12 Real Estate Finance

BACKGROUND

Finance is the lifeblood of the real estate industry. Developers, contractors, real estate brokers (REBs) and mortgage loan brokers (MLBs) must understand how real estate is financed.

Traditional sources of loan funds are the depository institutions: savings and loan associations, savings banks, commercial banks, thrift and loans, and credit unions. Other sources are insurance companies and non-institutional sources such as mortgage bankers, finance lenders, MLBs, private individuals, pension funds, mortgage trusts, investment trusts and securitized pools of mortgage loans.

Recent California legislation has characterized certain non-depository institutions as institutional lenders for defined purposes. These include: mortgage bankers, finance lenders, pension funds in excess of $15,000,000 in assets, mortgage trusts, investment trusts and securitized pools of mortgage loans which have either been qualified or registered for intra- and/or interstate issuance of public offerings, or which have met qualified exemption statutes and rules for issuance as private placements.

The secondary mortgage market (investors purchasing real estate loans originated by other lenders) has surpassed loan sources which dominated real estate lending prior to the 1990s. The significant financial collapse and consolidation of the savings and loan industry has contributed to this change. In the early 1980s, there were approximately 4,022 savings and loans in the United States. As of 1994 approximately 1,535 were left, with only a few being regulated by the State of California.

Before Deregulation

Partially because of the unstable market forces prevailing over the last 25 to 30 years, institutional financial intermediaries/lenders such as savings and loan associations, savings banks, commercial banks, credit unions, and thrift and loans experienced reductions in profitability. Unregulated non-depository institutions (e.g., uninsured money market funds) drew savings deposits away from regulated depository institutions by paying investors higher rates of interest.

During the late 1970’s, many institutional lenders were holding low-interest loan portfolios which steadily declined in value. At the same time, they were unable to make enough higher-interest loans to achieve acceptable profit levels. This happened in part because of the decline in personal savings, appreciating property values, and increasing interest rates. Many potential home buyers could not qualify for higher-rate loans and/or were unable to make required down payments.

Across the country, forced postponements of home ownership occurred except for transactions involving transferable first loans and seller-assisted financing. Subdividers and builders cut production. In late 1980 the prime interest rate reached 21.5%. On September 14, 1981, the interest rate for FHA and VA single-family home loans reached 17.5%. Tight money, stringent credit underwriting, and high interest rates made mortgage money scarce and expensive. Potential private and government sector borrowers were forced to bid for available loan funds.

Deregulation

The foregoing led to a period of deregulation, the process whereby regulatory restraints upon the financial services industry are reduced or removed. Deregulation has extended to California law and leveled the playing field for California licensed and chartered lenders.

Significant deregulation commenced with the Depository Institutions Deregulation and Monetary Control Act of 1980 and continued through the Depository Institutions Act of 1982, also known as the Garn - St. Germain Act.

Re-regulation

Re-regulation occurred as a result of substantial losses in the savings and loan industry. Re-regulation began with the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and continued with a significant number of amendments to both the Real Estate Settlement Procedures Act (RESPA) and the Consumer Credit Act, also known as the Truth in Lending Act (TILA).

FIRREA was designed to “bail out” the savings and loan industry and re-regulate federal financial institutions.

More Deregulation

More recently, Congress has returned to deregulation. An example is the Financial Institutions Regulatory Relief Act (FIRRA), also known as the Paper Reduction Act of 1996. FIRRA has terminated the Savings Association Insurance Fund (SAIF) and transferred insurance of those deposits to the Bankers Insurance Fund (BIF). The BIF operates under the Federal Deposit Insurance Corporation (FDIC).

With deregulation, the differences once separating the products, services, and purposes of savings and loans and commercial banks have been for the most part eliminated. Savings institutions now compete for business and profits with few government restrictions. Some experts in the financial world believe that depository institutions which survive this competition will be larger, more diverse, and more efficient than the lending institutions of the past.

Credit unions have been merging so that some have hundreds of millions of dollars in assets. Currently, approximately 7,244 credit unions control 205 billion in assets, 181 billion in deposits, and 120 billion in loans. (Commercial banks control 4.4 trillion in assets, 3.1 trillion in deposits, and 2.7 trillion in loans.)

California Law

Among recent changes at the California State level has been consolidation of the licensing of finance lenders, effective July 1, 1995, into the California Finance Lenders Law. A single license, the California Finance Lender (CFL) has replaced three licenses: personal property brokers, consumer finance lenders, and commercial finance lenders.

In addition, in 1996, the California Legislature created a new license category for mortgage bankers either originating or servicing loans in this state. The new licensees are known as residential mortgage lenders (RMLs). Several hundred firms are now licensed under this law. CFLs and RMLs are licensed and regulated by the Department of Corporations (DOC).

Some mortgage bankers are still licensed as REBs and continue to operate their non-residential commercial business under the regulation of the Department of Real Estate.

MLBs now deliver to lenders approximately 50% of the real estate loans secured by one to four residential units.

In 1996, the California Legislature passed legislation consolidating regulation of depository institutions into a new Department of Financial Institutions. This department replaces the Department of Banking and the (former) Department of Savings and Loans and will acquire from the Department of Corporations regulatory oversight of both state-chartered thrift and loans and credit unions.

California industrial loan companies, known as state thrift and loans, have also experienced significant restructuring. These institutions were legislatively required to switch from a California-based insurance fund to the FDIC. With this switch has come more regulatory oversight including stricter loan underwriting guidelines. Diminished profits followed the restructuring and the result has been the merger of many of these institutions into larger institutions which are able to function within the current regulatory climate and competitive market of the 1990s.

Redesigned Mortgage Instruments

Unstable economic conditions caused national and California legislators, consumers, lenders, and real estate industry representatives to explore a whole catalog of issues having to do with making alternative mortgage instruments available to home purchasers.

In 1970, legislation was passed and regulations adopted in California authorizing variable-rate mortgages (VRMs). The interest rate of a VRM changes with increases or decreases in a published index.

In 1980, State legislation authorized renegotiable rate mortgages (RRMs) in which the borrower has an option to either prepay or renew the residential loan at three or five year intervals. Generally, renewal of the loan is subject to renegotiation of the interest rate. The lender must offer a fixed-rate mortgage as an option to the RRM.

The California Legislature authorized adjustable rate mortgages (ARMs) in 1981, allowing for the interest rate to adjust periodically, by a set margin, to a certain index. Again, a lender was required to also offer a fixed-rate mortgage when offering an ARM.

Basically, adjustable mortgages result in borrowers contributing extra amounts to lenders' inflow of funds during periods of tight money and high interest rates.

The Fixed-Rate Mortgage

The use of alternative financing instruments, also authorized under preemptive federal law, constituted a major change in the traditional lender-borrower relationship in that the risk of changes in the market rate of interest was shifted from the lender to the borrower. However, marketplace competition, including FHA and VA loans, has resulted in continued availability of fully amortized, long-term, fixed-rate mortgages.

A Forward Look

Deregulation and the proliferation of alternative mortgage plans have been largely responsible for the restructuring of our housing finance system.

As always, the most important issue facing both mortgage lenders and borrowers is the availability and affordability of mortgage funds.

As legislators, lenders, and consumers address complex challenges and opportunities, more changes will occur in the lending process, including electronic loan origination.

The increased involvement of RMLs, CFLs, and MLBs in residential loan origination's is likely to continue. What remains to be seen is how much more consolidation will occur among these licensees, and if not consolidation, how many of these licensees will affiliate horizontally into what are now known as Affiliated Business Arrangements (ABAs).

THE ECONOMY

America's economic system is a regulated capitalistic system. Although individuals, partnerships and corporations own and control property and the means of production of goods and services, the government intervenes and influences general economic trends in an attempt to ensure reasonable competition and a viable, growing, fair and equitable economy.

Role of Real Estate in the National Economy

Real estate plays four major roles in our economy:

Net worth. Land and improvements make up a very large portion of the total net worth of the United States.

Income flow. As we see on the circular flow chart of our economy (next page), money is paid for the use of real estate (rent) and for the raw materials, labor, capital and management used in construction work of all kinds.

Major employer. The real estate industry (brokerage, construction, management, finance, etc.) is a major employer.

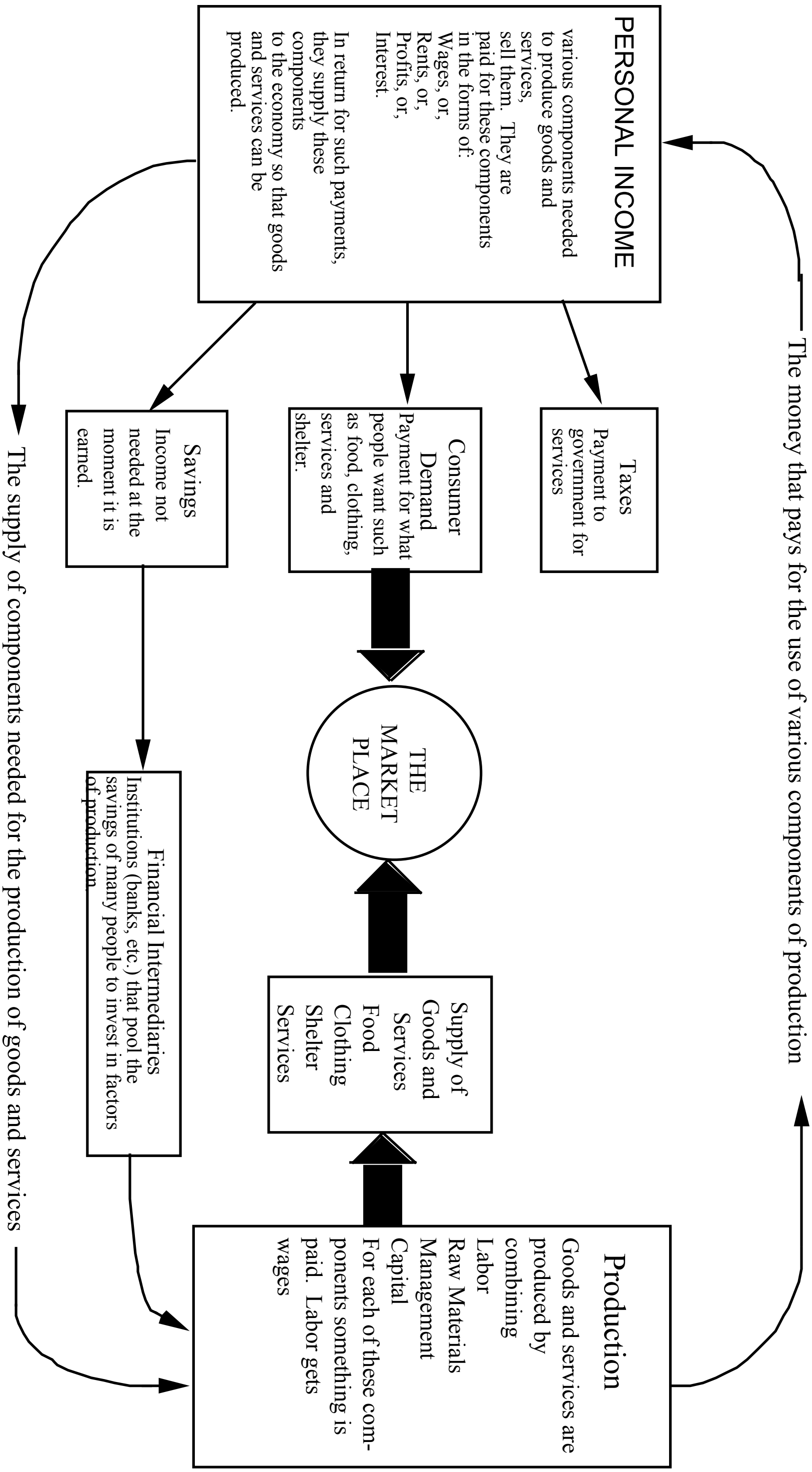
Appreciation and inflation. After having been in decline for much of the 1990s, residential real estate values are stabilizing and in many markets increasing. Income producing properties began to decline following the Tax Reform Act of 1986. Depending upon the area, values fell between 25% and 50% from their peak. Income producing properties are also again increasing in value.

Federal Reserve Bank System. The Federal Reserve Bank System (the Fed) is the nation's central bank. Its chief responsibility is to regulate the flow of money and credit to promote economic growth with stability. The goal is a monetary policy which encourages high employment, stable price levels and a satisfactory international balance of payments. This monetary policy attempts to counteract inflation, recession or any other undesirable shift in the economy.

The Fed's Board of Governors formulates monetary policy and shares responsibility for its application with the 12 Federal Reserve Banks. The governors are appointed by the President of the United States and confirmed by the Senate for 14-year terms, the long terms being intended to insulate the governors from outside pressures. The Chairman and Vice Chairman of the Fed are appointed by the President for four-year terms.

Monitoring the money supply. To avoid the peaks and valleys and "boom or bust" business cycles that spawn liquidity and credit crises, the Fed monitors economic conditions and controls the supply of money and credit. This is a delicate balancing act.

If The Fed makes too little credit available, borrowers may bid against each other for available funds and drive up the cost of borrowing. People then buy and borrow less, investments and sales decline, and a recession may follow. On the other hand, too much available credit translates into over stimulation of the economy and invites inflation.



THE CIRCULAR FLOW OF THE NATIONAL ECONOMY

To accomplish its goals, the Fed uses three basic tools:

- **Reserve requirements.** Member banks must set aside and keep as reserves a certain percentage of each deposit. By raising or lowering this reserve requirement, the Fed increases or decreases the amount of money in circulation. An increase in reserve requirements means banks have less money to lend, interest rates will likely increase, and borrowing and spending will slow. Conversely, a lessening of the reserve requirement increases lending funds and should lead to lower interest rates. Borrowing and spending can then be expected to increase.
- **Discount rates.** The discount rate is the interest rate the Fed charges on money it lends to a member bank. A decrease in the discount rate may encourage bank borrowing, increasing deposits which the bank may loan to businesses and consumers. An increase in the discount rate will have the opposite effect.
- **Open market operations.** The Fed also uses open market operations (buying and selling of government securities) to influence the amount of available credit. When the Fed buys government securities, cash is deposited into sellers' bank accounts, increasing reserves and allowing banks to extend more credit to borrowers. If the Fed sells securities, the opposite effect occurs.

Office of Thrift Supervision (OTS). Created pursuant to the restructuring required by FIRREA, the OTS regulates federally chartered savings and loans.

[FIRREA also reorganized the Federal Deposit Insurance Corporation (FDIC) into four offices and two subagencies. The four offices are the Deposit Insurance Fund (DIF), the OTS, the Resolution Trust Corporation (RTC), and the Resolution Funding Corporation (RFC). Under DIF are two insurance funds: the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). These two funds are to be combined pursuant to the Financial Institutions Regulatory Reform Act of 1996.]

THE MORTGAGE MARKET

Money serves as a medium of exchange. The potential to exchange money for goods and services can be stored. This is called savings. Savings are the primary source of funds for lending.

If the value of money is relatively stable, people are more inclined to save, since their stored capacity to exchange (with interest) is not being eroded by inflation.

Credit

"Credo" is a Latin word which means "I believe." A lender loans money believing that it will be paid back as agreed. Therefore, the lender grants, or extends, "credit."

Supply and Demand

The supply of capital is finite. Real estate borrowers must always compete with government, business, and other consumers for available funds. If mortgage money is in short supply, mortgage interest rates rise. One cause is placement of potential mortgage money in other markets which are paying higher interest rates.

Government Intervention Can Redirect Supply

Between late 1989 and the middle 1990s, a "credit crunch" occurred in a portion of the real estate market primarily because the federal government, through re-regulation and capital reserve requirements imposed under FIRREA, redirected mortgage lending by financial institutions.

The capital reserves then required for residential mortgage loans secured by one-to-four residential units were from 2% to 4%, depending primarily on whether or not the loan was insured or guaranteed by a federal agency. The reserve requirements for income-producing properties jumped to as much as 8%.

Accordingly, lenders rushed to make residential loans and avoided loans secured by commercial, industrial, and residential income properties. The flow of capital to residential mortgages helped cause “refinance mania” during the early and mid-1990s.

The Primary Mortgage Market

The Primary Mortgage Market consists of savings and loan associations, banks, other institutions and mortgage bankers that originate mortgage loans by lending funds directly to borrowers.

Participants in the Primary Mortgage Market replenish their funds by selling loans in the Secondary Mortgage Market.

Federal Housing Administration (FHA). This agency insures loans made by approved lenders. See discussion in Chapter 13.

Veterans Administration. This agency guarantees loans made to veterans for housing, farms or businesses. See discussion in Chapter 13.

Department of Veterans Affairs. This agency assists qualified California veterans with the purchase of housing and farms. See discussion in Chapter 13.

Mortgage bankers. Mortgage bankers are privately owned companies that are often affiliated with banks or savings and loans. Mortgage bankers generally originate conventional (including “subprime”) or FHA/VA loans.

In California, mortgage bankers are typically licensed as either Residential Mortgage Lenders (RMLs) or California Finance Lenders (CFLs). Some remain licensed as real estate brokers (REBs); however, the real estate broker’s license is oriented toward the status of an agent arranging a loan on behalf of another or others, and not the status of a lender making a loan.

Mortgage bankers may continue to service loans they have sold, sell the servicing to purchasers of loans, or sell the servicing separately.

The Secondary Mortgage Market

Participants in the Secondary Mortgage Market buy loans originated in the Primary Mortgage Market and also buy and sell among themselves.

Two types of purchases normally occur in the Secondary Mortgage Market:

- the purchase of individual mortgages; and
- the purchase of (securitized) blocks or pools of loans.

Federal National Mortgage Association (FNMA-Fannie Mae). Fannie Mae provides a secondary market for FHA and VA loans and, since the early 1970s, conventional mortgages originated by approved lenders.

Fannie Mae’s sources of funds are: borrowing; selling long-term notes, mortgage-backed securities (MBS) and debentures in the capital markets; issuing and selling its own common stock; and earnings from its mortgage portfolio, including fees.

Fannie Mae purchases graduated payment mortgages (GPMs), conventional fixed-rate first and qualifying second mortgages secured by one-to-four family homes, and a variety of ARMs. Fannie Mae also has a resale/refinance plan whereby lenders offer borrowers blended below-market interest rates or new loans at competitive interest rates.

FNMA's mortgage-backed securities (MBS) plan involves a lender selling a block or pool of mortgages in exchange for a like amount of securities which represent undivided interests in that pool of loans and may be sold or retained by the lender. FNMA provides 100% guaranty of full and timely payment of interest and principal to the security holder.

While FNMA is the largest investor in the secondary market, it delegates most underwriting and servicing responsibilities to approved sellers/servicers.

FNMA has played a major role in development of standardized loan origination documents, including the 1003 loan application form, promissory notes and deeds of trust and the uniform residential appraisal report.

Fannie Mae has a 15-member board of directors, 10 elected by shareholders and 5 appointed by the President of the United States.

Government National Mortgage Association (GNMA-Ginnie Mae). Ginnie Mae is a government corporation which administers mortgage support programs which could not be carried out in the private market place. Ginnie Mae increases liquidity in the secondary mortgage market and attracts new sources of funds for residential loans. Ginnie Mae does not purchase mortgages. Rather, it adds its guarantee to mortgage-backed securities issued by approved lenders. GNMA's three major activities are:

- Mortgage-Backed Securities (MBS) Program;
- Special Assistance Functions; and
- Management and Liquidation Functions.

Through the MBS Program, GNMA guarantees securities issued by financial intermediaries and backed by pools of mortgages. Mortgage bankers, savings institutions, commercial banks and other approved types of financial intermediaries are all issuers of securities. Security holders receive a pass through of principal and interest payments on the pool of mortgages, less amounts to cover servicing costs and certain GNMA fees. Ginnie Mae guarantees that the securities holders will receive payments of principal and interest as scheduled, as well as unscheduled recoveries of principal. Because of the Federal guaranty (pledge of full faith and credit of the U.S. Government), GNMA mortgage-backed securities are considered by many to be as safe, as liquid, and as easy to hold as Treasury securities.

The MBS programs of FNMA and GNMA have benefited all regions of the country by increasing the flow of funds from the securities market to the residential mortgage market and from capital-surplus to capital-short geographical areas.

Under the Special Assistance Functions, GNMA purchases certain types of mortgages to provide support for low-income housing and to counter declines in mortgage lending and housing construction.

Under the Management and Liquidation Functions, GNMA manages and liquidates (sells) portfolios of federally-owned mortgages.

The President of the United States appoints the President of GNMA, who acts under the direction of the Secretary of the Department of Housing and Urban Development (HUD).

Federal Home Loan Mortgage Corporation (FHLMC - Freddie Mac - or, The Mortgage Corporation). FHLMC increases the availability of mortgage credit for the financing of urgently needed housing by developing, expanding and maintaining a nationwide secondary market primarily for conventional loans originated by savings and loans, thrift institutions, commercial banks, mortgage bankers and other HUD-approved mortgagees.

Freddie Mac finances most of its mortgage purchases through the sale of mortgage Participation Certificates (PCs).

Through its Standard Programs, Freddie Mac buys:

- whole loans and participation interests in conventional l-to-4 family loans with both fixed and adjustable rates;
- home improvement loans; and
- multifamily whole loans and participation interests.

The mortgages purchased in the Standard Programs are generally less than one year old. FHLMC underwrites the loans delivered under its purchase commitments, and typically rejects only a small percentage of the loans submitted. Mortgages with loan-to-value ratios above 80 percent generally must carry private mortgage insurance.

Freddie Mac's Guarantor or "Swap" Program gives primary mortgage lenders an added source of liquidity during periods when the yield on mortgage portfolios of predominantly older loans is lower than the cost of funds for many lenders. Lenders may thus convert a low yield portfolio into highly liquid securities which can be sold or used as collateral for borrowing.

FHLMC is an independent stock company and functions in direct competition with FNMA.

Freddie Mac has an 18-member board of directors, 13 of whom are elected by FHLMC's stockholders; 5 are appointed by the President of the United States.

The "Subprime" Secondary Market

Securitization of mortgages into pools underwritten by Wall Street investment bankers has accelerated in recent years. These securitized pools are made up of mortgages known in the industry as "subprime." "Subprime" loans are those that will not qualify for sale to FNMA or FHLMC and cannot be securitized into a pool guaranteed by GNMA. Much of the growth is in low down payment mortgages made to home buyers who have poor credit. Conventional lenders, who traditionally ignored these borrowers, are now participating in the "subprime" residential mortgage market and benefiting from the higher interest rates involved.

Private Mortgage Insurance

Private Mortgage Insurance Companies (MICs) provide mortgage insurance for conventional loans, making these loans perhaps more attractive in the Secondary Mortgage Market. Private mortgage insurance enables borrowers to obtain loans with higher loan-to-value ratios and purchase better homes with smaller down payments. Mortgage insurance reduces the risk to the lender and to the investor.

MICs have underwriting standards which conventional lenders must meet so that investors will purchase the loans. A MIC may buy the insured loans and issue securities in the name of the MIC or a subsidiary.

MICs may also provide servicing of loans sold in the secondary market.

California and the Mortgage Market

The following characteristics make California attractive to suppliers of mortgage money from all over the world:

1. High demand for mortgage money.
2. A large, and usually growing, population.
3. Wide diversification of industry.
4. Generally high employment and prosperity.
5. Large financial depository institutions.
6. Presence of experienced and highly efficient mortgage loan correspondents (mortgage bankers).
7. Common usage of title insurance and escrow rather than settlement.
8. Predominant use of trust deeds with power of sale rather than mortgages as a legal basis to secure real estate loans.
9. The existence of financial institutions and sophisticated licensed lenders which will package mortgages together for sale with a guaranteed rate of return and no servicing problems to the institutional investor or government enterprise.

OVERVIEW OF THE LOAN PROCESS

There are four steps to obtaining a real estate loan:

- application
- analysis
- processing
- closing

The application. Historically, application forms varied from lender to lender. Now, however, a “standard” form for residential mortgage loan applications is commonly used: the FHLMC/FNMA 1003. Even FHA and VA use this form.

A loan application package consists of:

- the loan request;
- borrower information;
- property or collateral information;
- credit analysis;
- lender’s action (approval or disapproval); and
- processing check list.

The loan request. This is a written request by the prospective borrower giving the borrower's name, setting forth the amount and terms of the requested loan, the purpose of the loan, and how and when it will be repaid.

The federal Equal Credit Opportunity Act prohibits discrimination based on age, sex, race, marital status, color, religion or national origin. Senior citizens, young adults and single persons must be considered in light of income adequacy, satisfactory net worth, job stability and satisfactory credit rating, and credit guidelines are to be applied to each potential borrower in the same manner.

Borrower information. The following information helps the lender gauge the borrower's ability and willingness to repay the loan:

1. Purpose of the loan (home purchase, investment, refinance).
2. Type and duration of employment. If under 2 years, or type of employment appears unstable, further investigation is usually needed.
3. Other income: e.g., rents, annuities, royalties, etc.? How much? (Other sources of income are often not fully counted because they are usually less stable than full-time jobs.) Does spouse work? There can be no discrimination against income of spouse.
4. How many dependents must be supported by the borrower and for how long? Children help stabilize a borrower in one way but also add considerably to financial obligations.
5. What are the borrower's living expenses? How much of gross income is available for loan payments, taxes and insurance? How much are borrower's other installment payments and liabilities?
6. What happens to the loan in the event the borrower becomes disabled or dies? Is there sufficient insurance?
7. What previous experience has the lender had with borrower?
8. What is applicant's debt repayment record? What kind of credit and other references does the borrower have? Many lenders rely heavily on the findings of credit reporting services. Telephone check-ups made by the lender to other creditors of the prospective borrower can be revealing.
9. Type, location, value, encumbrances and repayment schedules for other real property applicant owns.

10 Borrower's other assets: bank and savings accounts, personal property, etc.

Property information. The property may have to function for quite some time as security for the loan. For this reason the lender is very much interested in the trend of the collateral's value and not just its status today.

This section will elicit the following information:

1. Specific identification of the property, including legal description and street address.
2. Title information: vesting, claims, encumbrances, liens, mortgages, etc.
3. Description of land and type of improvements, including work done within the last 90 days that might be subject to Mechanics' Liens.

4. Original price and terms; date purchased; taxes; zoning; assessments. If income property, operating income and expenses for several years and amount of income which will be available to support loan repayment.

5. Present value, trends, etc. (The appraisal is usually made after interview with borrower.)

Credit analysis. The lender will gauge the ability and willingness of the borrower to repay the loan based on:

- information contained in the application and supporting documents;
- information developed by the lender in checking the credit and character of the prospective borrower;
- verification of employment, bank deposits, etc.; and
- a personal interview.

Lender's action. Typically, approval or disapproval of the loan.

Processing check list. After loan approval, the lender will use a check list of steps and documentation necessary to close the loan.

DETAILS OF THE LOAN PROCESS

Processing the application. The prospective borrower should complete the application accurately and entirely to avoid needless delays and facilitate processing and closing.

With the completed application, the lender begins to process the loan.

Interview. Some lenders and government agencies deem necessary an initial interview with the prospective borrower. Some lenders interview the borrower by telephone or electronically. Telephonic and electronic interviews are particularly useful with borrowers who qualify for the "prime" or "A" residential mortgage market. Borrowers who are able to qualify only for the "subprime" or "A through C" or "B & C" mortgage market often require a face-to-face interview. Personal interviews with the borrower are important for the following reasons:

- Ensure accuracy of the application and enable the loan officer to make a personal assessment of the borrower and bring into play long experience as a judge of people.
- Help the loan officer evaluate the loan proposal and make certain the applicant understands the terms of the loan as proposed. Is it a sound loan for the borrower to carry? If it is not sound for the borrower it is not sound for the lender.
- Learn more about the property that will secure the loan. This information may be helpful to the appraiser in the appraisal function.
- Discuss loan costs. Often a prospective borrower is unaware of the various costs (notary, recording and legal fees, title, credit and appraisal reports, insurance) involved in obtaining a loan. (Under the Real Estate Settlement Procedures Act (RESPA), which is applicable to most federally-related mortgage loans to be secured by 1-to-4 residential units, good faith loan cost estimates and a special information booklet must be furnished the applicant within 3 business days of the loan application. Some lenders and brokers prefer to deliver the disclosures and booklet at the time of the loan application.)

Appraisal report. A staff or independent appraiser evaluates the property and estimates present market value and the value trend. The relationship between the amount of the proposed loan and the estimate of fair market value of the property is the "loan-to-value" ratio. Most lenders base their loans on price or value, whichever is lower.

Credit analysis. A lender will use a standard of ability to repay. Some lenders require that the applicant's fixed monthly expenses not exceed 30-35 percent of net monthly income. Other lenders use a ratio (e.g., 4 to 1) of the borrower's gross income to the proposed monthly loan payment.

An FHA lender will require gross monthly income, less long-term monthly debt payments, of 3-1/2 to 4 times the monthly mortgage payment (including impounds).

Lenders in the "prime" mortgage market generally prefer that not more than 25% to 28% of an applicant's gross income be spent for housing.

For income property, an insurance company may require that 50 percent of the gross income of the property be sufficient to pay the mortgage payments and real estate taxes.

Some institutions use Gross Annual Income Multipliers: i.e., the price of a property should not exceed 2-1/2 (or 3 or 4) times the borrower's annual gross income from salary. Again, such a ratio would be used in the "prime" mortgage market.

The issue of *willingness* to pay is also crucial to credit analysis. The lender will check the prospective borrower's department store charge accounts, oil company charge accounts, and other suppliers of credit to determine if the borrower pays bills on time.

Automated underwriting, where credit is granted almost as soon as the application is received, requires instant credit analysis. To this end, lenders use computer-generated credit scores as mathematical representations of an applicant's credit standing.

Numerous credit reporting agencies exist. However, these agencies or bureaus obtain their information from three sources: TRW, Trans Union, and Equifax. Each source has its own name for the credit scores it issues. Equifax calls its score a Beacon and Trans Union calls it an Empirica Score. TRW uses the name FICO Score. (FICO is an acronym for Fair, Isaac and Company.)

Loan committee. Some lenders operate with a Loan Committee of experienced senior officers who consider loan applications recommended to them by loan officers who have screened the applications with borrower interviews, appraisal reports, and credit analyses.

If the committee approves a loan application, the file then goes to the Loan Funding Department.

Closing the loan. The mechanics of closing will vary. For the sale of a residence, an escrow holder is usually handling a sale transaction between seller and buyer and a loan transaction between lender and buyer/borrower. During escrow, the escrow holder will typically furnish the lender with a certified copy of the signed sale escrow instructions, together with any amendments thereto, and other documents the lender requires. These may include:

1. Preliminary Report showing condition of the title, claims against the title, conditions, covenants, restrictions, encumbrances, etc.

2. Appraisal report estimating the market value of the property for loan underwriting purposes.
3. Survey, if applicable, showing the exact location of the property.
4. Soils report, If obtained, showing the condition of the soil and sub-soil, topography, flood and slide hazards, etc.
5. Payoff Demand showing the exact amount due if an existing loan is to be paid off. If an existing loan is to remain, a Beneficiary Statement is needed to verify existing loan terms, etc.
6. Tax report showing the exact amount of taxes due as of escrow closing date, to determine proration.
7. Insurance report for proration and insurance coverage purposes, including proper endorsements.
8. For income property, a statement showing rent paid in advance, security deposit, etc.; again, for proration purposes.
9. Contractors report and contract for new construction, showing cost breakdown, building plans and specifications, etc.
10. Geologic Hazard Report showing any known geologic or seismic hazards which affect the property.
11. Structural pest control, roofing, electrical, foundation, or generalist reports describing the condition of the property improvements.
12. Loan documents and disclosures and notices of rights, including the note and deed of trust, any riders or addenda thereto, any separate agreements between the lender and the borrower, lender's escrow instructions, disclosures and notices of rights required to be made or given by lenders or brokers.

The escrow holder then awaits confirmation that the lender is ready to fund the loan.

Recordation. When all instructions have been complied with, the lender places the loan funds in escrow. The escrow holder disburses funds as required and records the appropriate documents in the county recorder's office.

FEDERAL AND STATE DISCLOSURE AND NOTICE OF RIGHTS

Various federal and state disclosure laws and regulations apply to lenders who make, and brokers who arrange, real estate loans, especially when the securing property is 1 to 4 residential units.

Most notable of these laws and regulations are:

- the federal Consumer Credit Act also known as the Truth In Lending Act (TILA), implemented by Regulation Z;
- the Federal Real Estate Settlement Procedures Act (RESPA), implemented by Regulation X; and
- the state mortgage disclosure law known as Article 7 of the Business Professions Code, implemented by Title 10, Chapter 6, Section 2840, et seq. of California Code of Regulations.

Chapter 15 includes discussions of TILA and Article 7.

Real Estate Settlement Procedures Act (RESPA) Regulation X

RESPA, enforced by HUD, requires that borrowers, buyers and sellers receive closing cost information (estimates of fees, costs and commissions) for federally related loans used to purchase or refinance real property improved with one to four residential units, provided the property includes the principal residence of the buyer/borrower. An exemption exists for a loan secured by residential property of twenty-five or more acres.

A residential loan is “federally related” if made by a federal depository institution, a HUD-approved mortgagee, or a person who annually makes a million dollars or more in mortgage loans secured by real property improved with one to four residential units.

RESPA requires that a Good Faith Estimate (GFE) of loan costs, etc. be given to the borrower at the time of loan application or within three business days of the originating broker’s or lender’s receipt of the application. RESPA also requires the HUD-1 or HUD-1a closing statement be made available to the borrower at least one day before closing. RESPA imposes limitations on the payment of unauthorized referral fees (kickbacks) and regulates how affiliated entities may refer business/transactions to each other when those activities are subject to RESPA.

Computerized Loan Origination (CLO). Prior to June 7, 1996, real estate brokers benefited from an exemption permitting them to charge fees for limited borrower services: pre-qualifying, counseling, and matching available loan products to borrower qualifications and needs. The CLO had to meet certain federal standards and be accompanied by delivery of an advance notice describing the intended services and fees. If the standards were met, the broker was able to charge a negotiated fee, without direct regard to its relationship to the services provided. If the standards were not met, the fees charged by the broker were required to be reasonably related to the services provided. (Because of the fiduciary duty owed by a real estate broker to the borrower, this distinction was irrelevant under California law.)

HUD has withdrawn from CLOs both the required notice and the qualified exemption for payment of compensation to brokers. This change will likely eliminate the use of limited service CLOs.

Affiliated Business Arrangements. Affiliated Business Arrangements (ABAs or AFBAs), formerly called Controlled Business Arrangements, occur when affiliated service providers refer borrowers to each other in transactions subject to RESPA. ABAs include entities with a defined percentage of common ownership. This common ownership may be held by shareholders or by an entity common to both (e.g., a holding company). This may also apply to associated relationships where one entity exercises control over, or shares control with, the other (i.e., by joint venture, partnership or, in certain fact situations, a common business plan). If one service provider benefits financially by referring borrowers to another service provider, the cautious approach is to assume that the referral is subject to ABA disclosures.

Unless the affiliated entities or associated relationships are structured pursuant to an acceptable division of labor or services agreement, the ABA must function through a separate entity which may not be a division of either of the affiliated parties. HUD has required adequately capitalized separate entities to be either corporations or partnerships. The preferred option is that of a corporation. The separate entity must accept its own business risk, be licensed if required, and have, among other attributes, its own facilities and employees.

A component of an ABA, whether a separate entity or structured pursuant to an acceptable division of labor agreement, may be paid for performing compensable loan services when engaged in loan originations. HUD has made it clear that *sham* entities will not be recognized. They will be treated as a *ploy* for avoiding the unauthorized payment of referral fees.

When a face-to-face interview occurs with the borrower or when written or electronic referral is made to the borrower, the ABA disclosure must be delivered to the borrower at or before the time of the referral and the lender must keep a record of the delivery. After a face-to-face interview, the lender must attempt to obtain a written receipt from the borrower for the ABA disclosure. If the borrower refuses to sign the receipt, the lender must note the refusal in the business records.

If an ABA referral is made telephonically, the substance of the ABA disclosure must be given during the conversation, together with an explanation that a written disclosure will follow within three business days of the conversation. A record of the telephone discussion and mailing of the ABA disclosure must be included in the lender's records. Finally, if a referral is made by a lender to an affiliated lender, the ABA disclosure may be delivered to the borrower no later than the settlement booklet is delivered. Again, the lender should retain a record of this delivery.

HUD authority for cooperative agreements. In February 1995, HUD responded by letter to an inquiry from the Independent Banker's Association of American (IBAA) regarding agreements dividing loan origination services/compensation between IBAA members and other service providers. HUD provided an opinion letter which allowed division of labor or service agreements between service providers in certain fact situations. Before this letter, HUD generally refused to recognize any cooperative loan brokerage agreements in loan transactions subject to RESPA. Brokers may now share the performance of compensable services when originating RESPA loans.

A written agreement is necessary between brokers, describing the services each will perform. Each broker must perform at least six identifiable functions (or 5 plus the loan application for the broker representing the borrower). The division of compensation among cooperating brokers must be reasonably related to the services each performs. Likewise, agreements between brokers and lenders to share origination functions must be based upon performance by the brokers of compensable services for fees which are reasonably related to the services provided. Such agreements will not work between real estate and mortgage brokers, or between real estate brokers and lenders, if the loan transactions are FHA insured.

Bona fide HUD employee exemptions. In 1997 HUD modified the limitations imposed on payment of referral fees or fee-splitting in RESPA loan transactions. The modifications apply to payments which are made by employers to bona fide employees, (recipients of W-2 tax forms). The employer/employee relationship must be neither a *sham* nor established on a temporary basis to *circumvent* the intent of the regulation. HUD has outlined the following general exemptions for payments made by employers to bona fide employees:

- Payments for generating business for the employer, or for providing services in the loan origination process.
- Payments to marketing employees and managerial employees (employees not providing services) for referrals to the employer or another provider within an ABA. (The latter must include an ABA notice.)
- Payments to managerial employees based upon criteria relating to performance, as long as the payments are not on a per loan basis.

Independent contractor limitations. Independent contractor relationships are not subject to the same exemptions. Accordingly, loan representatives who are independent contractors of a mortgage firm must perform compensable loan services to be compensated in RESPA loan transactions. The compensation paid to independent contractors must be reasonably related to the services they provide and should be evidenced by a division of labor agreement between the mortgage firm and its independent contractors.

Loan Servicing

Whether the loan servicing function is an independent operation or part of the lender’s overall organization, the service operation must strive to assure the lender the expected yield on the investment, protect the investment from loss, and provide good and prompt service.

A servicing operation should have a written agreement with its principal, including the servicer’s responsibilities and compensation. This is true even if the servicing operation is part of the lender’s organization. The agreement may discuss collections, forwarding of payments, late charges, defaults, foreclosures, insurance, etc. In certain situations, including servicing under a real estate broker’s license, a written agreement is required by law.

Monthly collections. A major problem in loan servicing is the flood of payments arriving during the first ten days of each month. Two possible solutions are:

- computerized processing of loan payments;
- staggering loan payment schedules so that some payments are due on the first or 10th of the month, while others are due on the 15th or 20th, etc.

Delinquencies. Loan servicing software is available to quickly identify loan delinquencies and establish the length of delay in the receipt of payment. These software applications are capable of identifying and delivering various notices to borrowers including pre-notice of default, notice of default and notice of trustee’s sale.

Statute of limitations. A borrower has three years from the date of occurrence to bring an action against a lender for failure to timely disclose transfer of loan servicing and other loan servicing issues. The limit is one year from the date of occurrence for a lender's unauthorized payment of referral fees (kickbacks) or the forced use of a title insurance company.

PROMISSORY NOTES

The Obligation (Debt) and the Security

Real property loans are customarily evidenced by the borrower's signing the loan obligation (the promissory note or promise to pay) and the security instrument (the trust deed or mortgage).

The promissory note is the prime instrument and if there are conflicts in the provisions of the note and trust deed, generally the terms of the note are controlling.

Negotiable Instruments

A negotiable instrument is a written unconditional promise or order to pay a certain amount of money at a definite time or on demand. The promissory note exemplifies the instrument involving a promise and the draft and bank check are examples of instruments involving orders. Bank checks are the most common variety of negotiable instruments. Drafts (also known as bills of exchange and trade acceptances) are similar "three-party paper," except that they do not necessarily involve a bank.

Promissory notes constitute "two-party paper." The maker promises to pay the payee a specified amount of money. There are five basic kinds of notes in general use with the mortgage and trust deed:

1. A straight note calling for payment of interest only during the term of the note, with the principal sum becoming due and payable on a certain date.
2. An installment note calling for periodic payments on the principal, the payments being separate from the interest payments.
3. An installment note demanding periodic payments of fixed amounts, including both interest and principal. These are referred to as amortized payments.
4. An adjustable rate note with an interest rate that varies depending upon changes in an agreed upon index.
5. A demand note which does not become due until the holder makes demand for its payment.

Negotiable instruments are freely transferable in commerce. They are typically accepted as virtual equivalents of cash, yet the hazards of handling large sums of cash are avoided. However to be regarded as a negotiable instrument the document must conform strictly to the statutory definition. Thus a negotiable promissory note must be:

1. signed by the maker or drawer;
2. an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given the maker or drawer;
3. payable on demand or at a definite time; and
4. payable to order or bearer.

Every one of the listed elements must be present if the instrument is to qualify as a negotiable instrument. If any one is missing the document may still be valuable and transferable like an ordinary contract. As such the transferee or assignee receives no more benefits than the transferor had. Defenses which were good against the assignor are good against the assignee.

It is possible in the case of negotiable instruments that the transferee may receive more benefits than the transferor had. If the holder of the instrument transfers it to a third party who is a bona fide purchaser for value, that third party enjoys a favored position provided the third party takes the note as a *holder in due course* (without notice of defect or dishonor and absent a continual business relationship with the transferor). This holder in due course status facilitates trade and commerce because persons are more willing to accept such instruments without careful investigation of the maker's credit or of the circumstances surrounding creation of the instrument.

Holder in due course status is limited if the loan transaction is subject to the federal Truth In Lending Act (TILA). Transferees of such loans are liable to the maker if:

- Violation of the Truth-in-Lending Act is apparent on the face of the disclosure statement or the loan document (e.g., Reg. Z final disclosure shows the amount of the broker's commission to be $2,000.00 and the HUD-1 lists the commission as $5,000.00); or
- The assignment was voluntary, as opposed to involuntary (e.g. private investor dies and the estate inherits the loan or a court orders the loan assigned pursuant to a writ of execution).

Finally, loans which are subject to section 32 of Regulation Z of TILA are subject to a broader assignee liability standard: i.e., assignees of high cost and high fee loans do not benefit from standing as a *good faith purchaser* or a *holder in due course*.

Holder in Due Course Defined

A holder in due course is one who has taken a negotiable instrument (a) for value, and (b) in good faith, and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person. A holder in due course may be a person who has taken the instrument through a prior holder in due course, or, for that matter, through a person who was not a holder in due course.

Notice may be obtained in many ways, including defects on the face of the instrument and actual knowledge of dishonor or of a defense, but mere recording of an instrument does not give notice to prevent the holder from being in due course. (Commercial Code Section 3302)

FTC "Holder in Due Course Rule"

State law governing the rights of a holder in due course has been limited by the so-called "holder in due course rule" of the Federal Trade Commission (16 Code of Federal Regulations, Part 433, Preservation of Consumer's Claims and Defenses, 1977). Under this rule, any holder of a consumer credit contract is subject to all claims and defenses which the consumer could assert against the seller of goods or services obtained under the consumer credit contract or obtained with proceeds from the consumer credit contract. This rule has limited application in the field of promissory notes secured by liens on real property. It appears to be applicable only in the context of a home improvement contract secured by a deed of trust on the home. A typical example would be a siding contract. The normal promissory note secured by deed of trust used to finance the purchase or construction of improvements on residential or other real property is apparently not subject to the FTC holder in due course rule.

Negotiation

Negotiation is the transfer of an instrument in such form that the transferee becomes a holder. If the instrument is payable to order it is negotiated by delivery with any necessary endorsement; if payable to bearer it is negotiated by delivery. An exception to the requirement of delivery of the instrument is set forth in Section 10233.2 of the Business and Professions Code. Under this section, a real estate broker acting as a servicing agent of the note holder may perfect delivery by retaining possession of the promissory note or collateral instruments and documents, provided the deed of trust or assignment of the deed of trust or collateral documents in favor of the note holder is recorded in the office of the county recorder of the county in which the security property is located and the note is made payable to the note holder who is the lender or the assignee or endorsee.

An endorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto as to become a part thereof. An endorsement on a paper so affixed shall be valid and effective even though there is sufficient space on the instrument to write the endorsement.

An endorsement is effective for negotiation only when it conveys the entire instrument or any unpaid residue. If it purports to do less, it operates only as a partial assignment.

There are various types of endorsements, including:

1. Blank: the holder simply signs his or her name on the back of the note.

2. Special: the holder writes "Pay to the order of (named transferee)" and then signs.

3. Restrictive: the holder restricts future negotiation, as by writing "Pay to the order of ____________________ State Bank, for deposit only" and then signs.

4. Qualified: the holder adds the words "Without Recourse" to what would otherwise be a simple blank or special endorsement. This means that if the maker refuses to pay, the endorser will not be liable for the amount. Actually, such qualified endorsement does not eliminate the endorser's contingent liability on certain warranties implied by law. That is, by negotiating a note by simple delivery, or by endorsing the instrument, such individual still warrants that (a) the instrument is genuine and what it purports to be; (b) the transferor has good title to the instrument; (c) all prior parties had capacity to contract; and (d) The transferor does not know any fact that would impair the validity of the instrument or render it valueless.

It should be noted that when negotiation is by delivery only, the above warranties extend only in favor of the immediate transferee. Negotiability of a note is not affected by inclusion of a clause adding court costs and reasonable attorney's fees in the event litigation becomes necessary to collect; nor by inclusion of an acceleration clause which provides that default in one of a series of payments makes the entire principal amount immediately due. These and similar provisions actually make the note more acceptable to lenders.

Conflict in Terms of Note and Mortgage or Deed of Trust

The lien of a mortgage is a mere incident of the debt or obligation. Where there is a conflict in the note and mortgage provisions the provisions of the note will generally control. A mortgage or deed of trust gives no additional validity to an unenforceable note. The two instruments are to be construed together, and if a mortgage or deed of trust contains an acceleration clause, exercising it will cause the note to become due even though the note contains no such clause. However, since July 1, 1972, in every new mortgage or deed of trust on property containing four or fewer residential units, any provision accelerating the debt must be uniformly set forth in both note and mortgage to be valid.

TRUST DEEDS AND MORTGAGES

Security Interests

"Security interest" is a term designating the interest of the creditor in the property of the debtor. Certain assets of the borrower are set aside so that the creditor can reach or sell them if the debtor defaults on his or her obligation. The document that describes the rights and duties of the lender and the borrower is called a security instrument. Mortgages and deeds of trust are security instruments.

In General

The deed of trust is the security instrument most frequently used in California real estate transactions.

Early distinctions between the legal and economic effects of the mortgage and deed of trust have diminished considerably. Now both security instruments are basically subject to the same antideficiency limitations and reinstatement and redemption privileges before a foreclosure sale, and are also subject to the same judicial or nonjudicial procedures and restrictions. The same rules are generally applicable to both instruments, except when applying post foreclosure sale possession and redemption.

For a lender, the principal remaining advantage of the trust deed over the mortgage is that the trust deed's power of sale (nonjudicial action) is typically not outlawed by time (although subject to periodic renewal), while a mortgage remains subject to the statute of limitations (four years). For the borrower, the principal advantage of the mortgage over the trust deed may be the right of redemption and possession following a judicial foreclosure.

Unless indicated otherwise, references to "mortgage," "mortgagor," or "mortgagee" in this discussion include "trust deed," "trustor," or "beneficiary," and vice versa.

Home Mortgage Loan

A home mortgage loan is a debt, for any purpose, incurred by a private borrower, which is secured by a mortgage or other lien on the borrower's title to residential real property. If the borrower fails to pay, the creditor can look to the property, or its proceeds of sale, for payment (by judicial foreclosure or trustee's sale if the mortgage has a power of sale). A first mortgage is one that has priority over any other mortgage or lien on the property. A foreclosure by the holder of a first mortgage will wipe out all subordinate liens on the property. Junior lien holders in such circumstances are "sold out" juniors.

Differences Between Mortgages and Deeds of Trust

Mortgages and deeds of trust differ in several respects:

- Parties
- Title
- Statute of Limitations
- Remedy
- Reinstatement
- Redemption
- Deficiency Judgment
- Satisfaction

As to the parties. In a mortgage there are typically two parties: a mortgagor and a mortgagee. The mortgagor (borrower) gives the mortgagee (lender) a lien upon the mortgagor's property as security for the loan advanced by the mortgagee.

In a deed of trust there are three parties: the trustor (borrower), the trustee (third party), and the beneficiary (lender). The trustor conveys title to the trustee to hold until the trustor performs or defaults under the terms of the note. The trustee's function is to reconvey the property to the trustor when the loan is paid in full or, upon default by the trustor, to foreclose upon the property at the request of the beneficiary.

As to title. A mortgage does not convey title; it creates a lien. In a deed of trust, technical legal title for a limited purpose is conveyed to a trustee. In both cases, possession and equitable title remain with the borrower.

As to the statute of limitations. In the case of a mortgage, an action to foreclose is barred when the statute of limitations of four years has run on the note.

In a deed of trust, the rights of the creditor against the property are not ended when the statute has run on the note, for the trustee has title and can still sell to pay off the debt.

As to remedy. In a mortgage, the only remedy of the mortgagee is foreclosure, unless the mortgage contains a power of sale, in which event such power may be exercised. In a deed of trust, alternative remedies of trustee's sale or judicial foreclosure are permitted.

As to reinstatement. Under a mortgage, the mortgagor and certain other persons listed in Civil Code Section 2924c may reinstate the loan by curing the default at any time before the judicial decree of foreclosure by paying all delinquencies, including advances made by the mortgagee to a senior lienor (lenders), plus all costs and fees incurred because of the foreclosure action. Persons permitted by statute to cure a default are the mortgagor or his successor in interest, any mortgagee or beneficiary under a junior mortgage or trust deed, or any other person having a subordinate lien or encumbrance of record.

Reinstatement under a trust deed (or mortgage under a power of sale) is the same, except reinstatement must be made prior to five business days preceding the date of the trustee's sale or the date of any postponed sale if the power of sale is exercised.

Under either security instrument, the lender's right to accelerate payment of the debt on default is limited by the statutory right of reinstatement.

As to redemption. Code of Civil Procedure Section 729.020 provides that property sold subject to the right of redemption may be redeemed only by the judgment debtor or his successor in interest. Junior lienors are no longer entitled to redeem and have their liens reattach, but must sue as an unsecured creditor.

The redemption period is three months after the sale date if the sale proceeds are sufficient to pay the secured indebtedness plus interest and costs of foreclosure. The redemption period is one year after the sale date if the sale proceeds do not satisfy the amount of the debt plus interest and costs. However, if the mortgagee waives or is prohibited from obtaining a deficiency judgment, there is no longer any right of redemption according to Code of Civil Procedure Section 726 (the one action rule).

Under a trust deed or a mortgage with power of sale, the debtor in most cases has a statutory right of reinstatement after default up to five business days prior to the date of the trustee's sale or the date of any postponed sale and the right of redemption thereafter to the conclusion of the trustee's sale. No right of redemption applies following the trustee's sale. The sale is absolute.

As to deficiency judgment. A deficiency judgment is a personal judgment against a debtor for the difference between the unpaid balance of the secured debt (plus interest and costs and fees of sale) and the amount of the actual proceeds of the sale. California law places restrictions on deficiency judgments.

Where a mortgagee or beneficiary elects to foreclose the security by power of sale rather than by judicial foreclosure, a deficiency judgment is automatically barred under Code of Civil Procedure Section 580d. Section 726 of the same code sets certain limits for a deficiency judgment; and Section 580b of that code prohibits deficiency judgments when specified purchase money secured loans are involved.

A purchase money obligation may arise by:

- a seller extending credit to a purchaser and taking back from the purchaser a note secured by a trust deed on the property regardless of the nature of the security property; or
- a third party lender advancing cash to the purchaser to pay all or part of the purchase price of the security property which is the intended residence of the borrower and which consists of 1 to 4 residential units.

Usually, a seller extending purchase money credit cannot obtain a deficiency judgment if the buyer defaults and a foreclosure sale fails to bring sufficient proceeds to pay off the seller's note. An exception to this rule exists in the sale of a property to a developer for commercial development and the seller subordinates his purchase money lien to the lien of the purchaser/developer's construction loan. Thereafter, upon default of the purchaser/developer, the vendor loses his security interest after sale or foreclosure under the senior lien. Code of Civil Procedure Section 580b will not be applied to bar recovery by the junior vendor/lienor of the unpaid balance of the purchase price of the property.

A person lending cash may obtain a deficiency judgment unless the loan was to pay all or part of the purchase price of a residential dwelling consisting of 1 to 4 units to be occupied entirely or in part by the purchaser.

Where a deficiency judgment is permitted, the beneficiary must first look to the security to satisfy the debt through a judicial foreclosure before seeking a deficiency judgment, except a "sold-out junior" (lien holder) may sue directly on the note.

It should be noted that a purchase money mortgage or trust deed given for all or part of the purchase price of real property at the time of its conveyance has priority over all other private liens created by or against the purchaser's security, subject to the operation of the recording laws. This rule protects even third persons who furnished money, but only when it is loaned for the express purpose of paying for the property. (Civil Code Section 2898)

As to satisfaction. When any mortgage has been satisfied, the mortgagee or the assignee of the mortgagee must initiate the discharge procedure and shall execute a certificate of the discharge thereof, as provided in Civil Code Section 2939 and shall, within 30 days of satisfaction, record or cause to be recorded, except as explained below, such certificate in the office of the county recorder in which the mortgage is recorded. The mortgagee shall then deliver, upon written request of the mortgagor, the original note and mortgage to the person making such request. (Civil Code Section 2941)

When the obligation secured by any deed of trust has been satisfied, the beneficiary or the assignee of the beneficiary shall execute and deliver to the trustee the original note and deed of trust, a request for a full reconveyance and such other documents as may be necessary to reconvey the deed of trust. The trustee shall, within 21 calendar days after receipt of all necessary documents, instructions and fees, execute and record or cause to be recorded, except as provided below, a full reconveyance in the office of the county recorder in which the deed of trust is recorded. The trustee shall then deliver, upon the written request of the trustor, the original note and deed of trust to the person making such request and a copy of the reconveyance shall be delivered to the beneficiary, its successor in interest, or its servicing agent if known. (Civil Code Section 2941)

Limitation to Recording of Reconveyance

Pursuant to Civil Code Section 2941, the mortgagee or trustee shall not record or cause the certificate of discharge or the deed of full reconveyance to be recorded when any of the following circumstances exist:

1. The mortgagee or trustee has received written instructions to the contrary from the mortgagor or trustor, or the owner of the land (as the case may be), or from the owner of the obligation or debt secured by the deed of trust or his or her agent, or escrow holder.
2. The certificate of discharge or deed of full reconveyance is to be delivered to the mortgagor or trustor, or the owner of the land (as the case may be), through an escrow to which the mortgagor, trustor, or owner is a party.
3. Personal delivery is not for the purpose of causing recordation and the certificate of discharge or deed of full reconveyance is to be personally delivered with receipt acknowledged by the mortgagor or trustor or owner of the land, as the case may be, or their agent if authorized by mortgagor or trustor or owner of the land.

Required Timely Recording of the Deed of Full Reconveyance

If a deed of full reconveyance is not issued and recorded within 60 calendar days of satisfaction of the debt, the beneficiary, upon receipt of a written request by the trustor or trustor's heirs, successors in interest, authorized agent thereof, or assignee, may execute and acknowledge a document pursuant to Civil Code Section 2934a substituting another as trustee and issue a deed of full reconveyance.

If a deed of full reconveyance is not executed and recorded either in accordance with the previous paragraph or within 21 days of the trustee's receipt of all documents, instruments, instructions and fees necessary to effect the reconveyance, then within 75 calendar days of satisfaction of the debt or obligation a title insurance company may prepare and record a release of the obligation. The release shall be deemed, when recorded, to be the equivalent of a reconveyance of the deed of trust. However, at least 10 days prior to issuance and recording of a full release pursuant to this paragraph, the title insurance company shall mail by first-class mail, with postage prepaid, the intention to release the debt or obligation to the trustee, trustor, and beneficiary of record, or their successor in interest of record, at the last known address for each party.

The release shall set forth:

1. the name of the beneficiary;
2. the name of the trustor;
3. the recording reference to the deed of trust;
4. a recital that the obligation or debt secured by the deed of trust has been paid in full; and
5. the date and amount of payment.

Sanctions and penalties. Failure to comply with Civil Code Section 2941 makes the violator liable to the person affected for all damages sustained by reason of the violation. Further, the violator must forfeit to that person the sum of $300. In addition, Civil Code Section 2941.5 provides that every person who willfully violates Section 2941 is guilty of a misdemeanor punishable by a fine of not less than $50 nor more than $400, or by imprisonment in a county jail not to exceed 6 months, or by both such fine and imprisonment.

Fees for services rendered. A trustee, beneficiary or mortgagee may charge a reasonable fee to the trustor or mortgagor or the owner of the land for services involved in the preparation, execution and recordation of the full reconveyance including, but not limited to, document preparation and forwarding services, plus any additional official fees that may be required (e.g., notary and recording).

Fees charged for the foregoing are not to exceed $65 plus official fees. These fees are conclusively presumed to be reasonable. It is important to note that such fees cannot be charged prior to the opening of a bona fide escrow, or more than 60 days prior to full satisfaction of the debt or obligation secured by the deed of trust or mortgage.

Other Characteristics/Essentials of Mortgages and Trust Deeds

The parties and the property must be adequately identified in the instruments and the instruments signed and delivered. The parties should be named in the security instrument in the same manner they are named in the note. Acknowledgment of the security instrument is necessary for recording purposes.

A valid mortgage or trust deed must have a valid underlying debt or obligation, meaning the obligation must have consideration, otherwise the security instrument secures nothing because apart from the debt the security instrument has no meaning and no lien attaches to the property.

One security instrument can secure several debts or obligations (whether present or future), and one debt or obligation can be secured by several security instruments on several parcels of land. Notes in series which are secured by a single deed of trust or more than one deed of trust of equal priority, or notes providing fractionalized interests to non-exempt investors are securities requiring either issuance pursuant to a qualified exemption or pursuant to a permit from the Department of Corporations or the Securities and Exchange Commission (depending upon whether the securities are to be issued intra- or both intra- and interstate).

Unless prohibited by law, fractional interests as well as the entire fee interest may be mortgaged, but lenders are generally reluctant to lend on partial estates. No requirement exists that the trustor be the debtor. One person may give a mortgage or trust deed to secure the debt of another, or as a guaranty. However, the debtor and trustor are usually the same person.

A transaction which is really a mortgage transaction disguised to appear otherwise (grant deed to secure a loan, for example) will be subject to the "one form of action" and antideficiency rules.

A mortgagee or beneficiary under a power of sale will usually prefer the publicly held, privately conducted foreclosure sale (trustee's sale) if the real property is valuable enough to satisfy the debt and expenses of sale because the power of sale eliminates the debtor's right of redemption subsequent to the sale. If the property's sale will not satisfy the debt, the lender/creditor will generally initiate a judicial sale and seek a deficiency judgment following the foreclosure sale, if a deficiency judgment is allowable. The remedy is the creditor's choice.

JUNIOR TRUST DEEDS AND MORTGAGES

It is often necessary to obtain junior financing (secondary financing) to complete a transaction where the first trust deed loan plus buyer's down payment are not sufficient to meet the purchase price. Two non-institutional or non-licensed sources have been available for junior financing: sellers and private lenders. In recent years, institutional and licensed lenders have become active in the making of junior loans.

Seller Extending Credit

A seller who receives a substantial portion of the purchase price in cash from the proceeds of the first loan plus the buyer's down payment may be willing to extend credit to the purchaser usually, because of the increased risk, at an interest rate higher than that of the first loan.

When a seller "carries the paper," the extension of credit is called a "purchase money" trust deed. This financing method is often used when a seller wants to receive income spread out over a period of time instead of lump-sum cash or when an existing mortgage is to be assumed and seller extends credit for a portion of the purchase price. Such liens are used most often in periods of tight money.

Sellers accepting a junior lien may either retain it or sell it, with or without the services of a mortgage broker, to a permanent investor. The principal balance is usually discounted anywhere from 10 to 50 percent, depending upon the risk of the loan (due date, amount, interest rate, borrower stability, property securing the lien, and whether the loan includes due-on-sale, late charge or prepayment penalty provisions).

Disclosures required. Since July 1, 1983, where there is a transaction involving a purchase money lien on dwellings for not more than 4 families with the seller extending credit to the purchaser and there is "an arranger of credit" (typically a real estate broker), certain specific disclosures must be made by the arranger of credit to both seller and buyer. Also, the seller is to make certain disclosures to the purchaser with respect to information within the seller's knowledge and the purchaser is to disclose certain information (credit worthiness) within the purchaser's knowledge to the seller. Chapter 22 includes a discussion of these disclosures.

Private Lenders

Private persons may loan money directly or work through a mortgage broker because of the usury exemption, convenience and additional services provided. These direct lenders are usually persons desiring higher returns on their funds for higher risks. Individuals acting for their own account are subject to fewer laws and regulations, but must still operate within the laws of this state governing lending and usury.

Private lenders must receive a disclosure from the mortgage broker pursuant to Sections 10232.4 and 10232.5 of the Business and Professions Code prior to committing their funds to the loan transaction or to the purchase of a promissory note and purchase money lien. The borrower must receive a disclosure from the mortgage broker, pursuant to Sections 10240 and 10241 of the Business and Professions Code, prior to becoming obligated to complete the loan transaction. Chapter 15 includes a discussion of these disclosures.

Usury

In California, the passage of Proposition 2 in 1979 made significant changes to the constitutional provisions on usury. Now all loans secured in whole or in part by liens on real property and made or arranged by a licensed real estate broker are exempt from the usury law. Private individuals making such loans without a broker are controlled by the usury law. However, federal law preempts state constitutional and statutory interest ceilings on most federally related real property loans.

General Comments

Private lenders are usually highly subjective about loan decisions, make most of their loans on single-family residences within a geographic area known to lender and loans are for relatively small amounts with terms of three to five years. These loans are called “hard money” loans, meaning the lender actually gives cash to the borrower as opposed to the situation in which a seller extends credit only to a purchaser. The cost of such junior loans must of course be borne by the borrower and can prove to be a burden. Real estate brokers as fiduciaries have a duty not to make or arrange a loan which will obviously end in financial difficulty for a borrower who does not have the ability to meet mortgage payments from an overstrained budget.

With few exceptions, government loan programs prohibit the placing of junior liens on the real property concurrently with the recording of the government first mortgage lien. FHA permits no concurrent junior financing.

Balloon Payment Loans

Often in California when a “hard money” lender makes a loan or when a seller takes back a junior purchase money note and trust deed, the monthly payments do not amortize the loan. The last payment, called a balloon payment, is a substantial payment of principal and interest. Loans with balloon payments are usually short-term: i.e., three to five years.

Section 2924i of the Civil Code requires the holder of a balloon payment loan secured by an owner-occupied dwelling of four or fewer units to give 90 to 150 days notice of the due date of the balloon payment. Construction loans, loans for which creative financing disclosures have been made, seller “carry backs,” and loans made before January 1, 1984 are exempt from this requirement.

Certain “hard money” real property loans negotiated by real estate brokers (junior loans under $20,000 or first loans under $30,000) against nonowner-occupied dwellings with a loan term of less than three years (six years or less for owner-occupied) must provide for substantially equal installment payments over the loan term. No installment, including the final installment, can be greater than twice the amount of the smallest installment. This requirement does not apply to a purchase money note given back to a seller on account of the purchase price.

OTHER TYPES OF MORTGAGE AND TRUST DEED LOANS

Package Trust Deed

A package trust deed involves a loan on real property that is secured by more than just the lot and basic structure. It includes fixtures (appliances, carpeting, drapes, air conditioning unit) and perhaps items of personal property.

Blanket Trust Deed (Mortgage)

A blanket trust deed is a loan which covers more than just one parcel of property. Usually, the loan contains a "release clause" providing for release of a particular parcel upon the repayment of a specified portion of the loan. Typical use is in connection with a tract of homes built on speculation. Initially, one blanket trust deed covers the entire tract. When a home is sold, a separate loan (take-out loan) is made to the buyer covering only that buyer's new home and all or a portion of the proceeds of the new loan is paid against the blanket loan to obtain release of the sold property. Blanket trust deeds are often used in connection with construction loans to builders.

Open-End Trust Deed

An open-end trust deed involves a loan arrangement whereby additional amounts of money may be lent in the future without affecting the loan's priority. In California, the law provides that these additional amounts are considered as part of the original loan if the loan contract *requires* the lender to advance additional funds, as opposed to the advance(s) being optional on lender's part.

Interest-Only Mortgage

An interest-only mortgage is a balloon payment mortgage loan in which the monthly payments only cover the accrued interest. The unpaid balance, which remains constant, is due and payable on an agreed date, often in one to five years, or upon some other event (e.g., receipt of the proceeds from the sale of another property, or an agreed increase in the debtor's earnings), whichever first occurs.

Collateralized Junior Mortgage

A collateralized junior mortgage involves an arrangement whereby a secured loan is pledged as collateral (security) for a loan in a lesser amount.

Tandem (or Piggyback) Loan

A tandem loan, usually used in residential income type financing, occurs when two lenders share in making a single loan. For example, one lender supplies 60% of the loan funds and a participating lender supplies 25% of the funds. This is another form of junior mortgage financing. The purpose is to grant a higher than usual "loan-to-value" loan.

Swing Mortgage

A swing mortgage is a temporary loan made on a borrower's equity in his present home (which will be sold), or on the equity in both the present and the "contemplated" home (which will be purchased) for use as the down payment on the contemplated residence.

Refinance Mortgage

A refinance loan is one made to replace an existing loan. It usually is an obligation of the same debtor or debtors and it remains secured by the same property. In most cases:

- some additional credit is extended;
- the interest rate is adjusted to more closely reflect (if not equal) the current market interest rate;
- a new schedule of payments is arranged; and
- the lender and borrower may desire to substitute a basically different kind of mortgage (e.g., a variable rate mortgage in place of a conventional fixed-rate mortgage).

(Note: Under most circumstances, the character of the mortgage may be changed from that of a purchase money mortgage to a non-purchase money mortgage.)

Pledged Savings Account Mortgage

Under the pledged savings account mortgage, also known as the flexible loan insurance program mortgage, or FLIP, part of the borrower's down payment is used to fund a pledged savings account. The savings account is maintained as cash collateral for the lender and a source of supplementary payments for the borrower during the first (usually five) years of the loan. Interest on the account is usually paid to the borrower.

Wrap-Around Mortgage or Trust Deed (Also Called an Over-Riding or All-Inclusive Trust Deed - AITD)

Before discussing this type of financing, a word of caution. Anyone planning to use this security device should make sure the existing loan can be legally combined with (wrapped by) the new loan. Most institutional loans contain acceleration or alienation provisions (due-on-sale clauses) in their loan documents which preclude the transfer of the property to a new owner without lender approval. The advice of legal counsel is recommended to assure that all parties receive what they bargained in an AITD situation.

During periods of credit shortages and/or "tight-money," it is virtually impossible for some potential buyers to qualify for conventional loans and for other borrowers to refinance an existing loan on investment real estate to raise additional capital. Refinancing may be a practical impossibility in a number of cases because: no prepayment of the existing debt may be provided for in the debt contract; prepayment penalties often make refinancing too costly; or, if the existing loan is eliminated, there is no possibility of obtaining the desired financing to complete the sale.

These buyers and sellers may decide to use the AITD technique.

An AITD, like a junior mortgage, does not disturb the existing loan, yet the debtor is able to borrow an additional amount against the property. After the wrap-around mortgage loan has been arranged, the new lender assumes payment of the existing mortgage while giving a new, increased loan at a higher rate of interest to the borrower. The amount of the wrap-around mortgage includes the unpaid principal balance of the existing loan plus the new loan funds (or the amount of the purchase price being "carried back" by the seller).

The borrower makes payment on the new loan to the new lender, who makes payment to the holder of the prior loan. The new loan "wraps around" the existing loan. This method is also used to finance a sale of real estate where the purchaser has only a small down payment. The buyer executes a wrap-around mortgage to the seller who will collect a larger mortgage payment from buyer and continue to make payments on the old loan. The interest rate spread causes a profit for the lender or seller.

ALTERNATIVE FINANCING

Background and Purpose

In a stable economic environment (i.e., one involving low inflation and relatively constant market interest rates), the long-term fixed-rate mortgage is the typical financing vehicle for the purchase of residential real property.

Uncertainty regarding future inflation and interest rates can complicate matters for both lenders and borrowers. As people continue to build, sell, and purchase homes, the terms of home mortgages reflect economic realities and expectations and the periodic reluctance of lenders, investors and borrowers to accept long-term fixed-rate loans.

Loans that involve balloon payments, interest reset options, shared appreciation at resale, etc. have ramifications that are not readily apparent to most people. This section discusses some of the alternatives to the fixed-rate loan.

Graduated Payment Adjustable Mortgage (GPAM)

A GPAM provides for partially deferred payments of principal at the start of the loan term. There are a variety of plans. Usually, after the first five years of the term, the principal and interest payments increase substantially to pay off the loan during the remainder of the term (e.g., 25 years). This loan may be appropriate for borrowers who expect salary increases in the coming years. A GPAM involves negative amortization (i.e., increase in principal) in the early years of the loan. Thus, early sale of the home could require that the borrower repay more than the original amount of the loan. This could be a problem if the property has not increased in value.

Adjustable Rate Mortgage (ARM)

An ARM is a mortgage loan which provides for adjustment of its interest rate as market interest rates change. Thus, an ARM is called a fluctuating or floating rate mortgage.

An ARM's interest rate is linked to an index that reflects changes in market rates of interest. A variety of published indexes are used: e.g., the Cost-of-Funds Index published by the Office of Thrift Supervision, and the Federal Reserve Discount Rate.

Because ARM rates can increase over the term of the loan, ARM borrowers share with lenders the risk that interest rates will rise. This sharing permits the lender to charge a lower initial interest rate than would be charged for a fixed-rate mortgage.

Renegotiable Rate Mortgage (RRM)

An RRM is a long-term mortgage (up to 30 years) comprised of a series of short-term loans. The loans are renewable after specified periods (e.g., every three years, every four years, or every five years). Both the interest rate and the monthly payment remain fixed during periods between renegotiation/renewal.

Any change in the interest rate, limited by law, is based on changes in an index. If the borrower declines renewal after any period, the remaining balance is due.

Shared Appreciation Mortgage (SAM)

A shared appreciation mortgage (SAM) gives the lender the right to an agreed percentage of the appreciation in the market value of the property in exchange for an initial below-market interest rate. These loans are usually not available in markets where properties are not appreciating in value.

Rollover Mortgage (ROM)

The ROM (currently used extensively in Canada) is a renegotiated loan wherein the interest rate (and, hence, the monthly payment) is renegotiated, typically every five years. Consequently, the mortgage rate is adjusted every five years consistent with current mortgage rates, although monthly payments are amortized on a 25 or 30 year basis. Monthly payments are calculated in the same manner as a conventional mortgage, with the term decreasing in increments of five years to permit full payment at maturity specified at loan origination.

Reverse Annuity Mortgage (RAM)

Elderly homeowners often face the reverse problem of young families in that their incomes are relatively low and, although they own their homes free and clear, they must move in order to utilize their equity for living expenses. Under a reverse annuity mortgage, the lender pays the borrower a fixed annuity, based on a percentage of the value of the property. The borrower is not required to repay the loan for 15 or 20 years or until a specified event such as death or sale of the property, at which time the loan is paid (e.g., through a probate sale). In effect, a RAM enables a retired couple to draw on the equity of their home by increasing their loan balance each month. No cash payment of interest is involved, as the increase in the loan balance each month represents the cash advanced, plus interest on the outstanding balance.

Summing up. Alternative mortgages are not suitable to everyone. It is very important that those who recommend such plans, or who contemplate using them personally, have a good understanding of the potential risks and drawbacks as well as the benefits. A temporary solution to a financing problem may turn out to be a long-term detriment to the borrower and/or lender.

Real estate licensees should use caution when advocating the use of innovative financing techniques and be prepared to explain benefits and risks to their clients. Furthermore, innovative financing techniques generally should not be pursued without the advice of legal counsel. Alternative financing is not something that a licensee and his or her principal should learn together through trial and error.

EFFECTS OF SECURITY

Having subjected property to the lien of a trust deed or mortgage, the debtor must further submit to various incidents or effects of this security arrangement. Some of the more important effects refer to:

1. assignment of the debt by the creditor;
2. transfer of the property by the borrower;
3. satisfaction of the debt;
4. lien priorities; and
5. acceleration due to default.

Assignment of debt by the creditor. The assignment of a debt secured by a mortgage carries with it the security. An attempted assignment of the mortgage without the note transfers nothing to the assignee, but a transfer of the note without the mortgage gives the assignee the right to the security.

An assignment of a mortgage or deed of trust may be recorded and recordation gives constructive notice to all persons. After the note has been transferred and the assignment of the mortgage has been recorded, the debtor is not protected if he continues making payment to the original creditor. (Note: Recent federal and state changes require notice to the debtor of any transfer of servicing agent - RESPA and Civil Code Section 2937.)

Business and Professions Code Section 10234 requires every licensee negotiating a loan secured by a trust deed or an assignment of a trust deed, to cause the trust deed or assignment to be recorded, or when delivering these instruments to the lender or assignee, to give written recommendation that the trust deed or assignment be immediately recorded.

Transfer of property by the borrower. When mortgaged real property is transferred, the purchaser either obtains new financing (and the old mortgage is paid off), buys the property "subject to" the existing loan, or "assumes" the loan. Taking title "subject to" the existing loan generally results in no personal liability to the purchaser. Despite the grant, the seller will (except in purchase money mortgage fact situations) remain personally liable to the lender for the loan repayment. If a purchase money loan is involved, in the event of a default no deficiency judgment could be obtained and the lender would be required to look only to a sale of the security property to recover the amount of the debt.

If the loan terms do not include a due-on-sale clause and as long as the purchaser makes the loan payments in a timely manner, no problem should occur for the original signer and maker of the loan. If the buyer defaults and the loan is not a purchase money loan, the lender can look to the seller/maker for payment, even years after the transfer was made. The seller may also suffer a loss of credit status due to the purchaser's failure to make the payments.

Under a loan assumption, the buyer becomes the principal debtor and the seller either may remain liable to the lender as a continuing maker, or may become liable to the lender as surety for any deficiency resulting after the sale of the property. The safest arrangement for the seller is to ask the lender for a substitution of liability, relieving the seller of all liability in consideration for assumption of the debt by the buyer.

Caution regarding due-on-sale. Proposed loan transfers, whether as the result of assumptions or taking title "subject-to," must be very carefully considered in light of the Supreme Court ruling allowing the nation's federal lenders to automatically enforce due-on-sale provisions in their loans and the effects of the Garn-St. Germain or Depository Institutions Act of 1982. The federal act limited, and in 1985 eliminated, except in certain fact situations, automatic transfers of all other types of loans with due-on-sale provisions. Covert transfers, no matter how structured, are not acceptable practice and are to be avoided by real estate licensees.

Offset statement. In transactions involving an assignment of an existing mortgage or trust deed to an investor, an offset statement is customarily obtained for the benefit of the investor. The information included in the offset statement is typically the unpaid balance of note, date to which interest is paid, interest rate, payment amount and due date, the maturity/due date of loan, and whether or not the property owner has any claims which do not appear in the instrument being purchased by the investor. The offset statement is in addition to the beneficiary statement from the lender. Together, the offset and beneficiary statements confirm to the person purchasing the existing loan the nature of the obligation of the property owner (mortgagor) to the new holder of the mortgage (assignee).

Satisfaction of the Debt. See the discussion of this earlier in the chapter under the heading "**As to satisfaction**."

Lien priorities. Ordinarily, different liens upon the same property have priority according to the time of their creation. Notice is an important element in the determination of priority. Notice may be actual or it may be constructive from recordation, thus giving notice of the lien to subsequent purchasers and encumbrancers for value.

County and municipal tax liens are paramount and prior to an existing mortgage. Where there are successive tax liens, they are generally prior in the inverse order of their creation; that is, those attaching last are superior to the earlier ones. See Government Code Section 53930, et seq., as to the effect of successive special assessments. Such taxes and special assessments are on a parity of equal rank. When delinquent, a deed to any agency for taxes will not wipe out the other liens in favor of other agencies.

Acceleration clause. Trust deeds and mortgages generally contain a clause giving the lender the right to declare the full amount of debt due and payable upon default in payment of an installment, taxes, or interest or the happening of a certain event such as failure to maintain the property.

Also, a "due-on-sale" clause, which is a form of an acceleration clause, gives the lender the right or option to insist that a mortgage be paid off or renegotiated when the title to the mortgaged property changes ownership. When mortgage funds are available at acceptable interest rates, new buyers ordinarily obtain new financing and the owner pays off the existing loan. In times of scarce money and escalating interest rates, buyers prefer to assume or take "subject to" the existing mortgage. Lenders generally do not want to be "locked" into long-term, lower-than-market-rate loans. Often, lenders will argue that they must not only watch the value of their old loans decline but also are forced to pay higher interest rates to depositors who otherwise would withdraw funds and seek higher returns in other investments.

The issue of a lender's right to automatically enforce a "due-on-sale" provision upon transfer of the mortgaged property has been resolved as previously indicated in favor of the lender, as a result of a 1982 United States Supreme Court decision and 1982 federal regulations and law, with specified exceptions. Of course, loan documents containing no due-on-sale clause are not affected, and security properties usually, but not always, remain transferable without the lender's consent when encumbered by this type of loan security document.

DUE-ON-SALE

Recent History of Due-on-Sale Enforcement in California

The California Supreme Court ruled in *Wellenkamp v. Bank of America* (1978 21 Cal. 3d 943) that a state-chartered institutional lender could not automatically enforce a due-on-sale provision in its loan documents to accelerate payment of a loan when residential property securing the loan is sold by the borrower. Under this ruling an institutional lender had to demonstrate that enforcement was necessary to protect against impairment of its security or the risk of default (credit considerations).

In its opinion, the court reviewed prior decisions having to do with enforceability of due-on-sale clauses, particularly *La Sala v. American Savings and Loan Association,* (1971) 5 Cal. 3d 864, and *Tucker v. Lassen Savings and Loan Association,* (1974) 12 Cal. 3d 629. In *La Sala,* further encumbering of real property through a second loan was found to be insufficient justification for acceleration of the maturity date. In *Tucker,* sale of the property under a real property sales contract (installment contract) was held to be insufficient justification.

A flurry of California court cases followed *Wellenkamp* addressing issues it left unresolved, such as the applicability of Wellenkamp to private lenders, commercial as well as residential property, and federal regulations preempting state laws on due-on-sale provisions. The *Wellenkamp* rule was found applicable, and it generally prevailed.

However, federally-chartered banks and savings and loan associations successfully asserted that the validity and automatic exercise of due-on-sale provisions is applicable to them. This contention was upheld by the United States Supreme Court in *Fidelity Federal Savings and Loan Association v. de la Cuesta* (1982 458 US 141).

On October 15, 1982, the *Garn-St. Germain Depository Institutions Act of 1982* became effective. As mentioned previously, with certain exceptions the law makes due-on-sale provisions in real property secured loans automatically enforceable by all types of lenders, including non-institutional private lenders.

The federal law preempts state laws and judicial decisions which restrict enforceability of due-on-sale provisions in financing instruments, and assures that due-on-sale clauses in real property loans originated after October 15, 1982, can be automatically enforced. In addition, FHA and VA have since implemented rules and regulations restricting the transferability of the loans they insure, guarantee, or indemnify.

Enforceability

The following concerns the automatic enforceability of due-on-sale provisions in loan instruments:

1. Federally-chartered savings and loan associations may automatically enforce due-on-sale clauses in promissory notes and deeds of trust which they originated while federally chartered.

2. With certain exceptions of limited application, all loans originated after October 15, 1982 may be accelerated, upon transfer of the property securing the loan, if the security instrument includes a due-on-sale clause.

3. As of October 15, 1985, with very few exceptions, loan transfers without the consent of the lender no longer exist in California.

Other Exceptions

Notable exceptions to automatic enforceability of due-on-sale clauses enumerated under the law include, among others, the following:

1. creation of a junior deed of trust or lien on property which is not related to a transfer of the rights of occupancy when the security property is an owner occupied residence;

2. transfer of the property to a joint tenant;
3. transfer to a relative of a borrower resulting from the death of the borrower; and
4. transfer into an inter vivos trust of which the borrower is a beneficiary if it does not relate to a transfer of rights of occupancy of the property.

Assumptions May Still Be Negotiable

The Garn-St. Germain Act specifically encourages lenders to allow loan assumptions at a blended or below-market rate of interest and nothing in Garn is to be interpreted to prohibit any such assumptions.

Brokers should proceed cautiously in any transaction in which a buyer is proposing to take title "subject to" an existing loan. Such transactions should be reviewed by legal counsel in advance of consummation.

Lender may still require buyers to satisfy credit standards and complete customary credit forms. If the buyer refuses to provide the information within 15 days of the lender's written request, the lender may enforce the due-on-sale provision in its loan.

Special Provision

A clause in any trust deed or mortgage that provides for acceleration of the due date upon sale, conveyance, alienation, lease, succession, assignment or other transfer of property (containing four or fewer residential units) subject to the trust deed or mortgage is invalid unless the clause is printed, in its entirety, in both trust deed or mortgage and the promissory note or other document evidencing the secured obligation. (Civil Code Section 2924.5)

LENDER'S REMEDY IN CASE OF DEFAULT

Foreclosure Generally

Foreclosure is a legal procedure used to terminate the right, title and interest of a mortgagor or trustor in real property by selling the encumbered property and using the sale proceeds to satisfy the liens of creditors.

A mortgage without a *power of sale* can only be foreclosed judicially (i.e., by court proceeding). A mortgage or a deed of trust which contains a *power of sale* may be foreclosed nonjudicially by trustee's sale. Most security instruments in California expressly provide for *power of sale,* thus providing the choice of a trustee's sale or judicial foreclosure sale.

Where anti-deficiency judgments are sought and permitted by law, foreclosure must be by judicial proceedings and a creditor may proceed with both a foreclosure and an action to obtain a deficiency judgment in the same judicial action.

As a general rule, procedural requirements in effect at the time the foreclosure is begun will govern, even if the requirements change. (Code of Civil Procedure Section 725a, et seq.)

"One-Action" Rule

Under California law, the "one-action" rule applies for recovery of any debt or enforcement of any right secured by a mortgage on real property. (Code of Civil Procedure Section 726)

The “one-action” rule requires the mortgagee or beneficiary to first foreclose the property before seeking a personal money judgment against the debtor for the deficiency, if this latter action is permitted under the anti-deficiency rules. Only after the security has been exhausted may the unpaid creditor seek a personal judgment against the trustor/mortgagor.

There are specific exceptions to the “one-action” rule, such as the “sold out junior beneficiary” and “worthless-security” exceptions.

Where a junior lien holder on a property foreclosed by a senior lien holder holds a *non-purchase money* security which has become worthless because the junior creditor no longer has a lien on the property, the “sold out” junior may sue the debtor directly on the note. However, a “sold-out” junior beneficiary or mortgagee is prohibited from suing on a *purchase money note* following a foreclosure sale by a senior mortgagee or trust deed holder because a judgment would result in the equivalent of a deficiency judgment.

If a property is ‘‘legally” worthless, (i.e., nonexistent or not actually owned by the mortgagor, or in a situation in which foreclosure would be meaningless because the security has been destroyed or has become valueless without any act by the creditor) or where fraud is involved, the creditor is not limited to the “one-action” rule. Under such circumstances, the creditor may sue directly on the note and need not first foreclose. California Financial Code Section 7460 limits the damages available to the lender in fraud actions where the security property is or was the occupied residence of the borrower.

“Worthless security” does not include a loss in property value or security value due to marketplace or economic declines. Should an opinion of value of the security property be required, the mortgagee or beneficiary must first foreclose to have the court determine “economic worthlessness” and whether a writ of attachment may be granted.

Purchase Money Securities

Code of Civil Procedure Section 580b prohibits deficiency judgments with limited exceptions where “purchase money” securities are involved. For this purpose, “purchase money” means (l) credit extended by a seller to a buyer with the seller “carrying back” a promissory note executed by the buyer and secured by a trust deed on the property being purchased as a part of the purchase price, or (2) a third-party lender advancing funds to a buyer to be used to pay all or part of the purchase price of a dwelling of not more than four units to be occupied in part or entirely by the buyer.

Thus, buyer protection against deficiency judgments is limited by the type of real property purchased. Certain creditors are denied and other creditors may obtain a deficiency judgment. As previously indicated, where third-party money is advanced to enable a buyer to purchase a residential dwelling (1-4 units) in which buyer will reside, the lender is typically barred from obtaining a deficiency judgment. However, if the third-party lender loans funds to enable a buyer to purchase residential property over 4 units, or to purchase investment or commercial property, or raw land, or residential property of 1-4 units *not intended to be buyer occupied*, the lender may seek a deficiency judgment against the buyer when foreclosing judicially.

Anti-Deficiency Rules

When a mortgagee or beneficiary elects to “foreclose” under a *power of sale*, there is a complete bar against a deficiency judgment.

Under a judicial foreclosure, if a deficiency judgment is permitted following a judicial sale, the sale is subject to redemption (buy-back) by the debtor within three months if the proceeds of the sale were adequate to satisfy the amounts owing. Otherwise, the redemption period is one year after the sale. Only after the security has first been exhausted may the creditor sue the debtor for the balance owing on the note.

Deficiency Judgments

Purchase money anti-deficiency provisions also apply to installment land contracts, and to instruments determined to be, in fact, security devices (disguised mortgages, for example, equitable liens).

Transactions falling outside the provisions of Code of Civil Procedure Section 580b (i.e., non-purchase money transactions) depend upon a “purpose” scrutiny and a security property and related analysis by the court to determine if a deficiency judgment will be allowed where third-party lenders are involved.

A borrower generally cannot waive at the time of executing the loan the protections granted by law. Subsequent to signing the loan documents, a borrower may under limited fact situations execute a waiver of rights concerning the protections granted against deficiency judgments or the “one-action” rule.

Reinstatement Rights - Pre-sale

Under a judicial foreclosure, a trustor or mortgagor or his or her successor in interest, any beneficiary under a subordinate trust deed or mortgage, or any other person having a subordinate lien or encumbrance of record, may reinstate the loan at any time before entry of judgment by restoring the loan (usually to its installment-payment basis) by paying the delinquencies and advances on the debt plus costs and fees. Thereupon, all foreclosure proceedings terminate and the loan continues in full force and effect as if no such acceleration proceeding had taken place.

Under a trustee’s sale, the statutory right of reinstatement for the individuals named above ends five business days prior to the date of the trustee’s sale or of any postponed sale.

Redemption Rights - Post-Sale

Under a judicial foreclosure, only the judgment debtor or his or her successor in interest may redeem from a foreclosure sale. All junior lien holders are eliminated under the law effective July 1, 1983. (Code of Civil Procedure Section 729.020) As mentioned previously, the redemption period is three months if the sale proceeds satisfy the debt plus interest and costs of the action. If sale proceeds are insufficient to do this, the redemption period is one year. (Code of Civil Procedure Section 729.030) If the creditor waived the deficiency judgment or it was prohibited, there is no right of redemption. [Code of Civil Procedure Section 726(e)]

During the redemption period permitted under the judicial sale, the judgment debtor or tenant in the property is entitled to remain in possession but must pay rent to the buyer at the foreclosure. Often a mortgage or deed of trust permits the mortgagee or trustee to take possession upon default under the “assignment of rents” provision and manage the property, pay expenses, and collect the rent, applying the net proceeds to the maintenance of the property and to preserve the lender’s security.

Under the trustee’s power of sale foreclosure, no post-sale redemption right exists.

Statute of Limitations

Civil Code Section 2911 provides that a lien is extinguished by time if an action on the underlying debt or obligation is not brought within the time limits stated. Judicial foreclosure actions must be filed within four years after maturity of the obligation or any installment payment. Both a mortgage and trust deed secure a written debt or obligation that if not performed creates a cause of action for four years following the default. The mortgage, being only a lien, is extinguished without action by the mortgagee four years after default. (The rule is four years from and after: the date the last payment was due; the maturity date; the date the debt was last acknowledged by the mortgagor; or the date of the default under the loan terms, whichever is the later.) The power of sale under a mortgage is also lost for inaction.

However, a deed of trust grants the trustee all of the trustor's right, title and interest in the trust property. Even though the statute of limitations bars an action on the note, the power of sale continues unaffected by the passage of time, except the requirement to periodically renew certain deeds of trust.

Judicial Sale

The court form of foreclosure, a judicial foreclosure, is usually sought when a mortgagee or beneficiary wants to obtain a deficiency judgment. The mortgagee or beneficiary must be mindful of whether a deficiency judgment against the debtor will be sought before concluding the foreclosure remedy. Depending upon the sale results, i.e., the sale proceeds are either sufficient to pay the debt in full or insufficient to do so, the statutory period of redemption for the debtor is either three months or one year from the date of the sale.

The process. The judicial foreclosure sale process involves:

- filing a complaint and notice of action (lis pendens) which will bind all persons acquiring liens or interests in the property during the pendency of the action;
- a summons served on the parties whose interests are to be eliminated, such as the trustor or his successor in interest and junior lien holders;
- the trial, after which the judgment is entered (decree of foreclosure and order of sale);
- the recording and serving by the Sheriff of Notice of Levy followed by the Notice of Sale.

The Notice of Sale cannot be earlier than 120 days after recording and serving of the Notice of Levy if a deficiency judgment is barred or waived.

Where a deficiency judgment is available, the property is sold subject to the one-year redemption period, the 120-day notice period is not required and only a 20-day Notice of Sale is needed. The 20-day Notice of Sale must be made by posting the Notice of Sale in a public place and on the property at least 20 days before the sale and by publishing the notice once a week for three weeks in a newspaper of general circulation in the city or judicial district in which the property or any part of it are located. The notice must also be mailed to all defendants at their last known address and to any other person who has requested to be notified.

The sale. The sale is to be held between 9 a.m. and 5 p.m. on a business day in the county where the property or some of it is located. The foreclosing creditor, debtor, junior lien holders and others may bid at the sale. The foreclosing creditor may credit-bid up to the amount owed him, and cash bid in excess of the debt. All other bidders must bid cash except that a bidder may, if the bid price exceeds $5,000, deposit with the party conducting the sale the greater of $5,000 or 10 percent of the bid amount, and pay the balance within ten days of the sale, plus interests and costs, and damages if he fails to pay and a second sale is required.

After the sale. The Sheriff issues the highest bidder a prescribed Certificate of Sale stating the title is subject to any redemption privilege of the debtor. The certificate operates to transfer title to the purchaser. The purchaser receives no rights to possession for the period of redemption, but does have the right to receive rents. The title received by the highest bidder is subject to any senior liens but free of any junior liens. The Certificate of Sale is recorded.

Sale proceeds are applied to costs of lawsuit and attorney fees; selling expenses; amount due beneficiary; junior lien holders in order of priority; and finally the excess to the debtor.

If the debtor does not redeem the property within the 3-month or l-year (if a deficiency judgment has been obtained) redemption period, the Sheriff will issue a Deed of Conveyance containing special recitals concerning the foreclosure and sale and will record the deed. The grantee receives all right, title and interest of the trustor as of the date the trust deed or mortgage foreclosed upon was recorded. The grantee may now evict the trustor or tenant in possession.

A creditor seeking a deficiency judgment must file application in the court case within three months of the sale for a determination of the deficiency. If the court enters a deficiency judgment against the trustor or mortgagor and the beneficiary or mortgagee records it, the judgment becomes a lien upon all property owned by the debtor or acquired by him or her within ten years of the entering of the judgment ruling.

If a debt is secured by both real and personal property, the creditor may foreclose upon the real property under the power of sale and bring a separate action on the personal property security.

Trustee's Sale - "Power of Sale" Foreclosure

The alternative method of foreclosure is called a "trustee's sale" or "power of sale." Usually, a corporate trustee is the entity initiating and handling the proceedings for the beneficiary or mortgagee. It is important that all statutory provisions governing the sale be complied with, as any irregularity may invalidate the sale. The "power of sale" is based upon Civil Code Section 2924, et seq., which is procedural and not substantive law.

Unless a mortgagor or trustor files suit contesting the sale, or obtains a court injunction (for example, to determine whether a valid lien exists, or whether there is a default, or the amount of the default), the court system may be entirely bypassed in a trustee's sale. Under the existing statutes, the time required between filing of the Notice of Default and Sale and the actual sale date allows the debtor time to seek a judicial trial or injunction to establish underlying facts. Of course, after the trustee's sale, the mortgagor, trustor, or any other party affected by the sale may bring an action to set aside the sale, usually on procedural grounds, even though the sale is characterized as absolute.

Generally. No security instrument can be foreclosed at a trustee's sale unless it contains a "power of sale" provision. Without a power of sale, the mortgage or trust deed must be judicially foreclosed; however, the power of sale may be an independent document as long as it is properly integrated.

In a trustee's sale, no deficiency judgments are permitted, nor does the debtor have post-sale redemption rights. However, during the statutory reinstatement period (Civil Code Section 2924, et seq.), the debtor or any other party with a junior lien or encumbrance of record on the real property may in most fact situations reinstate (bring current and restore) the debt accelerated by the creditor because of the default.

Reinstatement restores the loan to its installment-paying or other basis by curing the default and paying all costs and fees incurred by the creditor, who must then terminate the foreclosure action.

After the statutory reinstatement period, the debtor may still redeem (buy back) the property and avert the foreclosure sale by paying off the entire debt, plus interest and costs, fees, advances and any damages to the creditor, at any time within five business days prior to the date of the trustee's sale or any sale. This is the exercise of the trustor's "equity of redemption" privilege.

Special rules. Special rules apply in trustee's sales involving bankruptcy, substitution of trustee, federally insured or guaranteed loans, individuals in military service, senior citizens, and Unruh Act mortgages (on single-family owner-occupied residences arising from a contract for goods or services). The advice of legal counsel should be obtained in advance of proceeding with a foreclosure involving any of the foregoing fact situations.

The Procedure

The beneficiary notifies the trustee of the default (usually a failure to make specified installment payments of principal and interest or make a balloon payment) and delivers the original note and trust deed to the trustee along with receipts, payment records and other evidence of advances made by the beneficiary to protect the security (e.g., payments to senior lenders, or taxes, fire insurance, etc.). The beneficiary signs a document for the trustee usually entitled Declaration of Default and requests foreclosure be started by the trustee.

(Any one beneficiary in a "fractionalized" trust deed may initiate the foreclosure. Further, Section 2941.9 has been added to the Civil Code regarding fractionalized trust deed holders or holders of notes in series. Section 2941.9 establishes a process through which all beneficiaries under a trust deed may agree to be governed by beneficiaries holding more than 50% of the record beneficial interest of the note. The parties must agree in writing to majority rule and each fractionalized note holder or holder of a note in series must be noticed of the action taken. The agreement between the note holders must be in the form of an affidavit and is to be acknowledged and recorded.)

The beneficiary furnishes the date of the original default to the trustee. The trustee normally obtains a title company foreclosure guaranty report showing the present condition of the record title, parties in interest and encumbrances. The trustee then prepares, records, mails and publishes the Notice of Default and Election to Sell as prescribed by statute (Civil Code Section 2924, et seq.).

Notice of default and election to sell. The Notice of Default must be executed by the beneficiary or the trustee and must state an election on the part of the beneficiary to declare the entire debt due because of the default. (Absent this declaration, the full amount owing on the debt cannot be collected at the foreclosure sale.) The Notice should make it clear that unless the default is noncurable, the trustor or the successor trustor may reinstate and cure the default prior to five business days immediately before the date of the trustee's sale or any postponed sale.

The Notice of Default is recorded in the office of the county recorder where the real property, or some of it, is located at least three months before Notice of Sale is given. Within ten days after recordation of the Notice of Default, a copy of the Notice containing the recording information must be sent by certified or registered mail to all persons who have requested notice and to the trustor at his or her last known address.

If there has been no request for notice by the trustor, or the request by the trustor includes no address, then the Notice of Default must be published weekly for four weeks in a newspaper of general circulation in the proper jurisdiction starting within ten days of the recording date, or the notice may be personally delivered to the trustor.

The Notice of Default, and also the Notice of Sale, are valid if the foreclosure statutes have been strictly followed, whether or not the trustor (mortgagor) has actual knowledge of the notices.

The Notice of Default must also be sent within one month of recording by registered or certified mail to persons listed in Civil Code Section 2924b even though they have not recorded a request to receive notice. These persons are: successors in interest to the trustor or mortgagor; a beneficiary or mortgagee of any junior recorded trust deed or mortgage or the assignee of such beneficiary or mortgagee; the vendee of any contract of sale, or the lessee of any lease of the interest being foreclosed which is junior to the security instrument being foreclosed, or to the successor in interest to such vendee or lessee; to the State Controller if a recorded lien for postponed property taxes exists against the property; and such other parties as are required by law.

Notice of sale. If the loan is not reinstated, the trustee issues a Notice of Trustee's Sale, the content and form of which is prescribed by Civil Code Section 2924f(b). The Notice of Sale sets a sale date not sooner than twenty days after the recording date of the Notice of Sale. Actual practice usually requires a longer time (e.g., 31 days), especially if federal tax lien notice requirements are to be met or other justifiable delays are encountered. In any event, the sale date is set to allow time for the required recording, publication, posting and mailing of the Notice of Trustee's Sale.

The Notice of Sale must be recorded at least fourteen days, and mailed by registered or certified mail to the trustor and other persons requesting/receiving notice of default at least twenty days, before the sale (Civil Code Section 2924b). The notice must be published once a week over a period of at least twenty days in a newspaper of general circulation in the city, county or judicial district where the real property, or any part of it, is located. Three publications of the notice not more than seven days apart are required. The notice must be posted for at least twenty days in at least one public place in the city, judicial district, or county of the sale, and in a conspicuous place on the property (a door, if possible, if the property is a single-family residence).

If the loan has not been reinstated by the debtor, a partial payment accepted by the beneficiary may not terminate the foreclosure. The beneficiary, however, should be careful when accepting partial payments to set forth in writing:

- whether it is the intention of the parties that the partial payment constitute a reinstatement and therefore a cure of the default; or
- whether the partial payment is to be construed to be part of a work-out agreement providing a plan for payment of all delinquencies and related costs and expenses; or
- whether the partial payment has been received without any effect on the foreclosure process, thereby permitting the beneficiary to proceed with foreclosure as though no payment has been received.

The sale. The sale is to be conducted at a public auction by the trustee, or auctioneer named by the trustee, on any business day between 9 a.m. and 5 p.m. in a public place in the county where the property, or some part of it, is located. All bids must be for payment in cash, cashier's check from a qualified lender specified in the code, or "a cash equivalent which is authorized by law or has been designated in the Notice of Sale as acceptable to the trustee." (Civil Code Section 2924h)

Until the auction bidding concludes, the debtor or any junior lien holder may still redeem the property by paying off the defaulted loan in full, plus all fees, costs and expenses permitted by law. Reinstatement of a monetary default under the terms of an obligation secured by a deed of trust or mortgage may be made at any time within the period commencing with the date of recordation of the Notice of Default, until five business days prior to the date of sale set forth in the initial recorded notice of sale. As previously stated, the reinstatement period revives as a result of a postponed sale where the postponed sale date is more than five business days subsequent to the initial sale date. [Civil Code 2924c, subdivision (e)]

Any person, including the debtor, creditor or a junior lien holder may bid. Only the selling beneficiary (holder of the debt being foreclosed) may credit-bid or offset up to the amount of the debt owed the creditor plus interest and costs. Junior lien holders may not credit-bid the amount of their junior liens. However, the amount bid by the junior lien holder would serve to reduce any potential liability that the trustor had to the junior lien holder. Further, the junior lien holder, who controls the senior lien being foreclosed, is not entitled to purchase the security property at a depressed price and then sue the trustor for deficiency under their now sold out junior promissory note.

A trustee may reject all bids if the trustee believes they are all inadequate. At the trustee's discretion, the sale may be postponed and a new sale date at the same location announced. Bid fixing, restraining from bidding or the offering or accepting of consideration for not bidding at a trustee's sale ("chilling the bidding process") is unlawful and subjects the participants to fine, imprisonment, or both. [Civil Code Section 2924h(f)] The trustee may postpone a sale, by announcement at the time and place of sale, up to three times, for other compelling reasons given in the statutes. If there are more postponements, a new Notice of Sale must be published, recorded, mailed and posted.

After the sale. The successful bidder receives a Trustee's Deed to the property containing special recitals giving notice of compliance with the foreclosure statutes to protect the purchaser and subsequent purchasers. The title conveyed is without covenant or warranty that there are no title defects and relates back in time to the date the trustor signed the trust deed. The Trustee's Deed passes to the purchaser the title then held and any after-acquired title of the trustor, not the trustor's title as of the sale date.

However, title will remain subject to certain liens:

- federal tax liens filed more than thirty days before the date of the trustee's sale unless the proper twenty-five day notice has been given the Internal Revenue Service;
- assessments and real property taxes; and
- valid mechanic's liens.

Even with proper notice to the IRS, the federal government may have the right for 120 days following the trustee's sale to redeem the property by paying the amount advanced by the successful bidder.

Provided that the beneficiary successfully makes a "full credit bid" (bids the full amount of unpaid principal and interest and any charges, penalties, costs, expenses, attorneys' fees, and advances that may be lawfully due and owing to the beneficiary), the sale eliminates the debt and obligation of the trustor. Whether a beneficiary full credit bids or underbids, completion of a trustee's sale will extinguish the mortgage or trust deed lien securing the debt and obligation in favor of a beneficiary, and will extinguish any junior liens and encumbrances (e.g., mortgages, deeds of trust, judgment liens, easements, and leases which do not have priority over the lien which has been foreclosed or which do not evidence a tenancy subject to a local rent control ordinance).

A beneficiary may elect to underbid when the beneficiary anticipates a collateral action against the debtor/trustor or a claim against a third party for part payment of the amount due and owing to the beneficiary. A beneficiary may elect to proceed with a legal action for fraud, waste or malicious destruction of the security against the debtor/trustor, or third parties, or, for example, if a casualty loss has occurred to the security property for which insurance coverage is available, a beneficiary would underbid and then file a claim against the insurer under the terms of the insurance policy to recover the cost of damage to the property as part of the amount due the beneficiary.

Liens or encumbrances, including real property taxes, which are senior to the foreclosed trust deed remain on the security property. The title is free of any right of redemption by the debtor/trustor and the debtor/trustor has no further rights or interest in the security property absent a successful legal action to set aside or void the trustee's sale. Further, a Petition in Bankruptcy may be filed by the debtor/trustor which may permit either the debtor/trustor or a trustee in the bankruptcy to void the foreclosure sale and return the security property to the estate of the debtor/trustor. Also, a transaction involving residential real property in foreclosure may be voidable and may be rescinded by the debtor/trustor within two years from the date of such transaction upon written notice if unconscionable advantage has been taken of the debtor/trustor. (See Civil Code Section 1695.14.)

The successful bidder and purchaser is entitled to immediate possession of the security property and may evict the debtor-trustor by instituting an Unlawful Detainer action subsequent to delivery of a three-day Notice to Quit. In the event the occupant is a tenant who occupies under the terms of a lease junior to the foreclosed lien and who does not occupy pursuant to any local rent control ordinance, the purchaser at the foreclosure sale may evict the tenant subsequent to the delivery of a thirty-day Notice to Vacate and thereafter, if the tenant fails to vacate, by instituting an Unlawful Detainer action subsequent to the delivery of a three-day Notice to Quit. Some attorneys recommend concurrently delivering a thirty-day and a three-day notice to tenants occupying the foreclosed property.

If a tenant occupies pursuant to a lease agreement that is senior in priority to the foreclosed lien or whose occupancy is subject to the provisions of a local rent control ordinance, the successful purchaser should seek legal advice before taking any action to evict the tenant or otherwise terminate the occupancy of the tenant. On the other hand, if the lease is subordinate in priority to the foreclosed lien, the leasehold interest may be extinguished as a result of the foreclosure sale.

Disposition of sale proceeds. The trustee distributes the foreclosure sale proceeds in the following order:

- to trustee's fees, costs and sale expenses;
- to beneficiary to satisfy the full amount of unpaid principal and interest and any charges, penalties, costs, expenses, attorney's fees, and advances that may be lawfully due and owing;
- to junior lien holders in order of priority, whether matured or not;
- any surplus to the debtor/trustor.

If either a junior lien holder or the debtor/trustor disputes the distribution of funds, the trustee should file an interpleader action and have the court decide the issue.

Foreclosure Abuses

In 1979, corrective legislation was passed aimed at home-equity purchasers and mortgage foreclosure consultants. (Civil Code Sections 1695, et seq. and 2945, et seq.) These laws provide protection for homeowners who are in default on loans secured by their residences.

Civil Code Section 1695, et seq. (Home Equity Sales Contracts) requires that a contract for the sale of a residence in foreclosure to a person (an equity purchaser) who does not intend to occupy the property contain specified provisions. The law allows rescission of such contracts under specified conditions. Further, an equity purchaser who violates Section 1695.6 or Section 1695.13 may be liable for actual damages, exemplary damages in an amount not less than three times the equity seller's actual damages, attorney's fees and costs, and equitable relief. A criminal conviction for violation of Section 1695.6 (or for any practice which operates as fraud or deceit upon the equity seller) may result in a fine of not more than $10,000 and/or a jail sentence of not more than one year.

The law establishes a presumption that a grant to an equity purchaser with an option for the equity seller to repurchase is a loan rather than a sale transaction.

Because of the specific requirements of the Home Equity Sales Contract Law, the standard real estate purchase contracts and receipts for deposits customarily used in the real estate brokerage business are not acceptable for use in home equity sales when the real property is in foreclosure. Accordingly, a real estate licensee should seek the advice of legal counsel to prepare the proper contract forms and for advice regarding the manner in which such sales must be conducted.

Civil Code Sections 2945, et seq. (Mortgage Foreclosure Consultants) address the problem of consultants who represent that they can assist homeowners who are in foreclosure, often charge high fees, frequently secure the payment of their fees by a deed of trust on the residence in foreclosure and have been known to perform no service or essentially a worthless service to the homeowner.

The law requires that contracts for services of foreclosure consultants contain specified provisions. The law allows rescission of such contracts under certain conditions and makes violation of the provisions relating to such contracts a crime.

It is illegal for any person to take "unconscionable advantage" of any property owner in foreclosure. While real estate licensees may, under certain circumstances, be exempt from the provisions of the Mortgage Foreclosure Consultants law, a licensee should proceed with an abundance of caution when dealing with owners of property where a Notice of Default has been recorded and/or a home-equity sales contract is being considered. Among other requirements, the real estate licensee must act within the course and scope of his or her license, must not accept any advance fees, and must not acquire any interest in the residence in foreclosure. Again, the real estate licensee should seek the advice of legal counsel prior to representing a seller of residential real property that is subject to a Notice of Default. Representing an equity purchaser may be difficult due to the bonding requirement because the bonds have been proven to be unavailable.

Statement of Condition of Debt

Pursuant to Civil Code Section 2943, any time before or within two months after the recording of a notice of default under a deed of trust or mortgage with power of sale, or before thirty days prior to entry of a decree of judicial foreclosure, the debtor, trustor or mortgagor or entitled person (as defined in the law) may make written demand of the beneficiary or mortgagee for a written beneficiary statement showing:

1. the amount of the unpaid balance of the obligation secured by the mortgage or deed of trust and the interest rate, together with the total amounts, if any, of all overdue installments of either principal or interest, or both;
2. the amounts of periodic payments, if any;
3. the date on which the obligation is due in whole or in part;
4. the date to which real estate taxes and special assessments have been paid to the extent the information is known to the beneficiary;
5. the amount of hazard insurance in effect and the term and premium of such insurance to the extent the information is known to the beneficiary;
6. the amount in an account, if any, maintained for the accumulation of funds with which to pay taxes and insurance premiums;
7. the nature and amount, if known, of any additional charges, costs or expenses paid or incurred by the beneficiary which have become a lien on the real property involved; and
8. whether the obligation secured by the mortgage or deed of trust can or may be transferred to a new borrower.

Section 2943 of the Civil Code also provides that the mortgagee or beneficiary may make a charge not to exceed $60 for furnishing the beneficiary statement, except when the loan is insured by FHA or guaranteed by the Department of Veterans Affairs. Whether the charge may be imposed and how much the charge may be will addressed in the deed of trust.

Within 21 days of receipt of the written demand, the beneficiary or his or her authorized agent shall prepare and deliver the statement together with a complete copy of the note or other evidence of indebtedness. In addition, if requested, the beneficiary or his or her authorized agent shall furnish a copy of the deed of trust or mortgage at no additional charge.

A penalty of $300 and liability for damages is prescribed for willful failure on the part of the beneficiary or mortgagee to deliver the statement within 21 days. The beneficiary may reasonably require that the entitled person produce evidence that they are eligible to make the request pursuant to the terms of the law and may demand payment of the fee at the time of request.

Civil Code Section 2943 was also amended to include the definition and use of pay-off demand statements as distinct from beneficiary statements. The beneficiary statement is intended to provide information when the loan may be transferred to a buyer of the security property. The pay-off demand statement details amounts owing for purposes of loan pay-off. While the beneficiary statement may not be requested subsequent to 60 days following the recordation of notice of default, the pay-off demand statement may be requested anytime except following the first publication of the notice of a trustee sale or of the hearing of a court supervised sale.

As is the case with a request for beneficiary statement, the beneficiary must respond to a request for a pay-off demand statement within 21 days of receipt and the failure of a beneficiary to timely respond may subject the beneficiary to an automatic $300 sanction plus actual damages and attorney's fees.

The fee for a pay-off demand statement is the same as the fee for a beneficiary statement. Failure to specifically identify whether the statement being requested is a beneficiary statement or a pay-off demand statement will allow the beneficiary to "default" to the pay-off demand statement.

Annual and Monthly Accounting

Under Section 2954 of the Civil Code, any mortgagor, trustor, or vendee under a mortgage, trust deed, or real property sales contract may make a written request of the lender or vendor for a statement of condition of account. A statement is to be provided within sixty days after the end of each calendar year. The statement includes an itemized accounting of money received for interest and principal repayment and received and held in or disbursed from an impound or trust account, if any, for payment of property taxes, insurance premiums, or other purposes relating to the property. The debtor is entitled to receive one statement for each calendar year without charge.

A monthly statement or passbook showing money received for interest and principal and received and held in and disbursed from an impound or trust account constitutes compliance with this requirement.

Where a written request for accounting is on file with the mortgagor, trustor, or vendee, the monthly rate of payment for impound or trust accounts cannot be increased until the itemized accounting of the condition of the account, a statement of the new monthly rate of payment, and an explanation of the factors necessitating the increase each have been furnished.

BASIC INTEREST RATE MATHEMATICS

The practice of real estate requires an understanding of the means by which we calculate values such as mortgage interest and principal, monthly payments, prorations, yields, etc. Although calculators, computers and charts will do the work, a real estate practitioner must know the underlying concepts and formulas and, indeed, may occasionally need to derive correct values without assistance.

Principal - Interest - Rate - Time

Principal is the amount of money on which interest is paid, usually the loan amount. Interest is termed "simple" or "compound." Simple interest is interest paid only on the principal owed; compound interest is interest paid on the principal plus accrued interest.

The basic simple interest formula has four components: interest (I), principal (P), rate (R) and time (T).

$I = P \times R \times T$ or $I = PRT$

To calculate one of these values, you must know the other three.

Example. Find the interest on $2500 for 7 years at 13%.

$I = PRT$

$I = \$2500 \times .13 \times 7$

$I = \$325 \times 7$

$I = \$2275$

Example. How much money must be loaned to receive $2275 interest at 13% if the money is loaned for 7 years?

I = PRT. As with any equation, if we do the same thing to both sides, it remains an equation. If we want to solve for P, we simply divide both sides of the equation by RT. Thus, I ÷ RT = PRT ÷ RT, which simplifies to I ÷ RT = P, which rearranges to:

$P = I \div RT$

$P = \$2275 \div .13 \times 7$

$P = \$2275 \div .91$

$P = \$2500$

Compound Interest

Compound interest is interest on the total of the principal plus accrued interest. For each time period, called the conversion period, interest is added to the principal to form a new principal amount and each succeeding time period has an increased principal amount on which to compute interest. Conversion periods may be monthly, quarterly, semi-annual or annual.

The compound interest rate is usually an annual rate and must be changed to "interest rate per conversion period" or "periodic interest rate." The formula to find compound interest is I = P x i, "i" being the annual interest rate divided by the conversion periods per year.

Example. How much interest will $5000 earn in 3 years if interest compounds annually at 12%?

$I = P \times i$

Because interest compounds annually, the number of conversion periods per year is 1. Therefore, $i = .12 \div 1 = .12$.

I = \$5,000 x .12

First year's interest: I = \$5,000 x .12 = \$600.

To calculate the second year's interest, we add the first year's interest to the \$5000 principal and again multiply by "i."

Second year's interest: I = \$5,600 x .12 = \$672.

To calculate the third year's principal, we add the second year's interest to \$5,600 principal and again multiply by "i."

Third year's interest: I = \$6,272 x .12 = \$752.64. Add to \$6,272 principal.

With interest compounding annually at 12%, \$5,000 will grow to \$7,024.64 (\$5,000 + \$600 + \$672 + \$752.64) in three years.

Example. How much interest will a \$1,000 investment earn over 2 years at 16% interest compounded semi-annually?

Since the conversion period is semi-annual, the periodic interest rate is 16% divided by two: i = 8%.

1.	Original principal amount	\$1,000.00
2.	Interest for 1st period (\$1,000 x .08)	<u>80.00</u>
3.	Balance beginning 2nd period	1,080.00
4.	Interest earned for 2nd period (\$1,080 x .08)........................	<u>86.40</u>
5.	Balance beginning 3rd period..	1,166.40
6.	Interest for 3rd period (\$1,166.40 x .08)...............................	<u>93.31</u>
7.	Balance beginning last period..	1,259.71
8.	Interest for last period (\$1,259.71 x .08)...............................	<u>100.78</u>
9.	Compound principal balance	1,360.49

Therefore, I for 2 years = \$1,360.49 - \$1,000 = \$360.49.

Note that annual *simple* interest would be \$40.49 less (\$1,000 x .16 x 2 = \$320 simple interest).

The One-Step Formula for Compound Interest

The above method for calculating compound interest is far too tedious for actual practice. Compound interest tables will give the answer quickly.

Further, the formula for computing compound interest is:

$S = P\ (l + i)^n$

S = the sum; the compounded amount (principal and interest)

P = the original principal amount (the present value of S)

i = the interest rate divided by the number of conversion periods per year

n = the number of conversion periods in the term

Example. You deposit $100 in a savings account paying 6% interest compounded quarterly. How much interest do you earn in one year?

S = compounded sum being sought

P = $100

i = 6% ÷ 4 = 1 1/2% = .0150

n = 4 (the number of conversion periods in the one-year term)

$S = P\ (1 + i)^n$

$S = 100\ (1 + .0150)^4$

S = 100 (1.0150) (1.0150) (1.0150) (1.0150)

S = 100 (1.0613634)

S = $106.14

The total interest is $6.14. [Simple interest ($100 x 6%) would be $6.]

Effective Rate of Interest

The "nominal" or "named" interest rate is the rate of interest stated in the loan documents. The effective interest rate is the rate the borrower is actually paying, commonly called the annual percentage rate (APR). The difference depends on how many times a year the interest is compounded. For example, 6% compounded semi-annually produces $6.09 per $100. Therefore, 6% is the nominal rate and 6.09% is the effective rate. A rate of 6% converted semi-annually yields the same interest as a rate of 6.09% on an annual basis.

Discount Rate

When the loan proceeds disbursed by the lender are less than face value (the original principal sum stated in the promissory note), the lender has deducted "up front" a loan fee and perhaps discount points as compensation for making the loan on the agreed terms. The borrower thus receives less than must be repaid under the contract. This lending practice is called "discounting." loans. Real estate lenders discount loans by collecting ‘‘points" in advance to increase yield. (Sometimes under a bank's commercial loan terms, the *total* interest is deducted in advance before the loan proceeds are given to the borrower. This method is usually associated with short-term bank loans.)

When interest tables are unavailable, it is possible to *approximate* effective interest cost when discounting occurs. Here is the procedure:

i = approximate effective interest rate (expressed as a decimal)

r = contract interest rate (expressed as a decimal)

d = discount rate (expressed as a decimal)

P = principal of loan (expressed as the whole number 1 for all dollar amounts)

n = term (years, periods, or fraction thereof)

The formula for approximating the effective rate of interest on a discounted real estate loan is written:

$i = r + [(d \div n) \div (P-d)]$

Example. What is the approximate effective interest on a $60,000 mortgage loan, with a 20-year term, contract rate of 12% per annum, if the loan is discounted 3% so that only $58,200 is disbursed to the borrower?

$$i = .12 + [(.03 \div 20) \div (1 - .03)] = .12 + .0015 \div .97 = .121546 = 12.15\%$$

Principal-Plus-Interest

Another manner of figuring interest is the Principal-Plus-Interest or the “interest extra” approach. Here the borrower makes a fixed payment on the principal each time *plus* paying the interest on the unpaid balance. Since the interest is different each time, the total payment is different each time. This method is not widely used in California in the case of first mortgages or trust deeds. It is occasionally found in secondary financing.

Types of Tables

The mathematics of financing is generally done with appropriate tables, formulas and calculators. Courses dealing with these subjects are available in most communities.

The following tables are used in real estate finance:

Amortization tables. These are commonly available in booklet form from various title companies, escrow companies, and banks. They indicate the monthly payment needed for periodic repayment of a loan, with interest.

Discount or present worth tables. Money has time value. A dollar in cash today is worth more than the payment of the same dollar a year from now. Or, to phrase it another way, a dollar to be paid in one year is worth less than a dollar paid today. But how much less? That depends on the rate of interest money would normally earn in that year. By checking a Present Worth Table we can determine how much less a payment in the future is worth today.

Proration table. This is simply a table that gives the number of days between various dates. It is used to prorate (adjust or divide between principals) items such as interest, insurance premiums, and rent.

Remaining balance table. This table shows the remaining balance of a loan expressed as a percentage of the original loan amount, using the following data: original loan amount, interest rate, age of loan, and original term of loan.

Mortgage yield tables. We use this table to determine yield on a mortgage at a specified discount or discount at a specified yield.

Balloon payment table. We use this table to determine the unpaid balance due on a loan before it has been amortized. Loans, especially second trust deed loans, often have terms of five years but are amortized over twelve or fifteen years, resulting in a lump sum (balloon) payment due at the end of five years.

Compound interest table. This table shows the six functions of $1 and annual constants for monthly payment loans. Arranged often in six columns with each column being one of the compound interest (future value) or annuity (present value) functions.

Constant annual percent tables. An annual constant is the sum of twelve (12) monthly payments expressed in percent of a principal loan amount. When multiplied times the loan amount, the annual loan payment may be determined. Remaining term of a loan, remaining loan balance, and interest rate of a loan may also be determined by use of a constant annual percent table.

Depreciation tables. These tables show the amount of depreciation that is deductible each year for properties with varying economic lives. There is usually a set for each economic life in terms of years and each set has columns devoted to the various methods of calculating depreciation (straight line, declining balance, and sum-of-the-years'-digits).

The amount of depreciation is usually expressed as a percentage of the depreciable value of the improvement.

THE TOOLS OF ANALYSIS - INCOME PROPERTY

The tools of analysis most commonly used to evaluate loan proposals for investment/income properties fall into four main categories: liquidity, leverage, activity and profitability.

Liquidity

A loan officer must determine how able a borrower is to pay bills as they come due. Current assets are compared to current liabilities. A liquidity ratio of 2 to 1 (current assets are twice the liabilities) or better is recognized as safe and acceptable by most lenders. Cash and accounts and notes receivable due within one year are "current" assets; liabilities due or payable within one year are considered "current."

Leverage

Leverage is the ability of the borrower/investor to control a large investment with a small amount of his or her own equity capital and a large amount of other people's money. The more money borrowed in relation to value of the property, the greater the leverage. Leverage tests reveal how much of the total financing for the project is supplied by the owner and how much is supplied by creditors such as the mortgage lender.

Debt-to-equity ratio. Leverage tests in connection with analysis of a borrower's financial statements are completed by comparing the owner's equity interest and the total value of the capital investment to the long term debt and the value of the total capital investment. The purpose is to find how much of the total investment is ownership and how much is debt. To determine the original equity ratio, divide the down payment by the purchase price. To determine the debt ratio, divide the loan amount by the purchase price.

It is common for equity investors to seek debt ratios in excess of 75-80%. Lenders, looking at risk factors, carefully scrutinize loan proposals to assure a safe equity ratio based on property characteristics and borrower's repayment record. The rule of thumb ratio for debt to equity ratio will be something between 3:1 and 4:1. The borrower often wants a more extreme ratio because it reduces the amount of his or her own money that is being risked. Real estate investment examples have been presented where ratios of 1 to almost 0 are achieved by borrowers. This is usually a very dangerous situation for the lender. An exception of course would be where the repayment of the loan is guaranteed or insured by some reputable third party in the transaction, such as the FHA or VA or a financially strong company such as a major chain store or oil company.

Some lenders are willing to risk entering a high debt to equity loan situation in anticipation of market prices going up, which automatically achieves growth in the owner's equity and a more moderate ratio is automatically achieved. Experience has repeatedly shown that this expectation is not always borne out, especially in unstable economic conditions.

Coverage of fixed expenses is a test of how many times net income before income taxes and fixed expenses (gross income minus operating expenses) will cover the fixed expenses. It reveals how low income can drop before the property (or the borrower) will be unable to meet the fixed expenses such as real estate taxes, insurance, license and permit fees.

Net income after operating expenses is divided by fixed expenses to get this ratio. If the ratio is 1:1, the net income after operating expenses is just barely able to cover the fixed expenses.

Activity

Activity tests are designed to reveal just how hard and effectively assets are working. There are several tests for this but the most widely used is the income to total asset ratio. This ratio is found by dividing total income by the value of total assets.

Profitability

Profitability tests are designed to see how much net profit results from the operation. The following are several of a variety of ratios and tests that are used to inquire into profitability.

Return on net worth. This is the ratio of net profit (after taxes) to the net worth of the project. This will yield a percentage return on investment which can be compared with the return available from other investments of comparable risk.

Yield analysis. This is a form of analysis well suited to determining profitability of real estate projects because it is relatively easy to compute and takes into consideration three factors unique in their combination to real estate investment: cash return, equity return, and tax shelter.

It involves dividing the total return (net spendable cash income, principal reduction of mortgage loans, and tax shelter) by the investor’s equity.