

1985

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### Recommended Citation

Dorothy E. Cumby, *Effects of Legislation on the Reverse Annuity Mortgage as a Means of Home Equity Control*, 13 Fordham Urb. L.J. 869 (1985).

Available at: <https://ir.lawnet.fordham.edu/ulj/vol13/iss4/2>

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# EFFECTS OF LEGISLATION ON THE REVERSE ANNUITY MORTGAGE AS A MEANS OF HOME EQUITY CONVERSION

## I. Introduction

The high rate of inflation in recent years has caused many elderly homeowners to become house-rich and cash-poor.<sup>2</sup> They are faced with rising costs and rapidly devaluating fixed incomes.<sup>3</sup> Increases in property taxes<sup>4</sup> and other costs of maintaining a home<sup>5</sup> add to their income plight.<sup>6</sup> Often, the elderly must sell their homes<sup>7</sup> to meet monthly expenses even though many of these homes are owned debt free.<sup>8</sup>

In 1981, seventy-five percent of the elderly had an income below \$10,000<sup>9</sup> and the median income for this group was \$5771.<sup>10</sup> The median income for those who lived alone was \$5134.<sup>11</sup> Only seven

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1. For the purposes of this Note, the terms "elderly" and "senior citizen" refer to those age 65 or over. However, this is an arbitrary figure and it is not intended to suggest that individuals in this age category are "old."

2. See Editorial, *Home Equity Conversion Plans—A Break for the Elderly*, 110 N.J.L.J. 4, 4 (Oct. 14, 1982) [hereinafter cited as Editorial]; Hagel, *Home Equity Conversion Programs: Are They Compatible With Public Entitlement Programs?*, 15 CLEARINGHOUSE REV. 254, 254 (July, 1981) [hereinafter cited as Hagel]; Kanner, *Dissaving for Elderly Homeowners: Plans and Pitfalls*, 9 REAL EST. L.J. 158, 158 (1980) [hereinafter cited as Kanner]; Note, *The Effect of Reverse Annuity Mortgages on SSI*, 16 U.C.D. L. REV. 435, 435-36 (1983) [hereinafter cited as Blumenstein & Harmann]. Elderly homeowners are living in homes which were purchased many years ago and which have a current market value many times the original price. Hagel, *supra*, at 254.

3. Kanner, *supra* note 2, at 158.

4. *Id.*

5. Editorial, *supra* note 2, at 4.

6. Kanner, *supra* note 2, at 158.

7. *Id.*; Editorial, *supra* note 2, at 4 (many senior citizens are forced to move to institutions after they sell their homes due to their inability to meet costs of carrying a home).

8. Editorial, *supra* note 2, at 4; Blumenstein and Harmann, *supra* note 2, at 435-36. Approximately 12,500,000 homes are owned by persons over 65 years of age; 80% of these are owned free and clear of any outstanding mortgage. STAFF OF SENATE SPECIAL COMM. ON AGING, 98TH CONG., 2D SESS., TURNING HOME EQUITY INTO INCOME FOR OLDER HOMEOWNERS 1 (S. Print 216, 1984) [hereinafter cited as SENATE COMM. ON AGING HOME EQUITY REPORT].

9. STAFF OF SENATE SPECIAL COMM. ON AGING, 98TH CONG., 2D SESS., AGING AMERICA: TRENDS AND PROJECTIONS 26 [hereinafter cited as SENATE COMM. ON AGING, AGING TRENDS REPORT]. Only 42% of those 25 to 64 years old had an income below \$10,000. *Id.*

10. *Id.* at 31. This figure applies to elderly, unrelated individuals.

11. *Id.* Although the income level of most senior citizens is low in the absolute

percent of the elderly had an income greater than \$20,000.<sup>12</sup> Nonetheless, seventy-two percent of this group owned their own homes.<sup>13</sup> These low fixed incomes<sup>14</sup> of elderly individuals do not meet the high costs of maintaining a house.<sup>15</sup> This problem is compounded by the necessity of frequent repairs in older homes.<sup>16</sup>

Methods of converting the equity<sup>17</sup> in senior citizens' homes into cash are necessary to prevent the elderly from suffering the trauma of having to sell their homes and relocate.<sup>18</sup> This need has been the focus of attention of different groups since the mid-1970's.<sup>19</sup> A recommendation was made to the White House Conference on Aging Mini-Conference on Housing to develop mechanisms to enable older

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sense, as well as in comparison to those adults under age 65, recent inflation has not affected the elderly population as much as the younger population. *Id.* at 29. The real median income of the elderly remained constant from 1980 to 1981. *Id.* The median income in constant dollars for the younger population dropped slightly between 1980 and 1981. *Id.*

12. *Id.* at 26. Approximately 25% of individuals aged 25 to 64 years had an income greater than \$20,000. *Id.*

13. *Id.* at 90. "For [a] majority of these [elderly] homeowners, the equity they have accumulated in their homes represents their single largest asset [and] their major lifetime investment." SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 1.

14. The sources of the fixed income of the elderly are pensions and social security benefits. *See* SENATE COMM. ON AGING, AGING TRENDS REPORT, *supra* note 9, at 33. Social security benefits are the single largest source of cash income to the elderly population. *Id.* The benefits are paid to 91.2% of the elderly population. *Id.* More than one-half of this group depend on social security benefits to provide them with 50% of their income, while 20% depend on these benefits for 90% or more of their income. *Id.*

15. The equity in the home could be drawn upon to meet the expenses of repairs and maintenance. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 1.

16. *See* SENATE COMM. ON AGING, AGING TRENDS REPORT, *supra* note 9, at 90 (significant proportion of elderly homeowners live in houses with flaws).

17. Equity in real property is the amount or value of the property above the total liens or charges encumbering the property. BLACK'S LAW DICTIONARY 484 (5th ed. 1979).

18. The elderly have psychological attachment to their homes and the emotional trauma of moving would be great, especially if no suitable housing is "available near shopping centers, churches and medical facilities with which they are familiar." P. BARNETT & J. MCKENZIE, ALTERNATIVE MORTGAGE INSTRUMENTS § 8.01 (1984).

A study completed in 1977 by Bruce Jacobs, a professor at the University of Rochester, showed that 25% of all low-income elderly homeowners could raise their incomes above the poverty level by drawing upon the equity in their homes. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 1.

19. *See, e.g., How Reverse Mortgage Creates Owner Equity*, 10 THE MORTGAGE AND REAL EST. EXECUTIVES REPORT No. 20, at 2 (December 15, 1977). *See also infra* notes 37-45 and accompanying text for a discussion of the Federal Home Loan Bank Board Study on Alternative Mortgage Instruments.

homeowners to convert their home equity into cash.<sup>20</sup> The suggested mechanisms included property tax postponement,<sup>21</sup> deferred payment loans for major home repairs,<sup>22</sup> sale-leaseback arrangements<sup>23</sup> and reverse (annuity) mortgages.<sup>24</sup>

A number of newly-created financing devices permit senior citizens to draw upon the equity in their homes without selling them.<sup>25</sup> The major device is the reverse (annuity) mortgage (RAM).<sup>26</sup> Simply stated, a RAM loan provides monthly payments to the elderly borrower which serve as a cash supplement.<sup>27</sup> Other major methods of financing are sale-leaseback arrangements,<sup>28</sup> split equity contracts<sup>29</sup> and special purpose loans.<sup>30</sup> Although some of these devices have been used for many years,<sup>31</sup> all of them are in the early stage of development in relation to unlocking equity in the homes of senior citizens.<sup>32</sup>

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20. Hagel, *supra* note 2, at 254.

21. *Id.* This mechanism allows unpaid property taxes and interest thereon to accumulate as a lien against the property. Kanner, *supra* note 2, at 161. These amounts become payable upon the death of the homeowner or the prior sale of the property. *Id.* Interest is usually charged at a low rate. *Id.* A number of states have enacted such a program for senior citizens who meet certain income qualifications. *Id.*

22. Hagel, *supra* note 2, at 254. A deferred payment loan permits the homeowner to repair or rehabilitate his home and to defer repayment of all principal and interest either for a specified time or until the house is sold. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 6. This mechanism enables a homeowner, whose monthly income is too small to qualify for a conventional loan, to renovate his home and create a rental unit to provide him with greater monthly income. *Id.*

23. Hagel, *supra* note 2, at 254. See *infra* notes 115-20 and accompanying text for description of the sale-leaseback arrangement.

24. Hagel, *supra* note 2, at 254. See *infra* notes 26-27, 57-108 and accompanying text for a description of the reverse (annuity) mortgage.

25. See *infra* notes 27-30 and accompanying text.

26. For the purposes of this Note, the term RAM will be used to refer to a reverse mortgage, whether or not such mortgage involves the purchase of an annuity.

27. See *infra* notes 87-108 and accompanying text for a more complete description and analysis of the RAM.

28. See *infra* notes 115-20 and accompanying text for a more complete description of the sale-leaseback arrangement.

29. See *infra* notes 121-26 and accompanying text for a more complete description of the split equity contract.

30. See *infra* notes 127-32 and accompanying text for a more complete description of the special purpose loan.

31. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4 (sale-leaseback arrangement is one of oldest methods of equity conversion).

32. HOME EQUITY BROCHURE 1 (National Center for Home Equity Conversion, Madison, Wisconsin 1984) [hereinafter cited as HOME EQUITY CONVERSION BROCHURE] (available at the *Fordham Urban Law Journal* office); Kanner, *supra* note 2, at 158.

This Note examines home equity conversion, focusing on the RAM. First, this Note explores both the development of legislation authorizing the use of the RAM and the effectiveness of the RAM in meeting the needs of the elderly.<sup>33</sup> This Note then examines the unfavorable consequences which current federal legislation imposes on the RAM borrower and recommends that such legislation be revised so that RAM proceeds received by the elderly will not decrease their Supplemental Security Income Benefits or increase their taxable incomes.<sup>34</sup> Finally, this Note examines the New York statutes regulating RAMs and concludes that: (1) the exclusion of shared appreciation RAMs avoids a number of legal and practical problems;<sup>35</sup> and (2) efforts to amend the statutes to permit a shared appreciation RAM should be resisted.<sup>36</sup>

## II. Home Equity Conversion

### A. Legislative Response to the Need For Alternative Mortgage Instruments

The high rate of inflation during the 1970's affected not only the elderly<sup>37</sup> but mortgage lenders as well.<sup>38</sup> The traditional level payment mortgage,<sup>39</sup> which had been used since the 1930's, lacked the flexibility to permit institutional lenders to keep pace with the cost of funds used for mortgage loans.<sup>40</sup> In 1976, the Federal Home Loan

33. See *infra* notes 37-135 and accompanying text.

34. See *infra* notes 136-209 and accompanying text.

35. See *infra* notes 242-328 and accompanying text.

36. See *infra* notes 210-327 and accompanying text.

37. See *supra* notes 2-8 and accompanying text for a discussion of the effects of inflation on the elderly.

38. R. KRATOVIL & R. WERNER, *MODERN MORTGAGE LAW AND PRACTICE* § 29.01 (1981) [hereinafter cited as KRATOVIL & WERNER]; M. MADISON & J. DWYER, *THE LAW OF REAL ESTATE FINANCING* § 3.04[3][c] (1981) [hereinafter cited as MADISON & DWYER]; G. OSBORNE, G. NELSON & D. WHITMAN, *REAL ESTATE FINANCING LAW* § 11.4 (1979) [hereinafter cited as OSBORNE, NELSON & WHITMAN]. See also *infra* note 40 and accompanying text for the effects of inflation on mortgage lenders.

39. The traditional form of mortgage was the level-payment self-amortizing type which provided for interest at a fixed rate over the life of the loan. OSBORNE, NELSON & WHITMAN, *supra* note 38, § 11.4, at 670.

40. KRATOVIL & WERNER, *supra* note 38, § 29.01. A large portion of lenders' investment portfolios consisted of long-term, low rate mortgages made years before, while they were paying higher and variable interest rates to depositors on money market certificates tied to treasury bills. As a result, their earning ability and

Bank Board (FHLBB)<sup>41</sup> authorized a study to be made on alternative mortgage instruments.<sup>42</sup> This study resulted in a three-volume publication<sup>43</sup> which explores various alternative mortgage forms designed to be more flexible and responsive to the needs of both the lender and the borrower during inflationary periods.<sup>44</sup> One of the least controversial of these forms is the RAM.<sup>45</sup>

Despite the initial opposition to the use of alternative mortgage instruments (AMIs),<sup>46</sup> the FHLBB, in 1978, permitted federally-chartered savings and loan associations to offer RAMs subject to FHLBB review.<sup>47</sup> Proposed RAM regulations drafted by the FHLBB<sup>48</sup>

lending capacity were seriously eroded. MADISON & DWYER, *supra* note 38, § 3.04[3][c], at 3-18. A mortgage which fixed a rate of interest at the outset, and which was to be in effect for a period of 25 to 30 years, was inadequate in rectifying this situation. KRATOVIL & WERNER, *supra* note 38, § 29.01, at 455.

41. The Federal Home Loan Bank Board supervises the Federal Home Loan Banks. Its functions include, but are not limited to, the following: (1) Prescribing the conditions upon which the Banks are authorized to make advances to its member and non-member borrowers; (2) prescribing rules governing the payment of interest on deposits, withdrawable accounts, and like matters; and (3) prescribing rules and conditions upon which the Banks are authorized to borrow, to pay interest upon their borrowings, and to issue obligations. 12 C.F.R. § 500.2 (1984).

42. MADISON & DWYER, *supra* note 38, § 3.04[3][c]. For a further discussion of this study, see *infra* note 43 and accompanying text.

43. FEDERAL HOME LOAN BANK BOARD, THE ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY (Kaplan ed. 1977).

44. MADISON & DWYER, *supra* note 38, § 3.04 [3][c], at 3-18. The study explores the variable-rate mortgage and other related mortgage forms designed to be more flexible and responsive to the needs of both the lender and the borrower during inflationary periods. *Id.*

45. *Alternative Mortgages: Hearings Before The Committee on Banking, Housing and Urban Affairs*, 95th Cong., 2d Sess. 126 (1978) [hereinafter cited as *Alternative Mortgage Hearings*].

Indeed it is the one we have received the most comments on—and overwhelmingly favorable—since we began the AMIRS [Alternative Mortgage Instrument Research Study] study in the Fall of 1976. . . . While there are still some technical and legal problems to work out, the RAM offers older households a mechanism to draw down the accumulated equity in their homes in a systematic and orderly fashion.

*Id.*

46. *Id.* at 202-03 (letter from Gale Cincotta, Chairperson of National People's Action, to Senator William Proxmire). The following were the concerns expressed about the RAM: (1) The interests of the consumer would not be protected; (2) many people would be attracted to it because the borrowing is done "painlessly;" (3) it would have an inflationary effect because it would encourage borrowing that otherwise would not be done; (4) people who want to borrow against their equity could use existing financing techniques; and (5) the lender rather than the borrower would benefit from it. *Id.*

47. MADISON & DWYER, *supra* note 38, § 3.04[3][c]; OSBORNE, NELSON & WHITMAN, *supra* note 38, at 677.

48. See *Alternative Mortgage Hearings*, *supra* note 45, at 183-86, which sets

did not include a shared appreciation feature.<sup>49</sup> In fact, regulations<sup>50</sup> authorizing the use of shared appreciation mortgages were not proposed by the FHLBB until 1980.<sup>51</sup>

Simultaneously, states began to pass legislation authorizing lenders to make RAM loans.<sup>52</sup> In 1982, however, Congress passed the Alternative Mortgage Transaction Parity Act of 1982 (the Alternative Mortgage Act)<sup>53</sup> which authorized all residential mortgage lenders, including state regulated lenders, to make, purchase and enforce alternative mortgage instruments including shared appreciation mortgages and RAMs.<sup>54</sup> All existing state laws prohibiting such transactions were specifically preempted by the Alternative Mortgage Act.<sup>55</sup> The Act provided, however, that a state could reassert its regulation of this area if, prior to October 15, 1985, it passed legislation explicitly overriding the preemption section of the Alternative Mortgage Act.<sup>56</sup>

forth such proposed regulations. These regulations were to be codified at 12 C.F.R. § 545.6-2(e). These regulations have not been approved and codified to date.

49. A shared appreciation feature allows the lender to take all or a portion of the appreciated value of the property upon the maturity of the loan. For a more complete discussion, see *infra* notes 238-41 and accompanying text.

50. See *Alternative Mortgage Hearings*, *supra* note 45, at 183-86.

51. 45 Fed. Reg. 1425 (1980) (to be codified at 12 C.F.R. § 545).

52. See 1977 Cal. Stat. 968, § 2 (empowering commissioner to prescribe rules and regulations to permit limited experimentation with AMIs, including RAMs) (codified at CAL. FIN. CODE § 7153.9, amended by 1981 Cal. Stat. 714, § 129 so as to be repealed by its own terms as of Jan. 1, 1983); 1978 Conn. Acts 114 (Reg. Sess.) (authorizing financial institutions to make AMIs, including RAMs); 1979 Conn. Acts 158 (Reg. Sess.) (setting forth terms which may be offered in RAMs) (collectively codified at CONN. GEN. STAT. ANN. § 36-9g, repealed by its own terms as of May 31, 1981); 1978 Hawaii Sess. Laws 139, §§ 1-2 (authorizing bank examiners to issue rules and regulations regarding AMIs, including RAMs) (codified at HAWAII REV. STAT. §§ 402-18); 1979 N.J. Laws 140 (authorizing mortgage lenders to make RAMs) (codified at N.J. STAT. ANN. §§ 46-10B-16 to 21); 1978 Vt. Acts 184 (authorizing Commissioner to promulgate rules and regulations to permit limited experimentation with AMIs, including RAMs) (codified at VT. STAT. ANN. tit. 8, § 1256; deleted by 1982 Vt. Acts 164).

53. Title VIII of Garn-St. Germain Depository Institutions Act of 1982, 96 Stat. 1545-48 (codified at 12 U.S.C. § 3801-3805).

54. See 12 U.S.C. § 3803(a) (1982). "In order to prevent discrimination against State-chartered depository institutions, and other nonfederally chartered housing creditors, with respect to making, purchasing, and enforcing alternative mortgage transactions, housing creditors may make, purchase, and enforce alternative mortgage transactions . . . ." *Id.*

55. See 12 U.S.C. § 3803(c) (1982) ("[a]n alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law, or regulation").

56. See 12 U.S.C. § 3804(a) (1982).

The provisions of section 3803 of this title shall not apply to any alternative

## B. The RAM: A Means of Home Equity Conversion

Many RAM features are opposite to those of a conventional mortgage loan.<sup>57</sup> Although a RAM is secured by the borrower's home, the proceeds are disbursed over a stated period of time to the elderly homeowner in monthly installments.<sup>58</sup> The amount of the monthly payment is determined by the amount of home equity borrowed against,<sup>59</sup> the interest rate and the length of the loan.<sup>60</sup> Repayment of principal and interest is deferred until a future time.<sup>61</sup>

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mortgage transaction in any State made on or after the effective date (if such effective date occurs on or after October 15, 1982 and prior to a date three years after October 15, 1982) of a State law or a certification that the voters of such State have voted in favor of any provision . . . which states explicitly and by its terms that such State does not want the preemption provided in section 3803 of this title to apply with respect to alternative mortgage transactions subject to the laws of such State . . . .

*Id.*

57. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 11.4, at 676-77; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 1. See also *infra* notes 58-62 and accompanying text for a discussion of features which are opposite of a conventional mortgage loan.

58. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 11.4, at 676. The proceeds of a conventional loan typically are disbursed at the commencement of the mortgage term and the borrower repays the loan in monthly installments over the term of the loan. See OSBORNE, NELSON & WHITMAN, *supra* note 38, § 1.1; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 2.

59. Usually the amount of home equity borrowed against is between 60% and 80% of the appraised value of the home. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3; see also N.J. STAT. ANN. § 46:10B-18 (West Supp. 1984-1985) (RAMs shall not be made in amount exceeding 70% of value of mortgaged property); 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(a)) (maximum amount of RAM shall be 80% of appraised value of mortgaged property). Since the home may decline in value, RAMs are not made for the full value of the home. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3. Also, many believe that homeowners who retain some equity in the property will maintain it better. *Id.*

60. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3; cf. Note, *Reverse Annuity Mortgages and the Due-on-Sale Clause*, 32 STAN. L. REV. 143, 146 (1979) (size of payments to homeowner depends upon administrative costs of loan, value of secured property, life expectancy of borrower, prevailing interest rate and mortality risk); Blumenstein & Harmann, *supra* note 2, at 441 (amount of monthly payments is determined by appraisal value of home, term of loan, and age of borrower).

61. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 1. Usually this time will be more than 10 years, and less than 15 years from the date of the mortgage. See *id.*; Kanner, *supra* note 2, at 158; SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3.



In some cases, the length of the loan term is limited only by the borrower's death or the prior sale of the home.<sup>62</sup>

There are several advantages to a RAM program. One advantage is that the home-owner may use the loan proceeds for a variety of needs, including medical and other living expenses.<sup>63</sup> Another advantage is its flexibility; it may be modified to include features advantageous to the particular situation of each elderly homeowner.<sup>64</sup> One such modification allows the borrower to receive the loan proceeds in an initial lump sum for the purchase of an annuity.<sup>65</sup>

The four most commonly offered variations of the basic RAM form are: (1) rising debt loan (Rising Debt RAM);<sup>66</sup> (2) a limited rising debt loan and deferral contract (Limited Rising Debt RAM);<sup>67</sup> (3) a fixed debt loan used to purchase a life annuity (Life Annuity RAM);<sup>68</sup> and (4) a fixed debt loan used to purchase an annuity with a refund provision (Refund Annuity RAM).<sup>69</sup> Of these four, the Rising Debt RAM and the Limited Rising Debt RAM are the most commonly discussed.<sup>70</sup> All of these forms may be varied and tailored to meet the needs of the individual borrower.

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62. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 2; Kanner, *supra* note 2, at 158; see SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 3 (loan is repaid at scheduled time or, under some arrangements, whenever homeowner chooses—usually when house is sold).

63. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; see also Iezman, *Alternative Mortgage Instruments: Their Effect on Residential Financing*, 10 REAL EST. L.J. 3, 23-24 (1981) (elderly can use RAM funds as retirement income or to pay unexpected cost of inflationary society) [hereinafter cited as Iezman]. Normally, mortgage proceeds are used for the purchase of the property, not for living expenses.

64. See *infra* notes 71-108 and accompanying text for an analysis of the different options.

65. See OSBORNE, NELSON & WHITMAN, *supra* note 38, § 11.4, at 676; SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; Blumenstein & Hartmann, *supra* note 2, at 442. See also *infra* notes 80-108 and accompanying text for a description of RAM programs involving an annuity.

66. See *infra* notes 71-79 and accompanying text for an analysis of the Rising Debt RAM.

67. See *infra* notes 80-92 and accompanying text for an analysis of the Limited Rising Debt RAM.

68. See *infra* notes 93-103 and accompanying text for an analysis of the Life Annuity RAM.

69. See *infra* notes 104-08 and accompanying text for an analysis of the Refund Annuity RAM.

70. *Alternative Mortgage Hearings*, *supra* note 45, at 138; Iezman, *supra* note 65, at 24. These two forms offer the most attractive buys. *Alternative Mortgage Hearings*, *supra* note 65, at 24.

### 1. *The Rising Debt RAM*

The proceeds of a Rising Debt RAM are advanced by the lender to the borrower in monthly installments over a fixed period of time.<sup>71</sup> Interest earned on the aggregate advances is accrued and deferred until the maturity of the loan.<sup>72</sup> Both the principal and the accrued interest are secured by the mortgage, and therefore, both become a lien against the property.<sup>73</sup> The accumulated principal indebtedness and all accrued interest generally are payable on the earliest of: (1) the sale of the property; (2) the death of the borrower; (3) the maturity of the loan; or (4) a rise in the loan-to-value ratio<sup>74</sup> beyond a predetermined level.<sup>75</sup> In the event that the loan matures prior to the occurrence of any of these other events, the borrower typically will either refinance the property or sell it and use the proceeds of the sale to repay the loan.<sup>76</sup>

There is, however, a risk in using the Rising Debt RAM. If the value of the property does not sufficiently appreciate so as to produce an acceptable loan-to-value ratio, refinancing will not be permissible.<sup>77</sup> This result would force the borrower to sell his home.<sup>78</sup> Therefore, this type of RAM is suitable only for borrowers who: (1) wish to liquidate a specific amount of equity in their homes over a period of time before selling the property; (2) have other sources of income to make amortization payments upon the maturity of the loan; or (3) wish to liquidate only a small portion of the equity in a home with a very high appraised value.<sup>79</sup>

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71. *Alternative Mortgage Hearings*, *supra* note 45, at 138; Iezman, *supra* note 62, at 24; Kanner, *supra* note 2, at 159.

72. *See Alternative Mortgage Hearings*, *supra* note 45, at 138; Kanner, *supra* note 2, at 159.

73. *See* Kanner, *supra* note 2, at 159; *cf. Alternative Mortgage Hearings*, *supra* note 45, at 138 (lender contracts to make periodic payments to borrower on security of his home, thus generating rising indebtedness over time).

74. Loan-to-value ratio is the "ratio, expressed as a percentage, of the amount of [the] loan to the value . . . of the real property . . ." *See* BLACK'S LAW DICTIONARY 845 (5th ed. 1979) (defining "loan ratio"). Usually, the higher the percentage, the greater the interest charged. *Id.*

75. *Alternative Mortgage Hearings*, *supra* note 45, at 138; *see* Iezman, *supra* note 65, at 24 (includes conditions i, ii, and iii only).

76. *See* Iezman, *supra* note 65, at 24.

77. *See* Kanner, *supra* note 2, at 159; *see also* 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(d)) (mortgaged property may be reappraised at end of loan term, and if value has appreciated, term may be extended and amount increased up to 80% of appreciated value).

78. *See* Kanner, *supra* note 2, at 159.

79. *See Alternative Mortgage Hearings*, *supra* note 45, at 139; Kanner, *supra* note 2, at 159.

## 2. *The Limited Rising Debt RAM*

The Limited Rising Debt is an economical RAM structure.<sup>80</sup> Under this variation, the lender advances a portion of the loan in a lump sum at the commencement of the loan term.<sup>81</sup> The borrower uses that sum to purchase an annuity,<sup>82</sup> on which payment to the borrower is deferred for a period of years.<sup>83</sup> The balance of the RAM loan proceeds are disbursed monthly throughout the remainder of the initial loan term.<sup>84</sup> At the end of this initial term, the total amount of principal advanced plus accrued interest will equal the face amount of the mortgage.<sup>85</sup> The debt then ceases to grow, and the pay-out on the annuity begins.<sup>86</sup> The lender receives a portion of the monthly annuity payment in repayment of the RAM loan while the borrower receives the balance as a cash supplement.<sup>87</sup>

There are two major advantages to this RAM structure. First, the borrower receives some protection in the event that he dies within the initial term of the loan.<sup>88</sup> During this period, he continues to

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80. See Kanner, *supra* note 2, at 160; *Alternative Mortgage Hearings*, *supra* note 45, at 140. For a more complete discussion of the economical aspects of this RAM structure, see *infra* notes 88-91 and accompanying text.

81. See Kanner, *supra* note 2, at 160; *Alternative Mortgage Hearings*, *supra* note 45, at 140.

82. An annuity is defined as "[a] fixed sum payable to a person at specified intervals for a specific period of time or for life." BLACK'S LAW DICTIONARY 82 (5th ed. 1979). Payments represent a partial return of capital and a return (interest) on the capital investment. *Id.* Under the usual form of annuity, a lump sum is paid to the insurance company for the purchase of the annuity and the annuitant receives the annuity payments as long as he lives. W. VANCE, HANDBOOK ON THE LAW OF INSURANCE § 200, at 1020 (3d ed. 1951) [hereinafter cited as VANCE]. Life insurance companies issue different types of annuities so as to meet the needs of the annuitant. See *infra* notes 83, 93 & 104 and accompanying text. See generally VANCE, *supra*, § 200 (general discussion of annuities).

83. See *Alternative Mortgage Hearings*, *supra* note 45, at 140; Kanner, *supra* note 2, at 160.

84. See Kanner, *supra* note 2, at 160; *Alternative Mortgage Hearings*, *supra* note 45, at 140.

85. See Kanner, *supra* note 2, at 160. For example, if a borrower aged seventy-five owns a home worth \$62,500, the lender can advance \$20,918 initially for an annuity deferred for five years. The lender then advances \$2,976 to the borrower annually. At the end of five years, these payments, plus interest accrued at nine percent, will total \$50,000, which is equal to the face amount of the mortgage and 80% of the value of the home at the commencement of the mortgage term. *Id.*

86. *Id.*

87. *Id.* In the example in note 85, *supra*, the annuity will pay the borrower \$2,976 annually and will pay the lender \$4,500 annually. *Id.*

88. See *Alternative Mortgage Hearings*, *supra* note 45, at 140; Kanner, *supra* note 2, at 160; *infra* text accompanying note 89.

receive payment of the loan proceeds and, therefore, the property is encumbered by less than the face amount of the RAM.<sup>89</sup> Second, since the entire amount of the RAM loan is not invested in the annuity, less of the borrower's home equity is subject to the lower rate of interest offered on the annuity.<sup>90</sup> Therefore, the borrower may receive a larger net annuity at no additional cost.<sup>91</sup> These advantages make the Limited Rising Debt RAM the most favorable RAM structure for many elderly homeowners.<sup>92</sup>

### 3. *The Life Annuity RAM*

The Life Annuity RAM, a fixed debt loan, is disbursed to the borrower in a lump sum to purchase a whole life annuity<sup>93</sup> for his benefit.<sup>94</sup> A portion of the monthly annuity payment is disbursed to the lender as payment of interest due on the RAM loan, and a portion is retained by the borrower.<sup>95</sup> The principal amount of the RAM loan is not payable until the earlier of the borrower's death or the sale of the property.<sup>96</sup>

The Life Annuity RAM offers several advantages to the elderly homeowner. It guarantees the borrower a supplemental cash income for the remainder of his life.<sup>97</sup> In addition, it eliminates the risk that the borrower will have to sell the property upon maturity of

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89. Kanner, *supra* note 2, at 160.

90. See *Alternative Mortgage Hearings*, *supra* note 45, at 140.

91. *Id.*

92. For a discussion of the risks, see *infra* notes 109-11.

93. A whole life annuity, or life annuity, is defined as an annuity which provides for payment of income to the annuitant only during his lifetime, even if his death is premature. BLACK'S LAW DICTIONARY 82-83 (5th ed. 1979); see also VANCE, *supra* note 82, § 200, at 1020-21 (obligation of insurer may be fully discharged by periodic payments during annuitant's life-time with nothing payable thereafter). This type of annuity is sometimes referred to as a "no refund" annuity. *Id.* at 1021.

94. See Iezman, *supra* note 65, at 24; *Alternative Mortgage Hearings*, *supra* note 45, at 139; Kanner, *supra* note 2, at 159.

95. *Alternative Mortgage Hearings*, *supra* note 45, at 139; Iezman, *supra* note 65, at 24-25; Kanner, *supra* note 2, at 159. For example, if a seventy-five-year-old borrower owns a house with an appraised value of \$62,500 and he borrows \$50,000 at nine percent interest to purchase an annuity (yielding a payment calculated on the basis of life-expectancy tables and a seven percent interest rate), the annuity will pay \$7,566 annually for the remainder of his life. The nine percent interest on the loan, \$4,500 per year, is paid to the lender while the borrower retains the balance which is \$3,066 per year, or over \$250 per month. Kanner, *supra* note 2, at 159.

96. Iezman, *supra* note 65, at 25; see Kanner, *supra* note 2, at 159.

97. See *supra* note 95 and accompanying text.

the RAM loan.<sup>98</sup> Further, under a Life Annuity RAM, accumulated accrued interest is not added to the amount encumbering the property since all accrued interest is paid monthly through the annuity payments.<sup>99</sup>

However, the Life Annuity RAM presents some problems. Since the amount of the annuity payment is determined by the annuitant's age,<sup>100</sup> only the very elderly can generate monthly payments sufficient to pay interest on the RAM loan and to provide the borrower with a monthly cash supplement.<sup>101</sup> In addition, the annuitant is wagering on his own life expectancy.<sup>102</sup> If he dies shortly after the transaction, he will have received only a small amount on the annuity while owing a large amount on the loan.<sup>103</sup>

#### 4. *The Refund Annuity RAM*

Under a Refund Annuity RAM, the borrower uses the loan proceeds to purchase a fixed annuity guaranteed for a definite period of years<sup>104</sup> and payable to either the borrower or his heirs.<sup>105</sup> If the

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98. See *supra* note 96 and accompanying text.

99. See *supra* note 95 and accompanying text.

100. See *supra* note 95.

101. In most cases the rate of return on the annuity will be well below the rate of interest on the loan. *Alternative Mortgage Hearings, supra* note 65, at 140; Kanner, *supra* note 2, at 159-60. Depending on the age and sex of the homeowner, the rate spread may result in no possibility of a positive net annuity. *Alternative Mortgage Hearings, supra* note 45, at 140; Kanner, *supra* note 2, at 159-60. The yield would be improved if this rate spread could be reduced or eliminated. *Alternative Mortgage Hearings, supra* note 45, at 140; see Kanner, *supra* note 2, at 159-60. This could be achieved if the insurance company handled both the loan and the annuity. Kanner, *supra* note 2, at 160.

102. Kanner, *supra* note 2, at 160. In consideration of the annuitant's risks, he receives payment on the annuity which is substantially greater than he would under a refund annuity. VANCE, *supra* note 82, § 200, at 1021. For a description of a refund annuity, see *infra* note 104.

103. Kanner, *supra* note 2, at 160. In the example in note 95, *supra*, if the seventy-five-year-old man died after one year, he would have received only \$7,566 on the annuity, while owing \$50,000 on the loan. *Id.*

104. This type of annuity is known as a refund annuity. A refund annuity is defined as an annuity in which the "[a]nnuitant is assured a specified annual sum during his life, with the further assurance that in the event of his premature death there will be paid to his estate an additional amount which represents the difference between the purchase price and the amount paid out during annuitant's life." BLACK'S LAW DICTIONARY 82-83 (5th ed. 1979); VANCE, *supra* note 82, § 200, at 1021. This amount represents the difference between the purchase price and the amount paid out during the annuitant's life. BLACK'S LAW DICTIONARY 82-83 (5th ed. 1979); VANCE, *supra* note 82, § 200, at 1021. This type of annuity is also called an annuity certain, which is defined as an annuity "[p]ayable for [a] specified period; no matter the time of death of the annuitant." BLACK'S LAW DICTIONARY 82 (5th ed. 1979).

105. Kanner, *supra* note 2, at 160; *Alternative Mortgage Hearings, supra* note

borrower outlives the fixed period, the annuity is converted to a whole-life annuity.<sup>106</sup> This RAM structure yields a smaller monthly payment due to the fixed payout period.<sup>107</sup> However, the risk of economic loss in the event of the annuitant's early death is lowered by the refund feature.<sup>108</sup>

### 5. Summary

It is clear from the above discussion that no RAM structure is completely risk-free.<sup>109</sup> A borrower who lives a long life without any other source of revenue eventually may be forced to sell his home to pay his accumulated debt.<sup>110</sup> However, when weighed against the hardships which may be faced without the option of home equity conversion through the RAM, the benefits outweigh the risks for many elderly homeowners. Even if the borrower is ultimately forced to sell his home, RAM financing would delay this occurrence. If sale of the property became a necessity, the senior citizen could consider alternative means of home equity conversion.<sup>111</sup>

### C. Other Forms of Home Equity Conversion

A variety of alternative means of home equity conversion are also available. Those most commonly used are the sale-leaseback,<sup>112</sup> the split equity arrangement<sup>113</sup> and the special purpose loan.<sup>114</sup> A brief description of each of these more restrictive devices is important for a full understanding of the benefits of a RAM.

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45, at 139 (refers to annuity certain rather than refund annuity).

106. Kanner, *supra* note 2, at 160. For a definition of whole life annuity, see *supra* note 93.

107. Kanner, *supra* note 2, at 160. This method will generate a significant cash supplement only for the very elderly due to the spread between the interest rate payable on the mortgage and the interest rate paid on the annuity. *Id.*; *Alternative Mortgage Hearings*, *supra* note 45, at 139.

108. Kanner, *supra* note 2, at 160; see *supra* note 104 and accompanying text.

109. See *supra* notes 71-108 and accompanying text.

110. *Alternative Mortgage Hearings*, *supra* note 45, at 138-39. Another risk is that the borrower will suffer a loss due to the rate spread between the amount payable on the RAM and the amount paid on the annuity. *Id.* at 139-40. See generally BARNETT & MCKENZIE, *supra* note 18, § 8.04 (discussion of two critical problems with RAMs: (1) small payments, (2) mortality risk).

111. See *infra* notes 115-21 and accompanying text for a discussion of other available devices.

112. See *infra* notes 115-20 and accompanying text for a discussion of the sale-leaseback arrangement.

113. See *infra* notes 121-26 and accompanying text for a discussion of the split equity arrangement.

114. See *infra* notes 127-32 and accompanying text for a discussion of the special purpose loan.

### 1. *The Sale-Leaseback*

In a sale-leaseback arrangement, the senior citizen sells his home to an investor at a discounted price.<sup>115</sup> The investor then leases it back to the seller who remains a tenant for life.<sup>116</sup> The investor is responsible for the payment of real estate taxes, insurance and maintenance of the property;<sup>117</sup> he also remits a monthly check to the seller from which the monthly rental is deducted.<sup>118</sup> The seller also may receive payment in equal monthly installments from an annuity purchased by the investor.<sup>119</sup> In some sale-leaseback arrangements, the seller's children purchase the home and thereby prevent the sale of the property to an unrelated third party.<sup>120</sup>

### 2. *The Split Equity Contract*

Under a split equity arrangement, the ownership rights to the property are divided into two parts.<sup>121</sup> The senior citizen sells the

115. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 3; Blumenstein & Harmann, *supra* note 2, at 438 n.28; SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4. See generally KRATOVIL & WERNER, *supra* note 38, § 23.01 (commercial sale-leaseback arrangements); MADISON & DWYER, *supra* note 38, § 6.04 (commercial sale-leaseback arrangements); Note, *Sale-Leaseback Transactions By Tax Exempt Entities and the Need for Congressional Guidelines*, 12 FORDHAM URB. L.J. 349, 352-63 (1984) (commercial sale-leaseback arrangements) [hereinafter cited as *Sale-Leaseback Transactions*].

116. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 3; Blumenstein & Harmann, *supra* note 2, at 438 n.28. See generally KRATOVIL & WERNER, *supra* note 38, § 23.01 (commercial sale-leasebacks with term of 20-30 years); MADISON & DWYER, *supra* note 38, § 6.04 (commercial sale-leasebacks, with lease to seller on "long-term basis"); *Sale-Leaseback Transactions*, *supra* note 115, at 352-63 (commercial sale-leasebacks).

117. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 3; Blumenstein & Harmann, *supra* note 2, at 438 n.28.

118. Blumenstein & Harmann, *supra* note 2, at 438 n.28. These monthly payments, in essence, constitute mortgage payments or a land contract. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 3.

The major incentive for the investor is the depreciation of the property for tax purposes. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; Blumenstein & Harmann, *supra* note 2, at 438 n.28. For a discussion of the advantages to both parties of commercial sale-leasebacks, see KRATOVIL & WERNER, *supra* note 38, § 23.01; *Sale-Leaseback Transactions*, *supra* note 115, at 361-63 (advantages and disadvantages).

119. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 3.

120. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 4.

121. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 5;

remainder interest in the property to an investor while retaining a life estate.<sup>122</sup> Since the investor makes periodic payments of the purchase price, the elderly homeowner may live in his home rent free either for life or for a fixed term of years.<sup>123</sup> The periodic payments of the purchase price should be sufficient to pay maintenance, taxes and insurance on the senior citizen's home and to yield a balance from which the senior citizen can meet other expenses.<sup>124</sup> The amount of the monthly check is based upon the value of the home and the owner's life expectancy.<sup>125</sup> In essence, these monthly payments represent a long-term installment contract for the purchase of the property.<sup>126</sup>

### 3. *The Special Purpose Loan*

Special purpose loans allow the homeowner to defer repayment of both principal and interest either for a specified period or until the property is sold.<sup>127</sup> However, the loan proceeds must be used for the purpose specified in the loan agreement.<sup>128</sup> These loans are usually obtained in connection with major repairs on the senior citizen's home.<sup>129</sup> The two basic types of special purpose loans are

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HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4; KRATOVIL & WERNER, *supra* note 38, § 29.02(d)(1); Kanner, *supra* note 2, at 161; Blumenstein & Harmann, *supra* note 2, at 438 n.28.

122. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4; KRATOVIL & WERNER, *supra* note 38, at § 29.02(d)(1); Kanner, *supra* note 2, at 161; *see also* Blumenstein & Harmann, *supra* note 2, at 438 n.28 (elderly homeowner sells his house to nonprofit group and lives in it rent free for life).

123. *See* Kanner, *supra* note 2, at 161; Blumenstein & Harmann, *supra* note 2, at 438 n.28.

124. *See* HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4; Blumenstein & Harmann, *supra* note 2, at 438 n.28.

125. Blumenstein & Harmann, *supra* note 2, at 438 n.28; *see also* KRATOVIL & WERNER, *supra* note 38, § 29.02 (d)(1) (purchase price is determined by expected future value of home discounted by interest and mortality factors); Kanner, *supra* note 2, at 161 ("price of the property less the carved-out life estate can be determined with reference to life-expectancy tables . . .").

126. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 5.

127. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 6 (using term "deferred payment loan"); HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4 (deferred either until borrower dies or sells his home).

128. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4.

129. *See* SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 6; HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4.



deferred-payment loans<sup>130</sup> and home-equity payment accounts.<sup>131</sup> The two differ in that the deferred-payment loan is disbursed in one lump sum, whereas the home-equity payment account is disbursed in a series of periodic installments.<sup>132</sup>

#### 4. Summary

Sale-leaseback arrangements, split equity contracts and special purpose loans are of limited utility due to their restrictive natures. Sale-leasebacks and split equity arrangements require the senior citizen to sell his home.<sup>133</sup> Special purpose loans restrict the amounts which may be borrowed and the purposes for which the proceeds may be used.<sup>134</sup> In contrast, the RAM permits the senior citizen to retain ownership of his home and to receive a monthly cash supplement which he may use for any purpose.<sup>135</sup> These characteristics make the RAM a more favorable means of home equity conversion for many elderly homeowners.

### III. Federal Legislation Adversely Affecting the RAM Borrower

Since the RAM is a relatively new creation,<sup>136</sup> it has not yet been fully integrated into all areas of the law affecting senior citizens.<sup>137</sup> Currently, aspects of both the Social Security Act<sup>138</sup> and the Internal

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130. These loans are used to upgrade the quality of the home, to weatherize it, or to make modifications, such as ramps, chair lifts and security devices. HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4. Most older homeowners' ability to pay for these kinds of investments is in the form of home equity rather than available cash. *Id.* Many elderly homeowners are reluctant to borrow money for these purposes because they are unable to repay an installment loan from current income. *Id.* Deferred-payment loans provide a solution to this problem. *Id.*

131. "Home equity payment accounts enable [elderly] homeowners to use [their] home equity to pay for regular, periodic expenses such as property taxes or in-home services." HOME EQUITY CONVERSION BROCHURE, *supra* note 32, at 4. These expenses are not paid in cash, but rather are charged to an account. *Id.* "The charges, plus interest, may be repaid at any time, but they are not due until the homeowner dies or sells the home." *Id.*

132. *Id.*

133. See *supra* notes 115-16, 121-22 and accompanying text.

134. See *supra* notes 127-32 and accompanying text.

135. See *supra* notes 57-65 and accompanying text for a discussion of the RAM.

136. See *supra* notes 25-26, 37-56 and accompanying text.

137. See *infra* notes 142-209 and accompanying text for an analysis of the areas of law which affect senior citizens and which have not integrated the effects of home equity conversion. "As yet the Social Security Administration has not developed policies to deal specifically with home equity conversion income." SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 8.

138. See *infra* note 146.

Revenue Code<sup>139</sup> present obstacles to RAM borrowers.<sup>140</sup> Both of these statutes should be amended to remove these obstacles and to encourage elderly homeowners to participate in RAM programs.<sup>141</sup>

### A. The Supplemental Security Income Program

Many senior citizens choose not to participate in a RAM program rather than risk the loss of eligibility for social security benefits.<sup>142</sup> Although RAM proceeds received by the senior citizen would not affect his eligibility for Social Security retirement benefits,<sup>143</sup> the payments could affect his eligibility for Supplemental Security Income (SSI)<sup>144</sup> payments.<sup>145</sup> The SSI Program was created by Congress under the Social Security Act<sup>146</sup> to insure a minimum level of monthly income to the elderly, the blind and the disabled.<sup>147</sup> The program was designed to "pay people only to the extent that their needs are not met from other sources, including, among others, Social Security payments, payments by other agencies, and payments from private

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139. See *infra* note 187.

140. See *infra* notes 142-209 and accompanying text.

141. See *id.* for an analysis of how and why these statutes should be amended.

142. See Hagel, *supra* note 2, at 255 (loss of SSI benefits might be tolerable for many senior citizens only if their income from a RAM program is appreciably higher than SSI standard). See also *infra* notes 150-83 and accompanying text for discussion of the effects of RAM loans on SSI eligibility.

143. The social security system has two programs: the insurance program and the welfare program. See P. FERRARA, SOCIAL SECURITY REFORM: THE FAMILY PLAN 16 (1982) [hereinafter cited as FERRARA]. Under the insurance program, individuals are paid benefits upon retirement or disability. *Id.* The amount of these benefits is based solely on the amount the individual has paid into the program, regardless of his need. *Id.* For a discussion of the welfare program, see *infra* note 144.

144. SSI is a welfare program administered by the Social Security Administration. AGING AND INCOME: PROGRAMS AND PROSPECTS FOR THE ELDERLY (B. Herzog, ed. 1978) [hereinafter cited as HERZOG]. The amount of the benefits paid under this program is based solely on the degree of need of the recipient. See *id.* The benefits are paid regardless of how much the recipient has paid into the program in the past. See FERRARA, *supra* note 143, at 16. For a further discussion of the SSI program, see *infra* notes 146-56 and accompanying text.

145. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 8; Hagel, *supra* note 2, at 254-55; Blumenstein & Harmann, *supra* note 2, at 438.

146. The Social Security Act, 42 U.S.C. §§ 301-1397f (1983 & Supp. 1984). Subchapter XVI of this Act provides for SSI for the aged, blind and disabled. 42 U.S.C. §§ 1381-1383c (1982).

147. See R. RUBIN, YOUR 1983/84 GUIDE TO SOCIAL SECURITY BENEFITS 82 (1983); J. Trout & D. Mattson, *A 10-Year Review of the Supplemental Security Income Program*, 47 SOC. SEC. BULL. 1, 3 (1984) [hereinafter cited as Trout & Mattson]; Blumenstein & Harmann, *supra* note 2, at 446-47.

pension plans."<sup>148</sup> The SSI Program remains committed to the principle that recipients should seek all other benefits to which they are entitled and should utilize SSI only to raise their income to the federally established floor level.<sup>149</sup>

The SSI program's commitment to remaining an income source of last resort<sup>150</sup> has resulted in stringent limitations on income<sup>151</sup> and resource<sup>152</sup> levels for eligibility.<sup>153</sup> However, some changes have been instituted to expand eligibility for the program.<sup>154</sup> In 1975, Congress excluded the home from consideration as a resource.<sup>155</sup> The broadening of the eligibility for SSI which would result from this change did not deter Congress from making this change because overall resource thresholds would prevent this plan from being too costly.<sup>156</sup>

Similarly, RAM proceeds should be excluded from consideration as a resource. Presently, regulations governing SSI benefits classify only traditional income sources<sup>157</sup> and therefore serve only as guide-

148. H.R. REP. NO. 231, 92d. Cong., 1st Sess. 149-50 (1971).

149. Trout & Mattson, *supra* note 147, at 21. SSI benefits bring the recipient up to a level of income which, in 1983, was 71% of the poverty index. *Id.*

150. *See infra* note 180 and accompanying text.

151. Income is defined as "anything you receive in cash or in kind that you can use to meet your needs for food, clothing, or shelter." 20 C.F.R. § 416.1102 (1984).

152. Resources are defined as "cash or other liquid assets or any real or personal property that an individual (or spouse, if any) owns and could convert to cash to be used for his support and maintenance." 20 C.F.R. § 416.1201 (1984). "If the individual has the right, authority, or power to liquidate the property or his share of the property, it is considered a resource." *Id.*

153. *See infra* notes 179-81 and accompanying text.

154. Trout & Mattson, *supra* note 147, at 21. *See infra* notes 155-56 and accompanying text for a discussion of one of these changes.

155. 40 Fed. Reg. 48,915 (1975) (codified, as amended by 42 Fed. Reg. 40,192 (1977), at 20 C.F.R. § 416.1212 (1984)). "Effective October 1976, the entire value of a home is excluded in determining the resources of an individual (and spouse, if any)." 20 C.F.R. § 416.1212(a)(2) (1984).

A home is defined as "any shelter in which the individual (and spouse, if any) has ownership interest and which is used by the individual (and spouse, if any) as his principal place of residence." 20 C.F.R. § 416-1212(b) (1984).

*See also* 20 C.F.R. § 416.1212(a)(1) (1984). "Prior to October, 1976, a home is excluded in determining the resources of an individual (and spouse, if any) to the extent its current market value does not exceed \$25,000 (\$35,000 in Alaska and Hawaii)." *Id.* Where the current market value exceeds this amount, only the excess is counted toward the resource limitation. *Id.*

156. Trout & Mattson, *supra* note 147, at 10.

157. *See generally* 20 C.F.R. §§ 416.1100-1266 (1984). Under these regulations, income includes both "earned income" and "unearned income." Earned income includes wages, federal income tax refunds and in-kind earned income. 20 C.F.R. §§ 416.1110-1111 (1984). Unearned income includes: annuities, pensions, alimony and support payments, dividends, interest, royalties, rents, life insurance proceeds,

lines for the treatment of RAM proceeds.<sup>158</sup> A number of these regulations must be considered in order to determine the effect of RAM proceeds on SSI eligibility.<sup>159</sup>

The regulations state that an elderly person must have limited income and resources to be eligible for SSI benefits.<sup>160</sup> Generally, benefits decrease as income increases.<sup>161</sup> Income is defined as anything received in cash or in kind that can be used to meet a person's needs for food, clothing or shelter.<sup>162</sup> Money borrowed by the individual is excluded from income.<sup>163</sup> Payments on annuities are considered unearned income<sup>164</sup> and are included in income calculations for purposes of determining eligibility and the amount of benefits.<sup>165</sup> Resources include any real property an individual owns and can convert to cash for his support and maintenance.<sup>166</sup> The home, however, is excluded from consideration<sup>167</sup> as are the proceeds from the sale of the home if used to purchase another home within three months.<sup>168</sup> Also excluded from consideration as a resource is non-liquid property considered essential for the self-support of the individual.<sup>169</sup>

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prizes and awards, gifts, inheritances, and in-kind support and maintenance. 20 C.F.R. § 416.1121 (1984). "In-kind income is not cash, but is actually food, clothing, or shelter, or something you can use to get one of these." 20 C.F.R. § 416.1102 (1984).

158. See Blumenstein & Harmann, *supra* note 2, at 449-50.

159. See *infra* notes 160-76 and accompanying text for an analysis of these regulations.

160. 20 C.F.R. § 416.1100 (1984).

161. *Id.*

162. 20 C.F.R. § 416.1102 (1984). See also *supra* note 151 for the definition of income.

163. 20 C.F.R. § 416.1103(f) (1984).

164. 20 C.F.R. § 416.1121(a) (1984) ("[t]his unearned income is usually related to prior work or service").

165. 20 C.F.R. § 416.1123 (1984) (describing how unearned income is counted). Up to \$60 of unearned income received in a calendar quarter is excluded from calculation if it is received infrequently or irregularly. 20 C.F.R. § 416.1124(c)(6) (1984).

166. 20 C.F.R. § 416.1201(a) (1984).

167. 20 C.F.R. §§ 416.1210(a), 416.1212 (1984); see *supra* note 155.

168. 20 C.F.R. § 416.1212(d) (1984).

The proceeds from the sale of a home which is excluded from the individual's resources will also be excluded from resources to the extent they are intended to be used and are, in fact, used to purchase another home, which is similarly excluded, within 3 months of the date of receipt of the proceeds.

*Id.* See *supra* note 155 for the definition of "home."

169. 20 C.F.R. §§ 416.1220, 416.1224 (1984). "In determining the resources of an individual (and spouse, if any) there shall be excluded . . . property so essential to the self-support of the individual (and spouse, if any) as to warrant its exclusion."

Using these regulations as guidelines, the classification of RAM proceeds is uncertain. If the loan proceeds are paid directly by the lender to the borrower, as in a Rising Debt RAM,<sup>170</sup> it seems that the proceeds would not be considered income and, therefore, would not affect the elderly borrower's SSI eligibility.<sup>171</sup> If, however, the loan proceeds are used to purchase an annuity, as in a Limited Rising Debt RAM,<sup>172</sup> a Life Annuity RAM<sup>173</sup> or a Refund Annuity RAM,<sup>174</sup> the monthly payments received by the borrower may be deemed payments on the annuity. If so, such payments could be considered "unearned income"<sup>175</sup> which could either decrease the amount of the SSI benefit or terminate the individual's eligibility for SSI benefits.<sup>176</sup>

Two possible arguments can be raised to assert that such annuity payments are not part of the "unearned income" contemplated by the current regulations. First, although under an annuity the payments are made by the insurer, the annuity represents loan proceeds which are excluded from computation of income.<sup>177</sup> Therefore, the annuity payments also should be excluded. Second, since non-liquid property considered essential for self-support is not considered a resource,<sup>178</sup> any equity an individual can extract from such property for support, such as RAM proceeds, also should be excluded.

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20 C.F.R. § 416.1220 (1984).

Nonbusiness property is considered essential for self-support if it is relied upon by the individual as a significant factor in producing income on which he can live, it is used to produce goods essential to the support of the individual, or it is used to provide services essential to the individual's support.

20 C.F.R. § 416.1244(a) (1984).

170. See *supra* notes 71-79 and accompanying text for a description of the Rising Debt RAM.

171. Loan proceeds are excluded from consideration as income. 20 C.F.R. § 416.1103(f) (1984); see *supra* note 163 and accompanying text.

172. See *supra* notes 80-92 and accompanying text for a description of the Limited Rising Debt RAM.

173. See *supra* notes 93-103 and accompanying text for a description of the Life Annuity RAM.

174. See *supra* notes 104-08 and accompanying text for a description of the Refund Annuity RAM.

175. See *supra* note 157 for a description of certain "unearned income."

176. Amount of income is a major factor in determining eligibility for and amount of SSI benefits. 20 C.F.R. § 416.1100 (1984). The more income an individual has, the less his benefit will be. *Id.* If an individual has too much income, he is not eligible for SSI. *Id.* Payments on annuities are unearned income. 20 C.F.R. § 416.1121(a) (1984). *But see infra* notes 177-78 and accompanying text.

177. See *supra* note 163 and accompanying text.

178. See *supra* note 169 and accompanying text.

Case law suggests that the receipt of RAM proceeds could be considered either income or a resource and thus cause the senior citizen to lose SSI eligibility or reduce his benefits.<sup>179</sup> The courts have adhered strictly to both the policies of SSI as a "last resort" means of support and a broad definition of income.<sup>180</sup> The result has been a reduction in the amount of an individual's benefit by any income not specifically excluded by the SSI regulations.<sup>181</sup>

The uncertainty as to the effect of RAM payments on SSI eligibility discourages the growth of RAM programs.<sup>182</sup> It also causes the elderly homeowner to lose an opportunity to generate supplemental cash to

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179. See, e.g., *Randall v. Califano*, 500 F. Supp. 691 (N.D. Cal. 1980) (nontraditional form of equity held to be unearned income and not excludable from computation of resources or income for purposes of determining eligibility for SSI benefits). Here, members of an Indian tribe received payments from private logging companies for timber cut on the reservation. The court stated that Congress has provided a number of exclusions from resource and income computation for SSI eligibility, and as this did not constitute one such exclusion, the payments are not excludable from computation. *Id.* at 696; see also *Haskin v. Secretary of the Dept. of Health & Human Servs.*, 565 F. Supp. 984 (E.D.N.Y. 1983) (since SSI program involves flat grant to eligible recipients, regardless of individual need, exact amount of grant is continuously subject to reduction if recipient obtains any earned or unearned income not excludable by regulations); *infra* note 180.

180. See, e.g., *Tierney v. Schweiker*, 718 F.2d 449, 451 (D.C. Cir. 1983) (to be eligible for SSI benefits person not only must qualify on age, but must also meet financial eligibility requirements; court also stated that to "ensure that benefits are granted only to individuals who are financially eligible, Congress has directed" administration to prescribe effective and efficient regulations); *Singer v. Secretary of Health & Human Servs.*, 566 F. Supp. 204 (S.D.N.Y. 1983) (SSI recipient who, between 1974 and 1978, saved almost \$9000 from SSI benefit payments apparently by going without food for periods of time and foraging for food in discarded food containers, found ineligible for continued benefits because purpose of SSI program is to assure minimum level of income for elderly people who do not have sufficient income and resources to maintain standard of living at established Federal minimum income level); *Glasgold v. Secretary of Health & Human Servs.*, 558 F. Supp. 129, 134-36 (E.D.N.Y. 1982) ("legislative history of SSI . . . militates in favor of a broad definition of income" in determining eligibility; once an individual is found to be eligible for SSI, his flat grant maximum amount is subject to reduction in amount of any available income which is not otherwise excludable under the regulations).

181. See *supra* notes 179-80.

182. It is difficult to find elderly homeowners who are willing to take a risk. SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 14. Such individuals will be especially reluctant to mortgage their homes because of the strong belief among many elderly that debt should be avoided. BARNETT & MCKENZIE, *supra* note 18, § 8.03. It follows from this that risk of loss of SSI benefits will add to this reluctance.

RAM payments could also result in the disqualification of the borrower from eligibility for Medicaid benefits as the income eligibility for such benefits cannot exceed 300% of the SSI benefit rate. 42 U.S.C. § 1396b(f)(4)(C) (1982); BARNETT & MCKENZIE, *supra* note 18, § 8.12[3].

meet his expenses and the federal government to lose an opportunity to encourage its citizens to become less dependent on welfare programs. Therefore, new SSI regulations should be promulgated to meet the needs of both the senior citizen and the Social Security Administration. Special consideration should be given to the classification of RAM proceeds within the SSI framework so that such payments would not automatically reduce the recipient's SSI benefit.<sup>183</sup>

## B. Federal Income Tax

The failure to be fully integrated into the SSI program<sup>184</sup> is not the only problem facing the RAM. It also has not been fully assimilated into the law governing federal income taxation.<sup>185</sup> Consequently, two major problems exist under the present tax code which produce unfavorable results for the RAM borrower.<sup>186</sup>

### 1. RAM Payments as Taxable Income.

Several provisions of the Internal Revenue Code (the Code)<sup>187</sup> impose unfavorable tax consequences on the Limited Rising Debt RAM,<sup>188</sup> the Life Annuity RAM<sup>189</sup> and the Refund Annuity RAM.<sup>190</sup> Section sixty-one of the Code includes annuity payments in gross income<sup>191</sup> and thereby imposes burdensome tax consequences on

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183. One proposed solution would increase disposable income among the elderly and reduce federal spending for SSI. This proposal suggests the enactment of a regulation which would reduce SSI benefits by one-third when RAM payments are made to SSI recipients, rather than the now existing dollar for dollar reduction of benefits when income is received. Blumenstein & Harmann, *supra* note 2, at 457-61.

184. See *supra* notes 136-83 and accompanying text.

185. See *infra* notes 186-209 and accompanying text.

186. The first problem is that RAM payments constitute taxable income. See *infra* notes 191-99 and accompanying text. The second is that interest accrued or paid on the RAM is not deductible. See *infra* notes 201-09 and accompanying text.

187. I.R.C. §§ 1-9602 (Prentice-Hall 1985).

188. See *supra* notes 80-92 and accompanying text for a description of the Limited Rising Debt RAM.

189. See *supra* notes 93-103 and accompanying text for a description of the Life Annuity RAM.

190. See *supra* notes 104-08 and accompanying text for a description of the Refund Annuity RAM.

191. I.R.C. § 61(a)(9) (Prentice-Hall 1985). "[G]ross income means all income from whatever source derived, including . . . (9) Annuities." *Id.*; see also I.R.C. § 72(b) (1982) (gross income does not include any amount received under annuity which "bears the same ratio to such amount as the investment in the contract (as

the recipient.<sup>192</sup> Such payments increase the amount of taxable income<sup>193</sup> and, in certain circumstances, the rate of taxation.<sup>194</sup> In addition, the tax credit granted the elderly under section twenty-two of the Code is reduced to the extent that the adjusted gross income exceeds the amount of the limitations on eligibility for the credit.<sup>195</sup> Thus, by using RAM proceeds to purchase an annuity, the elderly homeowner incurs the burdens of additional tax liability and the reduction of tax credits in addition to the hardship of mortgaging his home. Infliction of these additional burdens contravenes the goals of the RAM.<sup>196</sup>

Annuity payments received under a RAM should not be included in taxable income. Congressional policy, reflected in the Code, demonstrates that exceptions to the tax laws should be made for transactions involving a taxpayer's primary residence.<sup>197</sup> Under the Code, a gain on the sale of the taxpayer's residence is not recognized to the extent the taxpayer reinvests the full amount of the proceeds in another primary residence within two years.<sup>198</sup> In addition, a taxpayer aged fifty-five or older may exclude from taxable income, on a once-in-a-lifetime elective basis, up to \$125,000 of the gain realized on the sale or exchange of his principal residence.<sup>199</sup> This policy should be extended to senior citizens who wish to remain in their homes but must convert their home equity into cash in order to do so. A provision in the Code excluding from taxable income payments,

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of the annuity starting date) bears to the expected return under the contract (as of such date)').

192. See *infra* notes 193-96 and accompanying text.

193. Payments received under an annuity are included in gross income. I.R.C. § 61(a)(9) (Prentice-Hall 1985). Taxable income means gross income minus the deductions allowed under the Code. I.R.C. § 63(b) (1982).

194. Since the United States tax system is a progressive system, the rate of taxation increases as the individual's income increases. See I.R.C. § 1 (tax tables); CHIRELSTEIN, FEDERAL INCOME TAXATION 3 (3d ed. 1982).

195. I.R.C. § 22 (Prentice-Hall 1985) (formerly codified at I.R.C. § 37). If the adjusted gross income of the taxpayer exceeds (1) \$7,500 in the case of a single individual, (2) \$10,000 in the case of a joint return, or (3) \$5,000 in the case of a married individual filing a separate return, the amount of income subject to the 15% credit is reduced by one-half of the excess over these amounts. *Id.* § 22(d).

196. See *supra* notes 1-32 and accompanying text for a discussion of these policies and goals.

197. See *infra* notes 198-99 and accompanying text.

198. I.R.C. § 1034 (1982).

199. I.R.C. § 121 (1982). In order for this section to apply, the taxpayer must have used the property as his principal residence for at least three of the five years preceding the sale. I.R.C. § 121(a)(2) (1982).



in an aggregate sum of not more than \$125,000, received on annuities purchased with RAM proceeds would accomplish this objective.<sup>200</sup>

## 2. Interest Deduction Consequences

The Code disallows a deduction from taxable income for interest paid on a loan when the proceeds are used to purchase an annuity contract.<sup>201</sup> Consequently, the senior citizen must bear another burden which does not exist under a traditional mortgage loan.<sup>202</sup>

The tax policy behind this restriction is not applicable to annuities purchased with RAM proceeds.<sup>203</sup> Prior to the inclusion of this restriction in the Code, taxpayers could take loans to purchase annuities as a means of providing a tax shelter.<sup>204</sup> Congress then passed section 264 of the Code to close this loophole.<sup>205</sup> However, this restriction becomes too burdensome when applied to a senior citizen on a fixed income who purchases an annuity as a means of home equity conversion.<sup>206</sup> The policies for promoting home equity conversion,<sup>207</sup> tax credits for the elderly<sup>208</sup> and tax advantages for

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200. The New Jersey RAM statute excludes from income, for tax purposes, any income received by a borrower under a RAM. N.J. REV. STAT. § 46:10B-20 (West Supp. 1984-1985) (“[i]ncome derived by mortgagors from mortgages authorized pursuant to this act shall not be considered income for purposes of the ‘New Jersey Gross Income Tax Act’”).

201. I.R.C. § 264(a)(2) (1982). (“[n]o deduction shall be allowed for . . . (2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract”). A contract is treated as a single premium contract “if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased.” *Id.* § 264(b)(1). This definition applies to the Limited Rising Debt RAM, the Life Annuity RAM and the Refund Annuity RAM. See *supra* notes 80-108 and accompanying text for an explanation of such devices.

202. All interest paid or accrued on a traditional level-payment self-amortizing mortgage loan (in the absence of an annuity) is deductible from gross income. See I.R.C. § 163(a) (1982) (“[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness [unless subject to an exception]”).

203. See *infra* notes 204-05 and accompanying text for a discussion of the tax policy behind this restriction. See *infra* note 206 and accompanying text for a discussion of the reasons such tax policy is not pertinent to RAMs.

204. See B. BITTKER, L. KLEIN & W. STONE, FEDERAL INCOME TAXATION 653-54 (6th ed. 1984).

205. See *Knietsch v. United States*, 364 U.S. 361, 368 (1960) (citing *Hearings Before Senate Finance Committee on H.R. 7378*, 77th Cong., 2d Sess. 54 (1942)).

206. In the case of a RAM, the borrower/annuitant is borrowing money to purchase an annuity for the purpose of providing a monthly cash supplement to meet expenses. See *supra* notes 1-32 and accompanying text.

207. See *supra* notes 1-32 and accompanying text.

208. See *supra* note 195 and accompanying text.

homeowners<sup>209</sup> should be applied by Congress to revise the Code. The heavy tax burden on senior citizens participating in RAM programs either should be lightened or removed entirely.

#### IV. The Advantages of the New York RAM Legislation

Legislation authorizing RAMs was passed recently in New York.<sup>210</sup> This legislation differs from federal legislation<sup>211</sup> in that it requires RAMs to be offered at a fixed interest rate.<sup>212</sup> By placing this limitation on the RAM, the legislation avoids a number of both legal<sup>213</sup> and practical<sup>214</sup> problems which arise under the shared appreciation RAMs offered elsewhere. Therefore, all efforts to amend the New York law to allow shared appreciation RAMs should be resisted.

#### A. New York's RAM Legislation

##### 1. History

The Alternative Mortgage Act,<sup>215</sup> passed by Congress in 1982, preempts state law<sup>216</sup> unless explicitly overridden by the state.<sup>217</sup> New York State chose to override the provisions of the act which apply to residential real property and cooperative apartment unit alternative mortgage transactions.<sup>218</sup> The New York law provides that these transactions are to be controlled by the New York State Banking

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209. See *supra* notes 197-99 and accompanying text.

210. 1984 N.Y. Laws 789. This legislation was approved August 5, 1984 and became effective December 3, 1984. *Id.*

211. See Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3802(1)(C) (1982).

212. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(b)) (“[e]very reverse mortgage issued pursuant to section six-h of the banking law shall be subject to the following: . . . (b) The interest rate on the loan shall be fixed at its origination and not subject to future adjustment”).

213. See *infra* notes 242-99 and accompanying text for a discussion of these legal problems.

214. See *infra* notes 301-28 and accompanying text for a discussion of these practical problems.

215. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, tit. VIII, §§ 802-806, 96 Stat. 1545 (1982) (codified at 12 U.S.C. §§ 3801-3805 (1982)) (tit. VIII is known as the Alternative Mortgage Transaction Parity Act of 1982); see *supra* notes 53-56 and accompanying text.

216. 12 U.S.C. § 3803(c) (1982); see *supra* note 55 and accompanying text.

217. 12 U.S.C. § 3804(a) (1982); see *supra* note 56 and accompanying text.

218. N.Y. BANKING LAW § 6-g (McKinney Supp. 1984-1985).

Board (Banking Board) regulations rather than by federal regulations.<sup>219</sup> State-regulated lenders were not permitted to offer RAMs until December 3, 1984 when legislation authorizing them to do so became effective.<sup>220</sup>

## 2. *The Terms of the New York Law*

The New York statute<sup>221</sup> outlines the terms which may be offered by RAM lenders. The RAM may provide that the proceeds of the loan be advanced in installments or in a lump sum for the purpose of purchasing an annuity.<sup>222</sup> It also may be structured to provide for the addition of accrued and unpaid interest to the face amount of the mortgage.<sup>223</sup> Upon the maturity of the loan, the property may be reappraised.<sup>224</sup> If the property value has appreciated, the loan may be extended and the amount of the loan increased up to eighty percent of the appreciated value.<sup>225</sup> If it is not extended, the loan is to be amortized<sup>226</sup> over a period not to exceed thirty years.<sup>227</sup>

The New York law also limits the terms which may be offered in RAMs. First, RAM loans may not be offered to borrowers under sixty years of age.<sup>228</sup> Second, interest rates must be fixed at the origination of each mortgage and cannot be subject to any future adjustment.<sup>229</sup> Finally, the amount of the mortgage can be no greater than eighty percent of the appraised value of the property.<sup>230</sup>

219. See N.Y. BANKING LAW § 6-f (McKinney Supp. 1984-1985).

220. See 1984 N.Y. Laws 789, § 4. See also *supra* note 210 for the date this legislation became effective.

221. 1984 N.Y. Laws 789.

222. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(l)).

223. *Id.* This eliminates the problems connected with the prohibitions against charging interest on interest or compound interest. For the leading case in New York, see *Giventer v. Arnow*, 37 N.Y.2d 305, 333 N.E.2d 366, 372 N.Y.S.2d 52 (1975).

224. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(d)).

225. *Id.*

226. When a loan is amortized, it is repaid over regular specified time intervals, in equal installments, which are credited first to the payment of accrued interest, and then to the reduction of principal. See BLACK'S LAW DICTIONARY 76 (5th ed. 1979) (definition of "amortized mortgage").

227. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(e)).

228. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(f)). If the RAM proceeds are advanced for the purpose of purchasing an annuity, a higher initial age limit may be prescribed by the Banking Board. *Id.*

229. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(b)); see *supra* note 212 and accompanying text.

230. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(2)(a)).

All RAM lenders must conform to certain requirements under New York law. The loan documents must provide that the borrower has the option of prepayment without penalty at any time during the term of the loan.<sup>231</sup> In addition, any applicant for a RAM loan must be provided with disclosure, as prescribed by the Banking Board, describing the relevant provisions of the RAM being offered. Such provisions include: (1) a schedule of payments to and from the borrower; (2) a schedule of the total payments in dollars over the full term of the loan for both the borrower and the lender; (3) a prominently displayed statement advising applicants to consult appropriate authorities regarding tax and estate planning consequences of the RAM;<sup>232</sup> (4) a description of prepayment and refinancing features; and (5) the interest rate and total amount of interest payable on the loan.<sup>233</sup>

### **B. The Shared Appreciation RAM versus The Fixed Rate RAM**

The interest provision a lender may use in a RAM varies according to the law by which the lender is governed.<sup>234</sup> Banking organizations in states which have not overridden the Alternative Mortgage Act<sup>235</sup> may offer RAM loans with or without a shared appreciation feature.<sup>236</sup> Lenders governed by New York law, however, may offer RAMs only with a fixed interest rate.<sup>237</sup>

Shared appreciation and fixed rate RAMs differ only in that, in the former, a portion of the interest accrues at a fixed rate.<sup>238</sup> This

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231. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. Real Prop. Law § 280(3)(a)).

232. A counseling service for RAM borrowers is available in Nassau County, where the first New York RAMs are being offered, through the Counseling for Home Equity Conversion division of the Nassau County Department of Senior Citizen Affairs. See Greer, 'Reverse Mortgages' in Nassau County, *Newsday*, April 3, 1985, at 3, col. 1; DePalma, *Tapping Equity for Retirement Income*, *N.Y. Times*, Sept. 16, 1984, § 8, at 14, col. 4.

233. 1984 N.Y. Laws 789, § 3 (to be codified at N.Y. REAL PROP. LAW § 280(3)(b)).

234. See *infra* notes 235-37 and accompanying text.

235. The only states which have overridden the preemption section of the Alternative Mortgage Act are Maine and New York. See ME. REV. STAT. ANN. tit. 9-B, § 241(3) (Supp. 1984-1985); N.Y. BANKING LAW § 6-g (McKinney Supp. 1984-1985).

236. See *supra* notes 53-55 and accompanying text.

237. See *supra* note 212.

238. See MADISON & DWYER, *supra* note 38, § 3.04 [3][c], at S3-6 (Supp. 1984); Kanner, *Shared-Appreciation Mortgages*, 10 REAL EST. L.J. 259, 260 (1982) [hereinafter cited as Kanner, *SAMs*]; Iezman, *The Shared Appreciation Mortgage and the Shared Equity Program: A Comprehensive Examination of Equity Participation*, 16 REAL PROP. PROB. & TR. J. 510, 514 (1981) [hereinafter cited as Iezman, *SAMs*].

portion of the interest accrues on the loan at a fixed, below-market rate from the commencement of the term.<sup>239</sup> The balance of the interest payable to the lender is a percentage<sup>240</sup> of the appreciated value of the property at the earlier of: (1) the fixed maturity of the loan; (2) full prepayment; or (3) the sale of the home.<sup>241</sup>

### C. Legal Issues

A variety of legal issues inherent in the shared appreciation RAM but avoided by the New York statute are: (1) usury law violations;<sup>242</sup> (2) the priority of the lien of the mortgage over intervening liens;<sup>243</sup> and (3) clogging of the equity of redemption.<sup>244</sup>

#### 1. Usury

A shared appreciation mortgage permits the lender to receive a contingent rate of return on the borrower's funds.<sup>245</sup> This rate is determined by the appreciated value of the property from the commencement of the loan term.<sup>246</sup> This contingent rate, which under some RAM programs is as high as 100% of the appreciated value,<sup>247</sup> is collected in addition to the fixed rate of interest, albeit below the market rate of interest.<sup>248</sup> This double collection results in a conflict with usury laws<sup>249</sup> since all funds received by a lender, other than administrative fees, have been held to be interest.<sup>250</sup>

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239. MADISON & DWYER, *supra* note 38, § 3.04 [3][c], at S3-6 (Supp. 1984); Iezman, *SAMs*, *supra* note 238, at 514; Kanner, *SAMs*, *supra* note 238, at 259, 260; *see also* KRATOVIL & WERNER, *supra* note 38, § 29.02(g) (to obtain advantage of sharing in appreciation of property, lender makes loan at lower initial rate than typical mortgage).

240. That percentage can be as high as 100%. *See* AMERICAN HOMESTEAD MORTGAGE CORPORATION, *THE CENTURY PLAN: A SUPPLEMENTAL RETIREMENT INCOME PROGRAM FOR HOMEOWNERS 65 AND OVER 5* (1984) [hereinafter cited as *THE CENTURY PLAN PAMPHLET*] (available at *Fordham Urban Law Journal* office). In return, this plan provides for up to a 40-year loan term. *Id.* at 6.

241. MADISON & DWYER, *supra* note 38, § 3.04 [3][c], at S3-6 (Supp. 1984).

242. *See infra* notes 245-66 and accompanying text. For an analysis of other legal issues, including negative amortization, negotiability and the doctrine of unconscionability, *see* Levin & Roberts, *Future Forms of Financing in FINANCING REAL ESTATE DURING THE INFLATIONARY 80's* (ABA 1981).

243. *See infra* notes 267-83 and accompanying text.

244. *See infra* notes 284-304 and accompanying text.

245. *See supra* notes 238-41 and accompanying text.

246. *See id.*

247. *See supra* note 240.

248. *See supra* notes 239-40 and accompanying text.

249. *See infra* notes 251-66 and accompanying text.

250. *See* *Ve Bee Serv. Co. v. Household Fin. Corp.*, 51 N.Y.S.2d 590, 604

Usury laws place a limitation on the amount of interest chargeable on a loan.<sup>251</sup> This limitation protects borrowers from overreaching lenders.<sup>252</sup> The protection of borrowers from usurious loans has been a concern of governing bodies throughout history<sup>253</sup> and still is a predominant concern in the United States.<sup>254</sup> Usury laws, in most jurisdictions, have survived even the recent trend toward liberalization or elimination of ceilings on interest rates.<sup>255</sup>

The strong policy in favor of protecting borrowers is reflected in the severe penalties imposed for violation of the usury laws.<sup>256</sup> In some jurisdictions, the lender is forced to forfeit all right to interest, as well as all right to repayment of the loan principal.<sup>257</sup> Under New York law, banking institutions charging a rate of interest in excess of the legal ceiling are required to forfeit all interest agreed upon<sup>258</sup>

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(Special Term, Sup. Ct. N.Y. County 1944) (“an otherwise lawful requirement necessitating an expense to a borrower ceases to be lawful and becomes usurious when required by the lender under a plan or scheme whereby the lender intends to and does receive (directly or indirectly) a return or advantage of value, flowing from the borrower’s payment therefor, in addition to the maximum legal rate of interest”), *aff’d*, 269 A.D. 772, 55 N.Y.S.2d 570 (1st Dep’t 1945); *see also* N.Y. GEN. OBLIG. LAW § 5-501(2) (McKinney Supp. 1984-1985) (“amount charged, taken or received as interest shall include any and all amounts paid or payable, directly or indirectly, by any person, to or for the account of the lender in consideration for making the loan . . . except such fee as may be fixed by the commissioner of taxation and finance as the cost of servicing loans . . .”).

251. KRATOVIL & WERNER, *supra* note 38, § 13.02; MADISON & DWYER, *supra* note 38, § 5.01; Nosari & Lewis, *How Usury Laws Affect Real Estate Development*, 9 REAL EST. L.J. 30, 30 (1980) [hereinafter cited as Nosari & Lewis].

252. MADISON & DWYER, *supra* note 38, § 5.01, at 5-2; Nosari & Lewis, *supra* note 251, at 30.

253. The history of usury laws dates back to Old Testament times. “Thou shalt not lend upon usury to thy brother; usury of money; usury of victuals; usury of anything . . . . Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury.” *Deuteronomy* 23:19-20. This policy is also found in the New Testament. “Lend freely, hoping nothing thereby.” *Luke* 6:35. Originally, the meaning of usury was the taking of any interest at all. *See* KRATOVIL & WERNER, *supra* note 35, § 13.05; Benfield, *Money, Mortgages, and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819, 822-23 (1968).

254. *See* KRATOVIL & WERNER, *supra* note 38, § 13.05; MADISON & DWYER, *supra* note 38, § 5.01; Friend, *Shared Appreciation Mortgages*, 34 HASTINGS L.J. 329, 346-47 (1982) [hereinafter cited as Friend]; Forte, *Avoiding Usury in Real Estate Financing*, Nat’l L.J., Oct. 19, 1981, at 19, col. 4.

255. *See* *Charts: Interest—Usury*, 1 CONSUMER CRED. GUIDE (CCH) ¶ 510 (1985).

256. *See* MADISON & DWYER, *supra* note 38, § 5.01, at 5-3. *See infra* notes 257-59 and accompanying text for a discussion of these penalties.

257. *See supra* note 255.

258. N.Y. GEN. OBLIG. LAW § 5-511 (McKinney 1978) (“the knowingly taking, receiving, reserving or charging [a sum greater than the established usury rate] by

and may be subjected to criminal prosecution.<sup>259</sup>

Certain types of borrowers are not in need of the protection offered by usury statutes. For example, the profit-motivated commercial borrower, who has the sophistication and knowledge necessary to negotiate the terms of mortgage loans, does not need statutorily imposed protection.<sup>260</sup> In contrast, the elderly homeowner lacks this sophistication; therefore, he needs the protection of usury laws.<sup>261</sup> Consequently, RAM loans must comply with usury provisions.

The lender's intent to charge an excessive interest rate is the critical factor in determining a usury violation.<sup>262</sup> Courts do not require a specific intent to violate the usury statutes; rather, they look for clear evidence of usury on the face of the mortgage note.<sup>263</sup> Such

a savings bank, a savings and loan association or a federal savings and loan association shall only be held and adjudged a forfeiture of the entire interest which the loan or obligation carries with it or which has been agreed to be paid thereon. If a greater sum or greater value has been paid, the person paying the same . . . may recover from the savings bank, the savings and loan association or the federal savings and loan association twice the entire amount of the interest thus paid.'').

259. N.Y. PENAL LAW § 190.40 (McKinney Supp. 1984-1985).

A person is guilty of criminal usury in the second degree when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding twenty-five per centum per annum or the equivalent rate for a longer or shorter period. Criminal usury in the second degree is a class E felony.

*Id.*

260. KRATOVIL & WERNER, *supra* note 38, § 13.12(a), (c). The New York legislature has recognized this. See N.Y. GEN. OBLIG. LAWS § 5-501(6)(a) (McKinney Supp. 1984-1985) which states:

No law regulating the maximum rate of interest which may be charged, taken or received, except section 190.40 and section 190.42 of the penal law, shall apply to any loan or forbearance in the amount of two hundred fifty thousand dollars or more, other than a loan or forbearance secured primarily by an interest in real property improved by a one or two family residence.

*Id.*; see also N.Y. GEN. OBLIG. LAW § 5-501(b)(6) (McKinney Supp. 1984-1985) ("[n]o law regulating the maximum rate of interest which may be charged, taken or received, including section 190.40 and section 190.42 of the penal law, shall apply to any loan or forbearance in the amount of two million five hundred thousand dollars or more").

261. See KRATOVIL & WERNER, *supra* note 38, § 13.12(a), (c); MADISON & DWYER, *supra* note 38, § 5.01, at 5-2; Nosari & Lewis, *How Usury Laws Affect Real Estate Development*, 9 REAL EST. L.J. 30, 30 (1980).

262. See *In re Estate of Dane*, 55 A.D.2d 224, 226, 390 N.Y.S.2d 249, 250 (3d Dep't 1976); KRATOVIL & WERNER, *supra* note 38, § 13.03; MADISON & DWYER, *supra* note 38, § 5.02[1].

263. *Dane*, 55 A.D.2d at 226, 390 N.Y.S.2d at 250; KRATOVIL & WERNER, *supra* note 38, § 13.03; MADISON & DWYER, *supra* note 38, § 5.02[1].

clear evidence exists in a shared appreciation RAM if the sum of the amount of the appreciated value of the property plus the fixed interest rate exceeds the usury rate.<sup>264</sup> This problem, however, can be avoided by the use of the New York fixed rate RAM. Since the interest charged on the fixed rate RAM is not subject to change<sup>265</sup> and is not contingent upon the appreciated value of the property,<sup>266</sup> such loans can easily be structured to comply with usury laws. Therefore, they do not run the risk of violating usury laws at an undetermined future date.

## 2. Priority Over Intervening Liens

Under the Rising Debt RAM<sup>267</sup> and the Limited Rising Debt RAM,<sup>268</sup> the indebtedness secured by the RAM grows as the loan proceeds are advanced periodically.<sup>269</sup> This feature subjects the RAM to treatment as a mortgage securing future advances<sup>270</sup> and thus raises the issue of priority between the RAM lender's lien and subse-

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264. *Dane*, 55 A.D.2d at 226, 390 N.Y.S.2d at 250 (“[a] general intent to charge more than the legal rate as evidenced by the note, is all that is needed [to violate the usury statute]”). “The lender intends to charge what he charges the borrower, and if [that rate] exceeds the statutory maximum, usury is present even if the lender thought the charges he exacted would not create usury.” *KRATOVIL & WERNER*, *supra* note 38, § 13.03; *see Cusick v. Ifshin*, 70 Misc. 2d 564, 567, 334 N.Y.S.2d 106, 110 (Civ. Ct. N.Y. County 1972) (“[w]henver the lender stipulates even for a chance of an advantage beyond the legal interest, the contract is usurious, if he is entitled by the contract to have the money lent with the interest thereon repaid to him at all events”) (quoting *Cleveland v. Loder*, 7 Paige Ch. 557, 559, 4 N.Y. Ch. Rep. 273, 274 (1839)), *aff'd*, 73 Misc. 2d 127, 341 N.Y.S.2d 280 (1st Dep’t 1973). The loan will be usurious only if the fixed interest plus the contingent interest exceed the statutory minimum. *See Hartley v. Eagle Ins. Co.*, 222 N.Y. 178, 184, 118 N.E. 622, 624 (1918) (“an agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not *ipso facto* usurious, because of the possibility that more than the legal interest will be paid”).

265. *See supra* note 229 and accompanying text.

266. *See supra* notes 238-41 and accompanying text.

267. *See supra* notes 71-79 and accompanying text for a description of the Rising Debt RAM.

268. *See supra* notes 80-92 and accompanying text for a description of the Limited Rising Debt RAM.

269. *See supra* notes 71-92 and accompanying text.

270. *BARNETT & MCKENZIE*, *supra* note 18, §§ 4.05[2][b], 8.07[2][b], 8.07[6] (mortgage that provides for capitalization of interest or enlargement of secured debt after execution of mortgage becomes subject to law regarding mortgages to secure future advances); *see Barnett, Alternative Mortgage Instruments: How to Maintain Secured Lender Status*, 96 *BANKING L.J.* 6, 24 (1979) [hereinafter cited as *Barnett*].



quent intervening liens which attach to the encumbered property.<sup>271</sup> Loss of priority by the lender would render RAM loans risky, burdensome and undesirable for most mortgage lenders.<sup>272</sup>

The issue of priority turns on whether the subsequent advances are obligatory or optional in nature.<sup>273</sup> An obligatory future advance<sup>274</sup> is deemed secured from the time the mortgage originally was recorded.<sup>275</sup> The lender's interest, therefore, is superior to all liens which arise after the recording of the mortgage.<sup>276</sup> The priority of the obligatory advance would not be affected even if the subsequent lien attached before the advance was actually made or before the lender had actual notice of the lien.<sup>277</sup> An optional future advance,<sup>278</sup>

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271. BARNETT & MCKENZIE, *supra* note 18, §§ 4.05[2][b], 4.05[6], 8.07[6]; Barnett, *supra* note 266, at 24.

272. It is obvious that the lender's goal is to create a valid mortgage. If the lender loses priority, the mortgage becomes unenforceable against those third parties with intervening liens. See OSBORNE, NELSON & WHITMAN, *supra* note 38, § 12.7, at 759.

273. See BARNETT & MCKENZIE, *supra* note 18, §§ 4.05[6], 8.07[6]; G. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 118, at 191 (2d ed. 1970) [hereinafter cited as OSBORNE]; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 12.7, at 759; Barnett, *supra* note 270, at 24; Iezman, *supra* note 65, at 5 n.2; see also Security Trust Co. of Rochester v. Graney, 89 Misc. 2d 290, 391 N.Y.S.2d 46 (Sup. Ct. Monroe County 1977) (sums advanced in excess of maximum sum agreed to held to be optional, and therefore, plaintiff's mortgage did not have priority as to such sums); First Federal Sav. & Loan Ass'n of Rochester v. Green-Acres Bldg. Corp., 38 Misc. 2d 149, 236 N.Y.S.2d 1009 (County Court Monroe County 1963) (plaintiff made an advance to itself to cover accumulated arrearages of principal and interest; court held that since plaintiff would not have been subject to damages if it had not made payment, such payment was optional and no damages were awarded).

274. "[A]n obligatory future advance is a disbursement made pursuant to the terms of the mortgage." BARNETT & MCKENZIE, *supra* note 18, § 4.05[6][a]; Barnett, *supra* note 270, at 24; see *Graney*, 89 Misc. 2d at 293, 391 N.Y.S.2d at 48; *Green-Acres*, 38 Misc. 2d at 150, 236 N.Y.S.2d at 1010; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 12.7, at 759-60.

275. *Graney*, 89 Misc. 2d at 293, 391 N.Y.S.2d at 48 ("[t]he law is clear that if the holder of a mortgage to secure future advances is contractually bound to make advances in any event, the lien of his mortgage has priority as to advances made after, as well as before, the junior encumbrance attaches"); 38 Misc. 2d at 150, 236 N.Y.S.2d at 1010 ("[t]he rule is established that . . . if the mortgagee is contractually bound to make the advances in any event, his mortgage has priority as to the advances made after, as well as before, the junior liens or encumbrances attach"); BARNETT & MCKENZIE, *supra* note 18, §4.05[6][a], at 4-33; KRATOVIL & WERNER, *supra* note 38, § 11.02, at 159; Barnett, *supra* note 270, at 25; see OSBORNE, *supra* note 273, § 118; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 12.7, at 759-60.

276. See *supra* note 275.

277. *Id.*

278. An optional advance is any advance that a lender may decline to make,

however, may be deemed subordinate to a subsequent intervening lien.<sup>279</sup>

Advances under a RAM are considered obligatory if the amount by which the indebtedness is to be increased during the term of the mortgage is determined at the time of the origination of the mortgage and is stated accurately on the face of the document.<sup>280</sup> Such requirements can be adhered to easily provided that the RAM is subject to a fixed rate of interest.<sup>281</sup> However, if the interest rate under the RAM is contingent upon the appreciation of the property throughout the term of the loan,<sup>282</sup> it is impossible to meet these requirements.<sup>283</sup> Thus, the lender holding a shared appreciation RAM risks losing priority to intervening lienors.

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at his pleasure, without taking the risk of subjecting himself to damages or loss. See *Hyman v. Hauff*, 138 N.Y. 48, 55, 33 N.E. 735, 737 (1893); see BARNETT & MCKENZIE, *supra* note 18, § 4.05[6][a], at 4-33 ("optional future advance is any disbursement that a lender may make upon its election, with or without the borrower's consent, or that the lender may decline to make, even though requested by the borrower").

279. See *Hyman*, 138 N.Y. at 53-54, 33 N.E. at 736-37; BARNETT & MCKENZIE, *supra* note 18, § 4.05[6][a]; OSBORNE, *supra* note 273, § 118, at 191; OSBORNE, NELSON & WHITMAN, *supra* note 38, § 12.7, at 759; Barnett, *supra* note 270, at 25; Iezman, *supra* note 65, at 5 n.2; Iezman, *SAMs*, *supra* note 238, at 521.

280. See *Graney*, 89 Misc. 2d at 293, 391 N.Y.S.2d at 48 ("[w]here the obligation to make advances exists or where the right to decline depends upon facts outside the instrument . . . the obligation is not optional and the holder of the mortgage is warranted in making advances in reliance upon it"); *Green-Acres*, 38 Misc. 2d at 150, 236 N.Y.S.2d at 1010 ("if the mortgagee is contractually bound to make the advances in any event, his mortgage has priority . . ."); *Hyman*, 138 N.Y. at 54-56, 33 N.E. at 737 (holding that advance is obligatory if lender is subject to damages in event it is not made); BARNETT & MCKENZIE, *supra* note 18, § 4.05[6][a], at 4-34 to 4-35; KRATOVIL & WERNER, *supra* note 38, § 11.02; Barnett, *supra* note 270, at 18.

281. The Rising Debt RAM and the Limited Rising Debt RAM are structured so that the proceeds of the loan are advanced in installments, and the amounts of these installments can be determined at the commencement of the loan. See *supra* notes 71-103 and accompanying text for a discussion of these devices. Since the entire amount of the proceeds of a Life Annuity RAM and a Refund Annuity RAM are advanced in a lump sum, these devices are not subject to the laws regarding future advances. See *supra* note 104-08 and accompanying text for a discussion of these devices.

282. Such is the case with the shared appreciation RAM. See *supra* notes 238-41 and accompanying text.

283. If a portion of the indebtedness consists of the contingent interest based on the appreciated value of the property, the amount of the indebtedness cannot be determined at the commencement of the loan, and therefore cannot be accurately stated on the face of the mortgage. Consequently, the disbursements required to be made by the mortgage contract will have priority over subsequent liens, but such will not be the case with the contingent interest.

### 3. *Clogging the Equity of Redemption*

The long-standing doctrine<sup>284</sup> preventing mortgage lenders from clogging the borrower's equity of redemption<sup>285</sup> presents another problem for the shared appreciation RAM. Although this specific issue has not yet been tested in court, related cases<sup>286</sup> and the principles behind the doctrine<sup>287</sup> indicate that the shared appreciation RAM violates the doctrine.<sup>288</sup>

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The priority of the contingent interest will then depend upon whether or not it accrues prior to maturity. See MADISON & DWYER, *supra* note 38, § 3.04[3][c], at S3-8 (Supp. 1984). It would be difficult for the lender to argue that the interest does not accrue until maturity since the value of the property appreciates during the course of the loan and such amount is payable prior to the maturity date if the borrower decides to prepay, if the borrower dies, or if the property is sold. See *supra* note 241 and accompanying text for a discussion of due date of the contingent interest on a shared appreciation mortgage.

It is not suggested that this problem is insurmountable. The lender can conduct periodic searches of the state of title to determine if any liens have attached to the property. However, this will result in additional expenditures for the RAM borrower.

284. The doctrine prohibiting the clogging of the equity of redemption dates back to before 1700. OSBORNE, *supra* note 273, § 6, at 12-13. By 1700 the phrase "equity of redemption" was commonly used. *Id.* at 13; see OSBORNE, NELSON & WHITMAN, *supra* note 38, § 1.3, at 7; see Comment, *The Shared Appreciation Mortgage: A Clog on the Equity of Redemption?*, 15 J. MAR. L. REV. 131, 144-45 (1982) [hereinafter cited as *Equity of Redemption*].

285. When the mortgage was developed in fourteenth century England, it was an actual conveyance of the fee simple interest in the property by the borrower to the lender. *Equity of Redemption*, *supra* note 284, at 144-46. The conveyance was, however, subject to a condition subsequent which would vest title back in the borrower upon full repayment on "law day," or the maturity date. *Id.* at 144. If the borrower did not promptly repay the loan on the law day, he lost all interest in the property and the lender became the fee owner. *Id.* During the seventeenth century, the court of chancery began granting relief from such forfeitures by permitting the borrower to sue in equity for redemption; the chancellor could compel the lender to convey the property to the borrower upon repayment of the debt, with interest. *Id.* at 145 This was the birth of the right of the equity of redemption. *Id.* at 146 Lenders responded by having the borrowers waive their right to redeem. *Id.* The courts of equity countered this movement by establishing the doctrine against clogging the equity of redemption, which voided any agreement voiding the borrower's right to redeem without foreclosure proceedings. *Id.* See generally KRATOVIL & WERNER, *supra* note 38, §§ 1.2-1.5 (background information on equity of redemption); OSBORNE, *supra* note 273, §§ 5-7 (same); OSBORNE, NELSON & WHITMAN, *supra* note 273, §§ 1.2-1.4 (same).

286. See *infra* notes 292-93 and accompanying text.

287. See *infra* notes 289-93 and accompanying text.

288. A connected problem is that the shared appreciation RAM may be considered unconscionable. See BARNETT & MCKENZIE, *supra* note 18, § 7.06[2][a]; MADISON & DWYER, *supra* note 38, § 3.04[3][c], at S3-7 (Supp. 1984).

The prohibition against clogging the borrower's equity of redemption is based on the following three principles developed by courts of equity:<sup>289</sup> (1) "once a mortgage, always a mortgage;" (2) the borrower shall not have a "collateral advantage;" and (3) there must be nothing in the mortgage which will "fetter" the property on redemption.<sup>290</sup>

The first is the principle most commonly used in the United States<sup>291</sup> and is interpreted to mean that a mortgage may not be made irredeemable.<sup>292</sup> The courts have expanded this doctrine to prohibit an agreement which allows the lender to retain a portion of the mortgaged property and to limit redemption to the balance.<sup>293</sup>

The shared appreciation RAM, by its nature, conflicts with this principle. Although the lender of a shared appreciation RAM does not physically keep a portion of the mortgaged property, it does retain the appreciated value of the property.<sup>294</sup> Thus, the lender limits the borrower's right of redemption to a portion of the value of the premises. This limit clearly violates the theory that the borrower should be able to redeem the full value of the property.<sup>295</sup>

A recent trend in proposed statutory amendments advocates eliminating the clogging doctrine from certain mortgage transactions.<sup>296</sup> A proposal in the New York legislature<sup>297</sup> recognizes that an amendment eliminating the clogging doctrine should not apply to less

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289. See *infra* note 290 and accompanying text.

290. OSBORNE, NELSON & WHITMAN, *supra* note 38, § 3.1; Friend, *supra* note 254, at 411, 413; *Equity of Redemption*, *supra* note 284, at 146, 149; Colletti, *Lender's Equity Clogging Mortgagor's Redemption*, N.Y.L.J., Sept. 19, 1984, at 27, col. 1.

291. OSBORNE, NELSON & WHITMAN, *supra* note 38, § 3.1, at 28-29; *Equity of Redemption*, *supra* note 284, at 146.

292. OSBORNE, NELSON & WHITMAN, *supra* note 38, § 3.1, at 29 (citing Lord Davey in *Noakes v. Rice*, A.C. 24, 32 (1902)); Friend, *supra* note 254, at 411 (citing same); *Equity of Redemption*, *supra* note 284, at 146 (citing same); see Fogelman, *The Deed Absolute as a Mortgage in New York*, 32 *FORDHAM L. REV.* 299, 301 (1963).

293. OSBORNE, NELSON & WHITMAN, *supra* note 38, § 3.1, at 29 (citing *Salt v. Marquess of Northampton*, A.C. 1 (1891)); Friend, *supra* note 254, at 411 (citing same); *Equity of Redemption*, *supra* note 284, at 147 (citing same).

294. See *supra* notes 238-41 and accompanying text.

295. See *supra* note 293 and accompanying text.

296. See Colletti, *supra* note 290, at 29, col. 2.

297. *Id.* A bill was originally introduced in the 1982 legislature, and a new bill was introduced for consideration by the 1983 legislature, and is still under consideration. *Id.* This proposed bill provides that a holder of a mortgage in the principal sum of \$2,500,000 or more may obtain from the borrower a valid option or right to acquire an interest in the property in addition to the security of its mortgage lien. *Id.* at cols. 2-3.

sophisticated borrowers such as those eligible for RAM loans.<sup>298</sup> The proponents of the amendment acknowledge that American judicial policy has protected such borrowers through application of the clogging doctrine.<sup>299</sup> The fixed rate RAM, as opposed to the shared appreciation RAM, adheres to this policy.<sup>300</sup>

#### D. Practical Considerations

The Shared Appreciation RAM presents practical as well as legal problems. These include the unavailability of secondary financing to the borrower<sup>301</sup> and the unavailability to the lender of a title insurance policy which adequately insures all future contingent interest on the shared appreciation RAM.<sup>302</sup> A combination of these problems, the legal problems discussed above<sup>303</sup> and the policy against shared appreciation RAMs for elderly borrowers,<sup>304</sup> makes the New York fixed rate RAM the superior means of structuring the RAM.

##### 1. Availability of Secondary Financing

Older homes often require costly repairs<sup>305</sup> and the senior citizen who owns such a home may have to borrow money to finance them.<sup>306</sup> If the home is already encumbered by a RAM, the borrower's ability to obtain a second loan may depend on the presence or absence of a shared appreciation feature in the RAM.<sup>307</sup>

A shared appreciation mortgage creates a lien on the appreciated value of the home.<sup>308</sup> Since a RAM loan is typically for eighty

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298. *See id.* at col. 3. The threshold amount of \$2,500,000 insures that the legislation would only apply to sophisticated borrowers with able and knowledgeable counsel, as opposed to the "powerless unsophisticated" borrower. *See id.* at 29, col. 2.

299. *Id.*

300. *See supra* notes 289-95 and accompanying text.

301. *See infra* notes 305-14 and accompanying text for a discussion of secondary financing problems.

302. *See infra* notes 315-28 and accompanying text for a discussion of the legal problems.

303. *See supra* notes 242-300 and accompanying text.

304. The shared appreciation RAM takes away from the elderly homeowner some or all of the appreciated value of his home. *See supra* notes 238-41 and accompanying text. Whereas this device provides a means of converting the homeowner's home equity, it does so at a high cost to the elderly borrower.

305. *See supra* note 16 and accompanying text.

306. *See supra* notes 130-31 and accompanying text for a discussion of available financing devices.

307. *See infra* notes 308-14 and accompanying text.

308. *See* Friend, *supra* note 254, at 356 (no authority found which suggests that lien of ordinary mortgage does not secure accruing fixed interest and nothing inherent in shared appreciation mortgage should cause it to be treated differently).

percent of the value of the property,<sup>309</sup> very little equity remains to serve as collateral for the secondary lender. Lenders do not grant loans without sufficient collateral.<sup>310</sup> If the borrower is unable to obtain the necessary funds to complete repairs, the property will begin to deteriorate.<sup>311</sup>

The best interests of both the borrower and the lender are served by the completion of needed repairs. A major underwriting consideration for RAM loans is the expected appreciation of the property during the term of the loan.<sup>312</sup> Failure to make a necessary major repair would result in lower appreciation or, possibly, depreciation.<sup>313</sup> Thus, the value of the lender's collateral and of the borrower's asset would be seriously jeopardized.

A fixed rate RAM eliminates this problem. Since the fixed rate RAM does not encumber the appreciated value of the property,<sup>314</sup> equity in the property remains and may be used by the lender as collateral for a second loan. The final result is the protection of the investment of both the borrower and the lender.

## 2. Title Insurance

The standard form of title policy used in loan transactions does not insure the contingent interest<sup>315</sup> secured by a shared appreciation RAM.<sup>316</sup> Thus, the lender is without title insurance on a substantial portion of its expected return.<sup>317</sup> The critical problem presented by this lack of insurance is that the uninsured contingent interest will not have the same priority as the insured principal.<sup>318</sup>

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309. See *supra* note 59 and accompanying text.

310. See MADISON & DWYER, *supra* note 38, § 8.01 (lenders cautious about high loan-to-value ratios).

311. See SENATE COMM. ON AGING HOME EQUITY REPORT, *supra* note 8, at 6.

312. *Id.* at 13.

313. See HOME EQUITY CONVERSION BROCHURE, *supra* note 39, at 4 (under-maintenance is most common form of housing disinvestment by elderly).

314. See *supra* notes 238-41, 307 and accompanying text.

315. See *supra* notes 239-41, 245-48 and accompanying text for a discussion of contingent interest.

316. The American Land Title Association (ALTA) extended coverage lender's policy limits the amount recoverable under the policy to the original principal sum, less any principal repayments. Murray, *Title Insurance and the Equity Kicker*, Nat'l L.J., Nov. 9, 1981, at 21, col. 4 [hereinafter cited as Murray]. Paragraph 8(b) states: "[t]he liability of the company shall not be increased by additional principal indebtedness created subsequent to date of policy, except as to amounts advanced to protect the lien of the insured mortgage and secured thereby." *Id.* at col. 4.

317. *Id.* at col. 4.

318. *Id.* at 21 & 24, cols. 4 & 1. For a discussion of the priority problem, see *supra* notes 270-83 and accompanying text.

Some title companies have attempted to remedy this situation.<sup>319</sup> For example, companies which underwrite title insurance in California developed an endorsement to lenders' title policies which included coverage of the contingent deferred interest on a shared appreciation mortgage.<sup>320</sup> Recently, another title company began issuing a similar endorsement which is not restricted to loans made in California.<sup>321</sup>

This form of endorsement adequately insures the lender's contingent interest;<sup>322</sup> however, there are two major problems when it is applied to a RAM loan.<sup>323</sup> First, a ceiling is placed on the total sum which the title policy will insure. This ceiling is equal to 150% of the original amount insured by the title policy.<sup>324</sup> During times of

319. See *infra* notes 320-21 and accompanying text for a discussion of the solution.

320. BARNETT & MCKENZIE, *supra* note 18, § 7.07[1] & App. A-32, A-33.

321. This endorsement states:

Company hereby insures the insured against loss or damage that may be sustained by the insured by reason of a final decree entered by a court of competent jurisdiction finding that the lien of the mortgage as security for the ("additional interest" or "extra interest") as defined in the mortgage: (a) Is invalid or unenforceable, or (b) Does not, at the Date of Policy, share the same priority in relation to any other claims or liens against the land as is afforded the principal of the loan secured by the mortgage.

Nothing contained in this endorsement shall be construed as insuring against loss or damage sustained or incurred by reason of: (a) Usury, (b) Any consumer credit protection or truth in lending law, or (c) Costs, expenses or attorneys' fees required to obtain a determination, by judicial proceedings or otherwise, of the amount of any additional interest due. Upon representation by the insured that the insured mortgage shown in Schedule A of the policy to which this endorsement is attached secures a loan pursuant to which certain interest will be based upon an increase in the value of the insured premises, the Company agrees that upon request of the insured it will increase the Amount of Insurance, as stated in Schedule A of the Policy, to an amount not exceeding 150 percent of the stated Amount of Insurance. Such request by the insured may be made at any time while this policy continues in force provided that the Company's obligation under this endorsement will terminate 90 days after the insured acquires title in the manner specified in Paragraph 2(a) of the Conditions of Stipulations hereof.

Any such increase in the Amount of Insurance will not be applicable to the amount of liability the Company might have for any claim under the policy which the Insured has filed, or has knowledge of at the time the request for such increase is made.

The premium for such additional Amount of Insurance shall be in an amount determined by the insurer's applicable rate schedule in effect at the date of the request for increase.

Sample title endorsement (available at *Fordham Urban Law Journal* office).

322. See *supra* note 320 for the insurance covered by this endorsement.

323. See *infra* notes 324-26 and accompanying text for a discussion of these problems.

324. See *supra* note 320 and accompanying text ("[t]he Company agrees that

high inflation, this amount could prove inadequate.<sup>325</sup> Second, each time the amount of the title insurance is increased, a fee will be charged to the borrower based on the amount of the increase and the current market rates for title insurance.<sup>326</sup> Thus, the borrower will incur additional unanticipated costs.<sup>327</sup> Such a result contravenes the goals of the RAM.<sup>328</sup>

## V. Conclusion

Elderly homeowners in need of a monthly cash supplement can obtain such income through the RAM without selling their homes. However, the laws regulating SSI and federal income tax must be amended before these individuals can benefit fully from RAM programs. Congress should examine the goals of the RAM and apply long-standing policies to protect RAM payments from unfavorable treatment by the Social Security Act and the Internal Revenue Code.

The New York legislation requires RAMs to be granted at a fixed interest rate thereby excluding the possibility of a shared appreciation RAM. Thus, the New York RAM avoids the problems of: (1) usury violations; (2) loss of priority; (3) clogging the equity of redemption; (4) unavailability of secondary financing; and (5) the unavailability of a title insurance policy which insures the contingent interest. The New York RAM also prevents additional costs for the borrower inherent in the shared appreciation RAM. Therefore, all efforts to amend the New York legislation to permit shared appreciation RAMs should be resisted.

*Dorothy E. Cumby*

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upon request of the insured it will increase the Amount of Insurance . . . to an amount not exceeding 150 percent of the stated Amount of Insurance").

325. See MADISON & DWYER, *supra* note 38, § 3.04[3][c], at S3-6 (Supp. 1984) (citing Strum, *Economics of Variable Rate Mortgages* in FINANCING REAL ESTATE DURING THE INFLATIONARY 80's at 27, 29 (ABA 1981)) (\$80,000 house appreciating to \$125,000 in five years).

326. See *supra* note 321 ([t]he premium for such additional Amount of Insurance shall be in an amount determined by the insurer's applicable rate schedule in effect at the date of the request for increase").

327. See *supra* note 324 and accompanying text for a discussion of these charges.

328. See *supra* notes 1-32 and accompanying text for a discussion of the goals of the RAM.



