, the successful bidder at the foreclosure sale must purchase the property for less than the balance owed to the seller. If the true market value of the property exceeds the foreclosure sale price, then the seller can successfully purchase the property by bidding the balance owed on the note and can later resell the property under more favorable conditions.

37. *See* Note, *supra* note 24, at 393-94. In contrast to mortgagee-sellers, a third-party lender neither establishes the purchase price nor has a particular interest in promoting the sale of the land. *See* Currie & Lieberman, *supra* note 22, at 31. Also, unlike the seller, the third-party creditor has parted with cash and has received no down payment. *Id.* For these reasons, and because the property sold did not belong originally to the third-party lender, applying an anti-deficiency statute and limiting relief to the property conveyed will not restore this lender to his original position.

vent the statute. Broad judicial interpretations of the statute have eliminated the mortgagee's personal cause of action on the note, thereby strictly limiting his relief to an in rem foreclosure proceeding.[38] In addition, the supreme court has rejected the argument that the anti-deficiency statute should apply only to purchase money mortgages secured by residential property.[39] Finally, the court has refused to allow mortgagors to waive protection of the anti-deficiency statute, and thus has rendered void any express contractual provisions that attempt to deem the statute inapplicable.[40]

Because plaintiff in *Merritt* unsuccessfully disputed the "no waiver" interpretation of the statute,[41] the principal issue faced by the court was whether the anti-deficiency statute barred recovery of attorneys' fees and other costs associated with foreclosure.[42] In resolving this issue, the court had to ascertain whether the general assembly intended its use of "deficiency judgment" in section 45-21.38 to include these costs. In its attempt to define the components of a deficiency judgment, the *Merritt* court looked to the legislative purposes for enacting the anti-deficiency statute and also examined section 45-21.31, the statute that governs the distribution of foreclosure sale proceeds.

The first source the court examined was the legislative purpose underlying

38. The court applied a broad interpretation of the statute in Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 373, 250 S.E.2d 271, 275 (1979). In *Ross Realty* a purchase money creditor attempted to bring an in personam action to recover on the note, rather than seek payment by liquidating the security through an in rem foreclosure proceeding (to which the anti-deficiency statute clearly applied). The supreme court rejected the notion that a purchase money mortgagee had an option to elect between an in personam and an in rem proceeding and concluded that the general assembly intended to take away the creditor's option of suing on the note. *Id.* Faced with a similar issue six years later, the court again read the statute broadly. *See* Barnaby v. Boardman, 313 N.C. 565, 566, 330 S.E.2d 600, 601 (1985). In *Barnaby*, the purchase money mortgagee attempted to release his security interest and thereby create an unsecured note on which to sue. Once again the supreme court refused to recognize a mortgagee's attempt to circumvent the effects of the anti-deficiency statute. This time, however, the court declared that the "holder [mortgagee] must look exclusively to the property conveyed in seeking to recover any balance owed." *Id.*

39. *See Barnaby*, 313 N.C. at 570-71, 330 S.E.2d at 603-04 (concluding that the general assembly did not indicate any specific exclusion of the statute's application to purchase money mortgages secured by commercial property, and thus refusing to draw any distinction between commercial and residential property transactions). For a discussion of the distinction drawn by other jurisdictions, see *infra* note 79 and accompanying text.

40. *See Barnaby*, 313 N.C. at 568-69, 330 S.E.2d at 602; Bank v. Belk, 41 N.C. App. 356, 367, 255 S.E.2d 421, 428, *disc. rev. denied*, 298 N.C. 293, 259 S.E.2d 911 (1979).

41. *See Merritt*, 323 N.C. at 336, 372 S.E.2d at 563. The express language of section 45-21.38 strongly supports the court's "no waiver" construction. The statute provides that "the seller . . . shall cause a provision to be inserted in said note disclosing that it is for purchase money of real estate; in default of which the seller . . . shall be liable to purchaser for any loss which he might sustain by reason of the failure to insert said provisions . . . ." N.C. GEN. STAT. § 45-21.38 (1984).

Plaintiff neglected to assert any unconstitutional impairment of contract obligations based upon article I, section 10 of the United States Constitution. It is doubtful, however, that a constitutional attack on the anti-deficiency statute would prevail in light of prior United States Supreme Court decisions upholding similar debtor relief measures. *See, e.g.*, Richmond Mortgage & Loan Corp. v. Wachovia Bank & Trust Co., 300 U.S. 124 (1937) (upholding mortgagor's right to dispute that foreclosure sale price represents fair market value); Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447 (1934) (upholding Minnesota law allowing mortgagor to defer mortgagee's right to a deficiency judgment for the statutory period of redemption).

42. Because of the "no waiver" interpretation of the statute, the provision that expressly allocates the foreclosure costs to the buyer becomes material only if the general assembly's definition of "deficiency judgment" excludes these costs.

the enactment of the anti-deficiency statute. Following its own previous interpretations, the court reasserted that the legislature intended to protect buyers from oppression by mortgagee-sellers.[43] The supreme court and the court of appeals disagreed, however, on the question whether permitting recovery of the foreclosure costs and attorneys' fees would undermine this legislative purpose. While the court of appeals decided that the statutory prohibition of deficiency judgments applied only to recovery of the unpaid purchase price, the supreme court concluded that the general assembly intended an absolute ban on recovery of any costs associated with defaults by mortgagors. To effectuate its interpretation of the legislative purpose, the supreme court fashioned a judicial remedy that restricted the mortgagee-seller either to the property conveyed[44] or to the proceeds from the foreclosure sale.[45]

Even if one accepts the supreme court's interpretation of the general assembly's intent,[46] the *Merritt* majority never explained how extending section 45-21.38 to prohibit recovery of foreclosure costs and reasonable attorneys' fees would further any legislative purpose aimed at eliminating mortgagor oppression. Although the general assembly may have intended to discourage seller financing, nothing in the statute's language indicates an intent to eliminate its use completely.[47] At most, it appears the general assembly intended to ensure an equitable distribution of the risks associated with seller financing.

If the general assembly did intend to distribute equitably the risks between mortgagee-seller and mortgagor-buyer, then the court's decisions prior to *Merritt* seem sufficient to accomplish this goal. First, by restricting the mortgagee to the property conveyed, the court reallocated the risk of declining property values to the seller.[48] Furthermore, the anti-deficiency statute as previously interpreted provided the buyer with a unilateral right to rescind on the note.[49] Simply by electing to discontinue payment on the note, the mortgagor could

43. *Merritt*, 323 N.C. at 334, 372 S.E.2d at 562 (following *Barnaby* and Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 250 S.E.2d 271 (1979)). For a discussion of *Barnaby* and *Ross Realty* see *supra* note 38.

44. Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 370, 250 S.E.2d 271, 273 (1979) (quoted with approval in *Barnaby*, 313 N.C. at 569, 330 S.E.2d at 602).

45. *Merritt*, 323 N.C. at 336, 372 S.E.2d at 563.

46. While many courts and commentators agree that these inequities exist with residential seller financing, far fewer agree that these inequities exist with commercial transactions. *See, e.g.*, Note, *supra* note 24, at 401-02. See *infra* notes 75-79 for a discussion of other jurisdictions' anti-deficiency legislation and the judicial accommodations made for commercial mortgagees.

47. *See* Currie & Lieberman, *supra* note 22, at 42 (anti-deficiency statute abrogated only the remedy, not the practice of seller financing itself).

48. *See* Note, *supra* note 6, at 860 (stating that the anti-deficiency statute as interpreted in *Ross Realty* forces the mortgagee to bear "not only the risk of overvaluation of the security at the time of the sale, but also the risk of a decline in value of the mortgaged premises occurring after the sale"). Thus, the seller can no longer reach the personal assets of the buyer when the unpaid purchase price exceeds the proceeds from the foreclosure sale. This reallocation of risks favors mortgagors because it eliminates variables outside their control, such as seller-established purchase prices, general economic decline, and below market value foreclosure sale prices that can create deficiencies and subject a buyer's unmortgaged assets to a deficiency judgment. Although the buyer still forfeits any payments made to the seller, these payments arguably only compensates the seller for the buyer's use of the property prior to default. *See* Currie & Lieberman, *supra* note 22, at 30.

49. *See* Note, *supra* note 24, at 401 (citing Ross Realty Co. v. First Citizens Bank & Trust Co., 37 N.C. App. 33, 36, 245 S.E.2d 404, 406-07 (1978), *rev'd*, 296 N.C. 366, 250 S.E.2d 271 (1979)).

escape further personal liability.[50] At the same time the buyer elected to default, the costs at issue in *Merritt* became a necessary expenditure for the mortgagee to incur in pursuit of the only remedy surviving the court's prior decisions—foreclosure.[51] Thus, given that the court's previous decisions redistributed the majority of seller-financing risks to the mortgagee, the *Merritt* court's prohibition on bargaining over foreclosure costs and attorneys' fees seems unnecessary to further any legislative purpose.

In addition to ascertaining the statutory meaning of deficiency judgment from the legislative purposes of section 45-21.38, the *Merritt* court also justified its definition by reference to section 45-21.31,[52] which governs the distribution of foreclosure sale proceeds.[53] Section 45-21.31 expressly requires that specified items, such as the foreclosure costs and trustee commissions plaintiff sought in *Merritt*, be paid with the gross proceeds from the sale.[54] Upon payment of these costs, the statute authorizes use of the net proceeds toward satisfaction of the mortgagor's obligation on the note.[55] Finally, any surplus proceeds are remitted to the mortgagor.[56]

The supreme court read the distribution requirements of section 45-21.31 in conjunction with the anti-deficiency statute's prohibition on deficiency judgments. The court concluded that elimination of deficiency judgments meant the mortgagee should bear the entire loss from any deficiencies, including any deficiency created by first using the proceeds to pay the foreclosure costs.[57] Without explanation, the court in effect deemed section 45-21.31 to authorize the costs to be included in calculating the amount of any deficiency disallowed by section 45-21.38.

Section 45-21.31 clearly does govern the disposition of proceeds. It is less clear, however, that the general assembly intended it to supplement the anti-deficiency provisions and thereby place foreclosure costs ultimately on the mortgagee when a deficiency occurs.[58] Nevertheless, the court's reliance on section

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50. *See* Note, *supra* note 24, at 401.

51. The court stated that the mortgagee was limited strictly to either the property conveyed or the foreclosure sale proceeds. *Merritt*, 323 N.C. at 336, 372 S.E.2d at 563. Because the mortgagee must foreclose the mortgagor's equity of redemption to quiet title, foreclosure costs and related attorneys' fees are necessary expenditures.

52. N.C. GEN. STAT. § 45-21.31 (1984).

53. The statute provides in part:

> (a) The proceeds of any sale shall be applied by the person making the sale, in the following order, to the payment of—
>
> (1) Costs and expenses of the sale, including the trustee's commission, if any
>
> . . . .
>
> (4) The obligation secured by the mortgage, deed of trust, or conditional sale contract.
>
> (b) Any surplus remaining after the application of the proceeds of the sale as set out in subsection (a) shall be paid to the person or persons entitled thereto . . . .

Id. § 45-21.31.

54. *Id.* § 45-21.31(a)(1).

55. *Id.* § 45-21.31(a)(4).

56. *Id.* § 45-21.31(b).

57. *See Merritt*, 323 N.C. at 336, 372 S.E.2d at 563.

58. It is important to remember that the parties in *Merritt* expressly bargained over who should

45-21.31 to define the scope of the anti-deficiency statute appears justified for two reasons. First, section 45-21.31 establishes a priority system and requires payment of certain enumerated items before authorizing distribution of any net proceeds to the parties next in line.[59] Moreover, although the statute specifically entitles the mortgagor to "any surplus," it fails to state which party should bear the loss if a deficiency results.[60] One possibility is that the general assembly simply neglected to address the deficiency scenario. More likely, however, the general assembly was aware of the anti-deficiency statute and intended section 45-21.31 to govern the deficiency situation.[61] Thus, by implication it appears the general assembly intended section 45-21.31 to force the mortgagee to bear any foreclosure costs as part of the disallowed deficiency judgment.

A second justification for the *Merritt* court's cross reference to section 45-21.31 is that the interpretation is equitable. Whether the mortgagor or mortgagee bears foreclosure costs depends upon whether a surplus or a deficiency results from the sale. If a deficiency occurs, then the mortgagee bears these costs in the form of a disallowed deficiency judgment under section 45-21.38. On the other hand, if a surplus results, then the mortgagor ultimately bears the foreclosure costs as a decrease in the surplus proceeds she receives under the section 45-21.31 distribution system.[62] This method of allocation achieves an equitable result because it encourages the mortgagee to obtain a foreclosure sale price at least sufficient to cover the foreclosure costs plus the balance owed on the note, while at the same time it does not enable the mortgagor to participate in any surplus without bearing the costs created by his own default.

Even if the *Merritt* court justifiably refused to award the mortgagee recovery of foreclosure costs, neither the legislative purposes behind section 45-21.38 nor the priority system of section 45-21.31 justifies denial of the attorneys' fees. The court's denial of attorneys' fees is the most unsatisfactory part of its opinion because of the illogical application of accepted canons of statutory construction.

Plaintiff asserted that section 6-21.2[63] controlled the awarding of attorneys' fees because by its express terms the statute provided for recovery of attorneys' fees "arising from the collection of indebtedness."[64] Rejecting this argument,

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bear the costs associated with foreclosure. Moreover, plaintiff-seller never argued that the defaulting mortgagor always should bear these costs, but only that the court should recognize the parties' right to bargain. Presumably, in the absence of an express provision, section 45-21.31 would allocate these costs to the seller. *See infra* notes 59-62 and accompanying text. Yet, the court never explained why its "no waiver" interpretation associated with the anti-deficiency statute also applies to section 45-21.31.

59. *See* N.C. GEN. STAT. § 45-21.31(a) (1984).

60. *See id.* § 45-21.31(b).

61. The 1933 anti-deficiency statute predated section 45-21.31, which was enacted in 1949. Unlike the distribution of a surplus, which requires a separate determination of entitlement, the distribution of the proceeds in a deficiency situation occurs by systematically following the provisions in section 45-21.31(a).

62. N.C. GEN. STAT. § 45-21.31(b) (1984).

63. *Id.* § 6-21.2 (1986). In general, American courts disfavor awarding attorneys' fees to the successful party. Section 6-21.2, however, provides that "[o]bligations to pay attorneys' fees upon *any note*, conditional sale contract or other evidence of indebtedness, . . . shall be valid and enforceable, and collectible as part of such debt . . . ." *Id.* (emphasis added).

64. *Merritt*, 323 N.C. at 337, 372 S.E.2d at 563.

the court first stated an accepted rule of statutory construction that when "one statute deals with a particular situation *in detail*, while another deals with it in general and comprehensive terms, the particular statute will be construed as controlling *absent a clear legislative intent to the contrary.*"[65] Because the court believed section 45-21.38 dealt with the particular situation presented, and because the court found no clear legislative intent to the contrary, the court applied the anti-deficiency statute to deny recovery of the attorneys' fees.

A closer examination of the court's analysis here reveals two problems with its application of the statutory construction rule. First, the *Merritt* court incorrectly formulated the issue by assuming from the outset that attorneys' fees constituted one element of a deficiency judgment.[66] More specifically, the court construed the case as one involving a deficiency judgment comprised of attorneys' fees and a deed of trust used to secure a purchase money debt. Not surprisingly, the court then found the anti-deficiency statute to address in detail the issue presented. Yet, in no way did the court attempt to justify its assumption that foreclosure-related attorneys' fees constituted part of a deficiency judgment.[67]

Even if the court correctly concluded that the drafters of section 45-21.38 contemplated the particular situation presented, section 6-21.2 contains evidence of a contrary legislative intent that should have justified departing from the anti-deficiency provisions. First, section 6-21.2 indicates the general assembly's departure from the general rule that disallows recovery of attorneys' fees under any circumstances. Second, although the statute broadly permits recovery of attorneys' fees "upon any note," it narrowly limits recovery to those fees that are reasonable in amount and expressly contracted for in the debt instrument.[68] The majority disposed of this issue unsatisfactorily by summarily concluding that "[n]o such clear legislative intent to the contrary appear[s]."[69] However, as Justice Whichard persuasively argued in dissent, "[n]either the express terms of the [anti-deficiency] statute nor its underlying policy requires" placing a judicial gloss on the statute that denies mortgagees the benefits of a bargain.[70]

The *Merritt* decision continued the supreme court's trend of broadly construing section 45-21.38.[71] The effect of this broad interpretation, when applied

65. *Id.* (emphasis added).

66. *See id.*

67. The court should have formulated the situation presented in a manner that avoided reliance on an unfounded assumption. For example, the court could have phrased the issue as whether the anti-deficiency statute prohibits a party from contracting for attorneys' fees incurred to foreclose and collect payment on a secured debt. When formulated in this manner, section 6-21.2 seems to address the issue squarely, because it expressly permits recovery on "[o]bligations to pay attorneys' fees upon *any* note . . . or other evidence of indebtedness." N.C. GEN. STAT. § 6-21.2 (1986) (emphasis added).

68. *Id.* § 6-21.2. Plaintiff in *Merritt* expressly contracted to recover attorneys' fees and sought recovery of 15 percent of the outstanding balance of the debt. *See Merritt*, 323 N.C. at 332, 372 S.E.2d at 561. The statute specifically deems reasonable the recovery of fees up to 15 percent. N.C. GEN. STAT. § 6-21.2(1) (1986).

69. *Merritt*, 323 N.C. at 337, 372 S.E.2d at 563.

70. *Id.* at 338, 372 S.E.2d at 564 (Whichard, J., dissenting).

71. The broad construction of the statute started with Ross Realty Co. v. First Citizens Bank &

to commercial transactions, is to preclude mortgagee-sellers from bargaining over foreclosure costs and attorneys' fees. The result is a drastic reduction in the mortgagee-seller's ability to control risk in a seller-financed transaction.[72] While the prophylactic purpose of the statute may justify the effects of these decisions in residential real estate transactions, an argument for equitable redistribution of seller-financed risks to protect mortgagors from oppression seems untenable in commercial transactions.[73]

Commercial mortgagors, unlike residential home buyers, purchase real estate for the purpose of taking risks in order to turn a profit. Traditionally a commercial mortgagor, like defendant in *Merritt*, who speculated in land for profit, bore the entire risk of his business investment.[74] The supreme court's decisions up to and including *Merritt* enable a commercial real estate investor to engage in "no risk" land speculation and thus misallocate the investment risks in real estate transactions.[75] This misallocation of risks may have the effect of discouraging mortgagee-vendors from providing seller financing that facilitates commercial development.[76] Commercial mortgagors should not be able to avoid investment-related risks by claiming the umbrella protections currently existing under North Carolina's anti-deficiency statute.

The narrowing of the commercial mortgagee's rights is most disturbing when compared to the rights of mortgagees in other states with anti-deficiency legislation similar to that in North Carolina.[77] In all of these states, either through an express legislative provision or by judicial interpretation, the mortgagee is afforded at least one of the rights that North Carolina has eliminated by broad judicial construction. In particular, these states either provide the mortgagee with an election of remedies[78] or limit the anti-deficiency statute to resi-

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Trust Co., 296 N.C. 366, 250 S.E.2d 271 (1979), continued in Barnaby v. Boardman, 313 N.C. 565, 330 S.E.2d 600 (1985), and was further expanded in *Merritt*.

72. *See supra* notes 48-51 and accompanying text.

73. *See* Note, *supra* note 6, at 865 (stating that applications of the statute "in the context of commercial transactions in land call into question the wisdom of permitting the statute to remain in force"). *But see Barnaby*, 313 N.C. at 570-71, 330 S.E.2d at 603-04 (rejecting an argument that the anti-deficiency statute should not apply to purchase money mortgages relating to commercial transactions because the general assembly did not indicate any specific exclusion).

74. *See* Note, *supra* note 6, at 861.

75. *See Merritt*, 323 N.C. 330, 372 S.E.2d 559 (1988); Barnaby v. Boardman, 313 N.C. 565, 330 S.E.2d 600 (1985); Ross Realty Co. v. First Citizens Bank & Trust Co., 296 N.C. 366, 250 S.E.2d 271 (1979); *see also* Note, *supra* note 6, at 865 (claiming *Ross Realty* decision "disrupts traditional allocation of risk concepts in commercial real estate transactions").

76. *See* Note, *supra* note 24, at 401 (noting that a commercial buyer's unilateral right to rescind shifts the risks of commercial development and speculation to the mortgagee and thus will "have a substantial effect on commercial real estate development").

77. At least five other states have anti-deficiency legislation similar to North Carolina's section 45-21.38. *See* ARIZ. REV. STAT. ANN. § 33-729 (1974); CAL. CIV. PROC. CODE § 580b (West 1972); MONT. CODE ANN. § 93-6008 (1964); OR. REV. STAT. § 88.070 (1985); S.D. CODIFIED LAWS ANN. § 44-8-20 (1967).

78. By judicial decision, Oregon permits the mortgagee to choose between suing on the note or bringing a foreclosure action upon the buyer's default. *See, e.g.*, Bantier v. Harrison, 259 Or. 182, 485 P.2d 1073 (1971); Ward v. Beem Corp., 249 Or. 204, 437 P.2d 483 (1968). Likewise, South Dakota allows the mortgagee an election of remedies. *See* Federal Land Bank v. Schley, 67 S.D. 476, 293 N.W. 879 (1940).

dential real estate transactions.[79] Thus, while other states have restricted the scope of their anti-deficiency statutes, North Carolina courts continue to expand the statute's application.

In addition to misallocating the risks associated with commercial real estate transactions, the supreme court's broad construction of the anti-deficiency statute creates uncertainty in seller-financed transactions.[80] One unresolved issue is whether the anti-deficiency statute prohibits an in personam action by a seller, who, after subordinating her purchase money mortgage, has the underlying security involuntarily extinguished when a senior lienholder of the mortgagor forecloses.[81] Frequently, because construction lenders refuse to supply financing for material and labor unless made senior lienholders, the mortgagee-vendor subordinates her debt to accommodate the developer-mortgagor.[82] If the senior lienholder subsequently forecloses and leaves the mortgagee-vendor unpaid and without security, then applying the anti-deficiency statute to deny the mortgagee a "deficiency judgment" seems unfair, especially when it is often the mortgagor's incompetence or poor planning that caused the project to fail and the senior lienholder to foreclose.[83]

A second uncertainty created by the supreme court's broad construction of the statute is the possibility that guarantors who personally guarantee payment of the obligation may seek protection under the statute.[84] Protecting the guarantor from liability for the very event—foreclosure sale proceeds insufficient to

79. *See* ARIZ. REV. STAT. ANN. § 33-729 (1974) (eliminating deficiency judgments when mortgage is secured by "either a single one-family or single two-family dwelling"); CAL. CIV. PROC. CODE § 580b (West 1972) (eliminating deficiency judgments when mortgage is secured by "a dwelling for not more than four families"); First State Bank v. Chunkapura, 734 P.2d 1203, 1210-11 (Mont. 1987) (on rehearing, court limited application of the anti-deficiency statute to mortgages held on "occupied, single family residential property"). *But see* Cottage Grove Apt. Investors v. Brandenfels, 69 Or. App. 192, 197, 684 P.2d 1235, 1238 (1984) (Oregon Court of Appeals stated that attorneys' fees and foreclosure costs do constitute deficiency judgment when relating to foreclosure on *residential* property secured by a deed of trust).

80. One possible means of avoiding the negative effects of the anti-deficiency statute is to fractionalize the debt. *See* Leipziger, *supra* note 6, at 812. Fractionalization involves splitting the debt into two or more parts, with each part evidenced by a separate instrument and with one or more parts either unsecured or secured by collateral other than the property sold. *See* Leipziger, *supra* note 6, at 758 n.20.

81. *See* Brown v. Kirkpatrick, 217 N.C. 486, 487-88, 8 S.E.2d 601, 602 (1940) (seller, who held a junior purchase money mortgage, allowed to recover deficiency judgment because debt remained unpaid after senior lienholder foreclosed and extinguished the security). The supreme court rejected the reasoning of *Brown* when it declared that a purchase money mortgagor could not *voluntarily* release the security and then bring an in personam action on the note. *See* Barnaby v. Boardman, 313 N.C. 565, 570, 330 S.E.2d 600, 603 (1985). One commentator has concluded that *Brown* can be distinguished from *Barnaby* because of the involuntary extinguishment of the security in *Brown*. *See* Note, *supra* note 24, at 398 (implying *Brown* still should be good law). *But see* Sink v. Egerton, 76 N.C. App. 526, 528-29, 333 S.E.2d 520, 521-22 (1985) (distinguishing *Brown* and disallowing an in personam action by a subordinate purchase money mortgage holder who involuntarily had underlying security extinguished).

82. *See* G. OSBORNE, G. NELSON & D. WHITMAN, *supra* note 1, § 12.9.

83. *See* Leipziger, *supra* note 6, at 774. Leipziger notes that requiring the developer to indemnify the mortgagee by means of a deficiency judgment properly forces the developer to bear the risk of project failure. *See* Leipziger, *supra* note 6, at 769.

84. *See* Brown v. Owens, 251 N.C. 348, 350, 111 S.E.2d 705, 707 (1959) (concluding that mortgagee is not barred by anti-deficiency judgment statute from obtaining judgment against endorsers on an *unsecured* note).

satisfy the mortgagor's debt—against which the guarantor promised to indemnify the mortgagee seems inconsistent with the agreement between the guarantor and mortgagee, who relied upon the guarantor's promise in extending the loan.[85] The better view is that this transaction more closely resembles third-party financing by the guarantor, a lending transaction to which the anti-deficiency statute does not apply.

Due to the negative effects of broadly construed anti-deficiency legislation, and because economic conditions and markets have changed significantly since the enactment of the statute, the North Carolina General Assembly should reevaluate whether the statute continues to serve any useful purpose. Because third-party lenders finance most present-day residential real estate transactions, the statute's original prophylactic purpose of protecting farmers and homeowners from oppression has dissipated.[86] More importantly, the anti-deficiency statute, fueled by broad judicial interpretations, remains dangerously powerful in the commercial real estate sector. The general assembly should act to restore the traditional economic and legal notions that investors, not mortgagee-sellers, bear the risks associated with commercial land purchases motivated by profit expectations.

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85. Generally a guarantor is subrogated to the rights of the mortgagee and can seek a judgment against the mortgagor. Given the broad construction of the anti-deficiency statute and the "no waiver" policy, the supreme court might consider this maneuver an attempt by the mortgagee to circumvent the statute and deny the mortgagee a cause of action even against the guarantor.

86. *See* Note, *supra* note 22, at 401.