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FORECLOSURE RECEIVERSHIPS IN KENTUCKY

MARTIN R. GLENN*

INTRODUCTION

There have been few, if indeed any, subjects of substantive law that have undergone such evolutionary transitions as the law concerning mortgages and the enforcement of rights thereunder. By virtue of legislative fiat and judicial decisions, the entire theory and conception of this phase of the law of hypothecation has sharply deviated from the common-law principles in vogue in the early years of the Commonwealth.

Under the very early common-law, as known and practiced in England, a mortgage operated as a conveyance of the legal title which the mortgagee held as security for the debt. Upon default of the mortgagor, the mortgagee, without application to any court, entered, seized possession, and ousted the mortgagor for breach of covenant. At a later date, however, because of the harshness of the practice, courts of equity took cognizance of the matter and established the doctrine of redemption.

Under the doctrine of redemption it was held that while the mortgagor had, by virtue of the instrument of mortgage, parted with legal title, he nevertheless retained an equitable interest, namely, the right to redeem and avoid the conveyance by satisfying the debt. In order to divest the mortgagor of this purely equitable interest, it therefore became necessary for the mortgagee to invoke the aid of equity and foreclose upon the equitable right which remained in the mortgagor, after which the mortgagor was divested of all interest in the premises. This procedure, as modified by statute in the several states, is now referred to, in modern times, as "strict foreclosure".¹

This ancient mode of foreclosure was abolished in Kentucky more than a hundred years ago. Section 375 of the Kentucky Civil Code of Practice provides that "foreclosure of a mortgage is forbidden".

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¹ Insurance Co. of North America vs. Cheathem, 221 Ky. 668, 299 S. W. 545 (1927).
While the code provision does not define the type of foreclosure to which it refers and prohibits, it was intended to abolish the ancient mode of "strict foreclosure". It is not a prohibition against the enforcement of an equitable lien created under the modern doctrine whereby it is held that a mortgage conveys no title whatsoever, but operates as a mere equitable lien in favor of the mortgagee to secure the payment of the debt. Although the enforcement of this lien by the mortgagee is commonly called foreclosure, it should be borne in mind that such a proceeding is altogether different from the ancient and harsh "strict foreclosure" and is, on the contrary, a purely equitable proceeding to subject the property in partial or complete satisfaction of the debt.²

In the case of Insurance Co. of North America vs. Cheatem,³ the Court of Appeals of Kentucky said:

"Foreclosures were abolished by what is now Section 375 of the Civil Code, but, notwithstanding this provision of the Code, 'foreclosure' has been used by the text-writers and by this Court with but one meaning in mind, and that meaning is the institution of a suit to enforce a lien against property—In its ancient meaning it was a proceeding by which a mortgagor's equity was absolutely taken away from him—The Courts and the text-writers refer to foreclosure now as 'strict' foreclosure, which was the ancient meaning, and 'equitable' foreclosure, which is the modern meaning. The use of the word is more prevalent today than it has ever been in the history of jurisprudence. It is generally and uniformly understood in modern times as a proceeding whereby a lien is enforced and property is sold through a proceeding in Court to pay the debt."

From an examination of the above case, as well as an abundance of other authorities, it is evident that Kentucky is committed to the view that a mortgage conveys no title whatsoever, but operates as an equitable lien and that the mortgagee must enforce, in equity, his rights thereunder.⁴

Because of the great and necessary expansion of the lending business within the past few years, and because of the fact that the vast majority of loans being granted are secured by liens upon property, many interesting questions constantly arise

² Supra, note 1.
³ Supra, note 1.
⁴ Watts vs. Smith, 250 Ky. 617, 69 S. W. (2d) 796 (1933); Smith vs. Berry, 167 Ky. 646, 181 S. W. 379 (1916); Douglass vs. Cline, 75 Ky. (12 Bush) 608 (1877); Wooley vs. Holt, 77 Ky. (14 Bush) 788 (1879); Taliaferro vs. Gay, 78 Ky. 496 (1879); Mercantile Trust Co. vs. South Park Residence Co., 94 Ky. 271, 22 S. W. 314 (1893); Jones on Mortgages (8th Edition), Vol. 1, Pages 37-38, Sec. 35.
as to the respective rights of the parties under mortgages, vendors' liens, and other similar instruments and liens. The appointment of receivers in foreclosure proceedings is one of the most important and, in some instances, the most vexatious question that arises in the modern enforcement of liens. Much of the misunderstanding that exists in regard thereto is due to the fact that various types of lien-holders have different rights to the appointment of receivers. In the following pages the writer will discuss (1) the rights of mortgage holders to the appointment of receivers, (2) the rights of other lien-holders to the appointment of receivers, (3) the status and duties of receivers, and (4) the rights of lien-holders to rents, issues and profits.

**Rights of Mortgage Holders to the Appointment of Receivers**

(A) When The Mortgage Does Not Expressly Confer Such Right:

Kentucky Civil Code of Practice, Section 299, reads as follows:

"In an action by a mortgagee for a sale of the mortgaged property, a receiver may be appointed, if it appears that the property is in danger of being lost, removed or materially injured, or that the condition of the mortgage has not been performed, and that the property is probably insufficient to discharge the mortgage debt."

It has been held, in *Murray vs. Murray*, that, under the above provision, the holder of a mortgage which does not provide for the appointment of a receiver, must, in order to procure the appointment of same, show either (1) that the property is in danger of being lost, removed or materially injured, or (2) that the condition of the mortgage has not been performed and that the property is probably insufficient to discharge the mortgage debt. This is the well established rule.

Of course, the appointment of a receiver in such a case is

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*124 Ky. 426, 99 S. W. 301 (1907).*

*Columbia Trust Co. vs. Morgan, 19 Ky. L. Rep. 1761, 44 S. W. 389 (1898); Douglass vs. Cline, 75 Ky. 608 (1877); Mayfield vs. Wright, 107 Ky. 530, 54 S. W. 864 (1890); Hindman vs. Volk, 30 Ky. L. Rep. 818, 99 S. W. 660 (1907); Jennings vs. Columbia Life Ins. Co., 213 Ky. 477, 281 S. W. 477 (1926); Watts' Admr. vs. Smith, 250 Ky. 617, 63 S. W. (2d) 796 (1933).*
a matter of sound legal discretion and should be made or refused by the Court upon the facts presented.\(^7\)

(B) **When The Mortgage Expressly Confers Such Right:**

While the holder of a mortgage which makes no provision for the appointment of a receiver upon foreclosure must, in order to procure the appointment of same, plead and prove that the property is in danger of being lost, removed, or materially injured, or that the condition of the mortgage has not been performed and the property is probably insufficient to discharge the mortgage debt, no such allegations or proof is necessary when, by the express terms of the mortgage, it is provided that the mortgagee may procure the appointment of a receiver in a foreclosure action.

Quite often, a provision is contained in a mortgage to the effect that, in an action to enforce the mortgage lien, the court may, upon the application of the holder of the mortgage, appoint a receiver to take possession of the premises and collect the rents, issues and profits. It is well settled, in Kentucky, that, when a mortgage contains such a provision, the holder of the mortgage who is enforcing the same, has an absolute contractual right to the appointment of a receiver for such purposes, regardless of the provisions of the above-quoted Section 299 of the Kentucky Civil Code of Practice.\(^8\)

In *Brasfield & Son vs. Northwestern Mutual Life Insurance Co.*\(^9\), the Court said:

"By virtue of its provision appellee had a lien on the rents and was entitled to a receiver both under the terms of the mortgage, *Handman vs. Volk*, 99 S. W. 660, 30 Ky. Law Rep. 818, and under the undenied allegations of the petition, bringing the case within Section 299, Civil Code of Practice."

In *Southern Trust Co. vs. First City Bank & Trust Co., of Hopkinsville*,\(^10\) it was said:

"It was provided in these two mortgages of the appellants: 'That upon institution of proceedings to foreclose this mortgage plaintiff..."

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\(^7\) *Douglass vs. Cline*, supra, note 6; *Goldsmith vs. Flechheimer*, 16 Ky. L. Rep. 432, 28 S. W. 21 (1894); *Mortgage Union of Penn. vs. King*, 245 Ky. 691, 54 S. W. (2d) 49 (1932).

\(^8\) *Brasfield & Son vs. Northwestern Mutual Life Ins. Co.*, 233 Ky. 94, 25 S. W. (2d) 72 (1930); *Southern Trust Company vs. First City Bank & Trust Co. of Hopkinsville*, 259 Ky. 151, 82 S. W. (2d) 205 (1935).

\(^9\) *Supra*, note 8.

\(^10\) *Supra*, note 8.
shall be entitled to have a receiver appointed by the court to take care of the premises, to collect the rents and profits, and to put the premises in good repair.

"Such an agreement or contract right of the mortgagee to have a receiver appointed was not involved in Watts' Admr. vs. Smith, supra, ... it seems to us that there is a contract right to the appointment of a receiver in case of default by the mortgagor."

Inasmuch as the mortgagor's right, in such an instance, arises from agreement or contract, it is submitted that there is no opportunity presented for the exercise of judicial discretion by the court. Instead, the court is bound to appoint a receiver upon application of the mortgagee; a refusal to do so would amount to a failure, on the part of the court, to enforce the valid terms of a contract.

**RIGHTS OF OTHER LIEN-HOLDERS TO THE APPOINTMENT OF RECEIVERS**

Kentucky Civil Code of Practice, Section 298, reads as follows

"On the motion of any party to an action who shows that he has, or probably has, a right to, a lien upon, or any interest in, any property or fund, the right to which is involved in the action, and that the property or fund is in danger of being lost, removed or materially injured, the court, or the judge thereof during vacation, may appoint a receiver to take charge of the property or fund during the pendency of the action, and may order and coerce the delivery of it to him. The order of a court, or of the judge thereof, appointing or refusing to appoint a receiver, shall be deemed a final order for the purpose of an appeal to the Court of Appeals. Provided, that such order shall not be superseded."

A cursory reading of the above provision may leave the impression that the holder of a lien, other than a mortgage lien, may procure the appointment of a receiver upon the same terms as the holder of a mortgage which does not expressly confer such a right upon the mortgagee. Such a conclusion is erroneous.

As has been previously said, Section 299 of the Kentucky Civil Code of Practice allows the holder of such a mortgage to procure the appointment of a receiver whenever (1) the property is in danger of being lost, removed or materially injured, or whenever (2) the condition of the mortgage has not been performed and the property is probably insufficient to discharge the mortgage debt. But Section 298 of the Kentucky Civil Code
of Practice does not allow the holder of a lien, other than a mortgage lien, to procure the appointment of a receiver upon a showing that the condition of the mortgage has not been performed and the property is probably insufficient to discharge the mortgage debt.

The holder of a lien, other than a mortgage lien, must, in order to procure the appointment of a receiver, allege and prove that the property is in danger of being lost, removed or materially injured. In brief, waste, or threatened waste, is the sine qua non when the holder of such a lien seeks the appointment of a receiver.11

In Columbia Trust Co. vs. Morgan,12 it was said:

"In an application to appoint a receiver by a vendor, the motion should not prevail unless it is made manifest, not only that the party in possession is insolvent and the property is insufficient to pay the debt, but also that the party in possession is committing or threatening to commit waste or by bad husbandry is impairing the value of plaintiff's security."

In Murray vs. Murray,13 the Court said:

"A general lien holder cannot obtain the appointment of a receiver upon a showing that his debt is overdue and that the property incumbered by the lien is probably insufficient to pay it. He must establish that the property is in danger of being lost, removed or materially injured. The property may not be sufficient to satisfy his debt; but this fact alone will not authorize the court to put it in the hands of a receiver."

STATUS AND DUTIES OF RECEIVERS

Kentucky Civil Code of Practice, Section 300, provides that "excepting representatives, guardians, curators and committees of persons of unsound mind, neither a party to an action, nor his attorney, nor any person interested therein, shall be appointed receiver."

It has been held, however, that the appointment of an interested party as receiver is not void, but voidable.14 Furthermore, an interested party may always be appointed as receiver upon the agreement of all parties in interest.15

11 Columbia Trust Co. vs. Morgan, 19 Ky. L. Rep. 1761, 44 S. W. 389 (1898); Murray vs. Murray, 124 Ky. 426, 99 S. W. 301 (1907).
12 Supra, note 11.
13 Supra, note 11.
15 Young vs. Fidelity and Columbia Trust Co., supra, note 14.
Generally, the remedy of receivership is purely ancillary, being a proceeding in rem, and being incidental to other relief sought in the action. A receiver does not represent any particular party to the litigation. Instead, he represents the Court itself. His status was defined by the Court in the action styled Crump & Field vs. First National Bank of Pikeville, wherein he was defined as being:

"An indifferent person between the parties; an officer of the Court appointed on behalf of all parties, and not on behalf of the complainant or defendant only; the creature and arm of the Court."

With this definition in mind, it is interesting to speculate here whether a receiver, as an officer of the court, is such a public officer whose compensation, though fixed by the court, cannot exceed the limitations imposed by the Constitution of Kentucky upon other public officers.

It is very well settled that the appointment of a receiver amounts to an equitable ejectment of the lienor. Thereafter, the possession of the receiver is the possession of the court. And refusal to deliver property to a receiver may be punished as contempt.

The powers and duties of receivers are succinctly stated in Section 302 of the Kentucky Civil Code of Practice, which provides as follows:

"The receiver has, under the control of the court, power to bring and defend actions, to take and keep possession of the property, to receive rents, collect debts, and generally to do such acts respecting the property as the Court may authorize."

A receiver may, when so ordered by the court that appointed him, maintain an action. In such event he may, under Section 21 of the Kentucky Civil Code of Practice, bring the action without joining with him the person or persons for whose benefit it is prosecuted, with the exception that he must join with him all parties in interest in actions involving title to

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16 Evans' Admr. vs. Clinton Bank, 244 Ky. 270, 50 S. W. (2d) 563 (1932).
17 239 Ky. 526, 17 S. W. (2d) 426 (1929).
18 Southern Trust Co. vs. First City Bank & Trust Co. of Hopkinsville, 259 Ky. 151, 82 S. W. (2d) 206 at 207 (1935).
19 Hazelrigg vs. Bronaugh, 78 Ky. 62 (1879); Rapp Lumber Co. vs. Smith, 243 Ky. 317, 48 S. W. (2d) 17 (1932).
20 Rebham vs. Fuhrman, 21 Ky. L. Rep. 17, 50 S. W. 976 (1899).
Likewise, it has been held that an action cannot be brought or maintained against a receiver without the permission of the court that appointed him.23

In the prosecution or defense of such actions the receiver may, if necessary, procure counsel to represent him. But the compensation of such counsel will be fixed by the court appointing the receiver, regardless of the contract between the receiver and his counsel.24

The court may, in some instances, authorize the receiver to continue the operation of the business for a certain period when it appears that a discontinuance of the business within that time would probably result in great loss.25 Ordinarily, however, the customary and main functions of receivers are the preservation of the premises and the collection of the rents, issues and profits during the pendency of the foreclosure action.

In collecting the rents, issues and profits the receiver must exercise reasonable care, and, if his failure to collect same is due to negligence on his part, he is liable therefor.26 Furthermore, he is liable for money deposited without authority of the court that appointed him, in a bank that subsequently fails.27 He has no discretion as to the application or disposition of the fund or property, and must dispose of it in the manner and amounts as adjudged by the court.28 And he can be held to account for the misapplication of funds coming into his hands.29

**Rights of Lien-Holders to Rents, Issues and Profits**

Under the ancient legal rule, the holder of a mortgage, or other lien, who had no specific pledge of the rents, issues and profits, could not claim them as a legal incident growing out

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22 Caldwell vs. McWhorter, 8 Ky. L. Rep. 79, 34 Ky. 130 (1886).
23 Spalding vs. Com., 88 Ky. 125, 10 S. W. 420 (1889); May vs. Ball, 24 Ky. L. Rep. 875, 70 S. W. 196 (1902).
24 Marble vs. Husbands, 185 Ky. 605, 215 S. W. 435 (1919); Johnston vs. Stephens, 206 Ky. 83, 266 S. W. 881 (1924); Fidelity & Columbia Trust Co. vs. Grommes & Ullrich, 186 Ky. 345, 216 S. W. 1078 (1919).
25 Mountain City Motor Co.'s Receiver vs. Mountain City Motor Co., 221 Ky. 579, 299 S. W. 189 (1927).
26 Higgins vs. Shields, 151 Ky. 227, 151 S. W. 391 (1912).
of his lien. But even before the adoption of our first Civil Code of Practice, courts of equity had adopted, in suits to foreclose mortgages, the rule of appointing receivers and authorizing them to collect the rents, issues and profits accruing after the date of their appointment.

In the case of Wooley vs. Holt, the court had before it the question of the right of the mortgagee to the rents, issues, and profits when the instrument of mortgage made no reference to same. The court held that, in the absence of an express pledge of the rents, issues and profits, the mortgagee’s right to them is “inchoate”, and its perfection is dependent upon the appointment of a receiver, and, furthermore, such a perfected right is subject to the rights of all third persons that have intervened before the appointment of a receiver. The doctrine of this case was affirmed recently in Watts’ Admr. vs. Smith.

The above cases indicate that a different rule might apply if the instrument expressly pledged, in addition to the real estate, the rents, issues and profits arising therefrom. Many instruments contain such provisions.

A great number of cases involving this question have been before the Court in past years. But all of them turned upon other points and, with great skill, the determination of the effect and status of real estate mortgages covering rents, issues and profits, was carefully evaded.

Gradually, the court has reached the conclusion that such an instrument which covers real estate and, in addition thereto, the rents, issues, and profits arising therefrom, is an “inchoate” right to said usufruct and can only be perfected by the appointment of a receiver. In other words, the court makes no distinction, in this respect, between a mortgage which specifically pledges the rents, issues and profits, and one which does not

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30 Watts’ Admr. vs. Smith, 250 Ky. 617, 63 S. W. (2d) 796 (1933).
31 Watts’ Admr. vs. Smith, supra, note 30.
32 Watts’ Admr. vs. Smith, supra, note 30.
33 Watts’ Admr. vs. Smith, supra, note 30.
34 Newport & Cincinnati Bridge Co. vs. Douglass, 73 Ky. 673 (1877); Louisville vs. Baumeister, 87 Ky. 6, 7 S. W. 170 (1887); Handman vs. Volk, 30 Ky. L. Rep. 818, 99 S. W. 660 (1907); Brasfield & Son vs. Northwestern Mutual Life Ins. Co., 233 Ky. 94, 25 S. W. (2d) 72 (1930); Northwestern Mutual Life Ins. Co. vs. Stofer, 242 Ky. 144, 45 S. W. (2d) 1025 (1932); Watts’ Admr. vs. Smith, 250 Ky. 617, 63 S. W. (2d) 796 (1933).
expressly pledge them. Furthermore, it has been held that the rights of third parties to the rents, issues, and profits are prior to the real estate mortgage specifically pledging same where the said rights have intervened previous to the appointment of the receiver.

The facts in the recently decided case of Southern Trust Co. vs. First City Bank & Trust Co. of Hopkinsville, were as follows: On January 2, 1925, C. W. Garrott executed two mortgages on his farm to the Southern Trust Co. The mortgages contained the following provision, "the mortgagor does hereby mortgage and convey unto the mortgagee, its successors and assigns, the following tract of land, together with all the rents, issues, profits and all appurtenances and improvements now upon or which may hereafter be put upon said real estate." One of these mortgages was assigned to the Metropolitan Life Insurance Company.

In April and May, 1930, Garrott executed chattel mortgages to the First City Bank & Trust Co. of Hopkinsville upon the crops growing and to be grown upon the farm to secure the payment of $8,600. These chattel mortgages were taken with actual as well as constructive knowledge of the real estate mortgages and were promptly recorded.

On December 22, 1930, the Southern Trust Co. filed suit to enforce its real estate mortgage on the land and the crops. The Metropolitan Life Insurance Company and the First City Bank and Trust Company of Hopkinsville were made parties thereto. A receiver was appointed on March 19, 1931.

At a judicial sale of the land, it was purchased by the insurance company but did not bring enough to pay the mortgage held by the Southern Trust Company. The crops placed in the hands of the receiver yielded $4,553.18. The Southern Trust Company claimed that, because of the express pledge of the rents, issues and profits in its real estate mortgage, it had a lien thereon prior and superior to the chattel mortgage held by the First City Bank & Trust Company of Hopkinsville. The trial court adjudged priority to the chattel mortgage. The Court of Appeals affirmed and said:

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35 Southern Trust Co. vs. First City Bank & Trust Co. of Hopkinsville, 259 Ky. 151, 83 S. W. (2d) 205 (1935).
36 Southern Trust Co. vs. First City Bank & Trust Co. of Hopkinsville, supra, note 35.
“Where there is a pledge of, or a contract right to, the rents, issues and profits, the mortgage or lien will be construed to cover those things on hand when they are taken into possession by the mortgagor or receiver... Indeed, the whole tenor and effect of instruments mortgaging the rents, issues and profits in addition to the real estate, is that they are regarded as secondary security with the lien continuing as an inchoate right which will be and must be perfected or consummated by asserting the right by some definite action looking toward possession and subjection. Of course, that must be done in some lawful manner. Ordinarily, even without a specific provision authorizing it, it is by asking the court to have a receiver take control for the pledgee’s benefit. Such, in effect, is an equitable ejectment of the mortgagor and the acquiring of possession by the mortgagee. Until that is done, he does not acquire a vested lien that will prevent a completed lien imposed subsequent to his inchoate lien from becoming prior and paramount in effect. Until that is done, the mortgagor may dispose of the rents, issues and profits as he desires without being liable to account therefor to the mortgagee.”

It should be noted, however, that the doctrine, as enunciated in the above action, does not allow the removal or severance or disposition of standing timber, minerals, soil, or buildings from the land which is encumbered, without the written consent of the lien-holder of record. This is predicated upon the fact that these articles are a part and parcel of the land itself, and not the mere usufruct thereof.

The General Assembly of Kentucky, at its 1936 session, recognized this distinction and enacted a measure imposing a fine and imprisonment for the removal or disposition of such articles from encumbered property, where such acts impair the value of the security in an amount exceeding Twenty Dollars ($20.00). Furthermore, by another measure enacted at the same session, it was provided that whoever purchases or severs or removes said articles and converts them to his own use, takes same subject to the recorded encumbrance on the land from which they are removed; and also that such acts shall render the person, firm or corporation, who so purchases or severs or removes and converts same to his own use, liable in damages to the record holder of the encumbrance on the land.

Conclusion

In the foregoing pages the writer has attempted to show that (1) Kentucky adheres to the equitable lien theory of mort-

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37 Senate Bill 78 (Not published in statute form at time this article was written).
38 Senate Bill 79 (Not published in statute form at the time this article was written).
gages and other encumbrances, (2) that a mortgagee is entitled to the appointment of a receiver, even though the instrument of mortgage does not specifically provide therefor, upon a showing of waste or upon a showing of default coupled with the fact that the property is probably insufficient to satisfy the mortgage debt, (3) that, where the mortgage specifically gives to the mortgagee the right to have a receiver appointed in foreclosure proceedings, it is a contractural right which the mortgagee may exercise at its option and which the court must respect, (4) that the holders of other liens can only procure the appointment of a receiver upon alleging and showing waste, actual or threatened, (5) that receivers are officers and agents of the court appointing them, whose duty it is to protect the premises and collect the rents, issues and profits, and also perform such other acts as authorized by the court, and (6) that whether a real estate mortgage specifically pledges the rents, issues and profits, or is silent in regard thereto, the lien thereon is an inchoate right which is not perfected until the appointment of a receiver, after which it is prior and superior to any or all other claims on the said rents, issues and profits that attach subsequent to receivership.