

California Real Estate Finance
Chapter 9
Instruments of Real Estate Finance

Chapter Purpose

This chapter is the first of three chapters that answers the question *How do I get a loan?* It presents the broad legal aspects of pledging real estate as collateral for a loan. It describes the various interests secured by a real estate loan. This chapter also examples the components of the three basic instruments of real estate finance—the note and deed of trust, the note and mortgage and the real property sales contract—and analyzes the special provisions available for designing each to satisfy the participants’ specific requirements. It introduces the student to the legal implications of promises, obligations and responsibilities established between the parties to a loan.

Suggestions to the Instructor

Although somewhat technical, the material in this chapter is essential to a student’s understanding of real estate finance. It is important to point out the differences among the three instruments as they pertain to borrowers’ and lenders’ rights. For instance, the note and mortgage format is very much a borrower-oriented instrument, since those states using this form have adopted relatively long redemption periods. The note and mortgage form is used mainly in agrarian states. On the other hand, in California, the widespread use of the deed of trust reduces redemption periods to as little as 120 days, while in some circumstances, the real property sales contract can be foreclosed in 30 days.

Additional effort should be made to explain that, although the creation of a real property sales contract appears to be relatively simple, it does, in fact, create a complicated relationship among parties.

Learning Objectives

Upon completion of this chapter, the student should be able to:

1. list the interests secured by a real estate loan, including fee simple as well as less-than-freehold interests;
2. understand the ramifications of title versus lien theories of real estate finance, as well as the modified lien theory as exemplified by the use of the deed of trust;
3. describe the anatomy and use of a deed of trust;
4. define a note and mortgage and a real property sales contract and describe their uses;

5. understand the legal relationships between borrowers and lenders under the three forms of finance;
6. differentiate between senior and junior loans;
7. describe the special provisions available to be included in all the finance forms to satisfy the requirements of the participants.

Presentation Outline

- I. Why Lenders Insist on a Priority Lien
 - A. A lien as an encumbrance
 1. Physical encumbrance
 - a. easements
 - b. public and private restrictions
 - c. encroachments
 2. Financial encumbrances
 - a. voluntary vs. involuntary
 - b. general vs. specific
 - c. mortgage as an example of a specific voluntary lien
 - B. Priority of lien position
 1. Tax liens
 2. Mechanic's and materialmen's liens
 3. Mortgage liens
 - C. Priority lien established by requiring a first mortgage or first deed of trust
 1. First in time, first in right
 - a. lenders establish their priority lien positions according to the date when their loan documents are recorded
 - b. the recording process establishes lien priorities and gives legal and constructive notice to the public
 2. To be in senior position means that the lender is entitled to receive all foreclosure proceeds from the public sale of property
- II. Interests Secured by a Real Estate Loan
 - A. Ownership interests
 1. Fee simple ownership
 2. Less than fee simple ownership
 3. Personal property, trade fixtures
 - B. Title theory of finance
 1. Lender's rights emphasized
 2. Lender remains legal fee owner of collateral
 3. Borrower acquires equitable ownership
 - C. Lien theory of finance
 1. Borrower's rights emphasized
 2. Borrower is legal title holder of collateral
 3. Lender acquires equitable interest in property

4. Defaulted borrower allowed to retain possession, title and rights in property until lien is perfected by foreclosures
 5. After foreclosure, borrower has rights of redemption, up to two years
- D. Intermediate theory
1. Borrower is trustor
 2. Lender is beneficiary of trust
 3. Holder of deed is trustee
 4. Trustee may also be beneficiary in California
 5. After loan is paid in full, borrower regains legal title
- E. General requirements for a finance instrument
1. Formalized in writing
 2. Adequate consideration
 3. Accurate legal description
 4. Loan repayment details
 5. Legally competent parties
 6. Signatures properly attested
 7. Adequate consideration
- III. Note and Deed of Trust
- A. Definitions
1. Borrower (trustor) transfers title together with a power of sale to trustee to hold for beneficiary
 2. Trustee collects payments and forwards to beneficiary
 3. In the event of a default, trustee pursues foreclosure
 4. Redemption after the foreclosure is eliminated under power of sale in deed of trust form of financing
 5. Used almost exclusively in California
- B. Note secured by a deed of trust
1. Date signed
 2. Participants' identities
 3. Promise to pay
 4. Payment due dates
 5. Amount and terms
 6. Reference to security
 7. Signatures and endorsements
 8. Cosigners
- C. Deed of trust
1. California deed of trust
 - a. identifies parties to the trust
 - b. conveys "title" to trustee
 - c. describes property being pledged
 - d. repeats terms and conditions of note

- e. refers to “fictitious” deeds of trust recorded previously
 - (1) AKA “master trusts”
 - (2) comprehensive documents defining the borrower and lender relationship under a deed of trust
 - (3) too cumbersome to reproduce each time so merely referred to in each new loan transaction
- 2. Thirteen covenants
 - a. preservation and maintenance
 - b. fire insurance
 - c. legal action
 - d. taxes and assessments
 - e. beneficiary and trustee expenditures
 - f. condemnation
 - g. late payments
 - h. reconveyance
 - i. extensions, subordination and modification
 - j. assignment of rents
 - k. acceleration
 - l. successors and assigns
 - m. trustee acceptance

IV. Note and Mortgage

- A. Note secured by mortgage
 - 1. Terms and conditions of loan specified in note
 - 2. Provisions for future advances and acceleration also included
 - 3. Only one copy to be signed by borrowers
 - 4. To be attached to mortgage
- B. Mortgage
 - 1. Participants
 - a. mortgagor
 - b. mortgagee
 - 2. Pledge
 - a. granting clause
 - b. “grant, bargain, sell and convey”
 - c. benefits “successors, heirs and assigns”
 - 3. Property description
 - 4. Covenant of Seisan
 - a. mortgagors have legal title
 - b. mortgagors can pledge title as collateral
 - 5. Note attachment
 - a. note is promise to pay
 - b. mortgage is lien on property to back up note
 - 6. Mello-Roos Disclosure
 - a. tax levied on some properties
 - b. assessed on land value
 - c. to generate funds for public improvements

7. Property taxes
8. Insurance
9. Defeasance and acceleration
 - a. mortgagor will regain clear legal title when loan repaid
 - b. total amount of loan balance is due in full in the event of a default
10. Maintenance of the collateral
11. Signatures and acknowledgement
12. Release of mortgage

V. Real Property Sales Contract (Land Contract)

A. Definition

1. Usually a junior loan when buyer does not have sufficient cash or credit to secure a senior loan
2. Both a sales agreement and financing instrument in one contract
3. Seller-lender-vendor retains legal right
4. Buyer-borrower-vendee receives equitable title

B. Terms of contract

1. Payments and interest rate
2. Existence of underlying loans (wraparound)
3. Escrow collection service
 - a. collects and disburses payments
 - b. keeps records
 - c. third-party holder of the deed
4. Foreclosures follow mortgage procedures requiring judicial foreclosure proceedings

VI. Special Provision in Real Estate Finance Instruments

A. Clauses to preserve a lender's yield

1. Late payment penalty
 - a. imposed after 10 days of delinquency
 - b. fee a percent of the payment or a flat charge
 - c. constant late penalties jeopardizes credit
2. Prepayment privilege
 - a. loan can be paid in full at any time without cost if no prepayment penalty specified
 - b. some loans allow a portion to be prepaid
3. Prepayment penalties
 - a. if paid sooner than schedule, some loans include a penalty fee
 - (1) a percentage of the loan balance
 - (2) six month's interest
 - b. often waived if refinanced with same
 - c. FHA, DVA, Fannie Mae and Freddie Mac have no prepayment
 - d. Cal-vet imposes a six month's interest prepayment penalty

- e. Article 7, 10242.6 California Real Estate Law allows a six month's interest prepayment penalty on single-family, owner-occupied homes on any amount of principal paid in excess of 20% of the loan balance up to 7 years from the loan's inception. No penalties allowed after 7 years. No penalties allowed on dwellings damaged by natural disasters.
- 4. Lock-in clause
 - a. cannot repay a loan before its due date
 - b. preserves high interest rate yields
 - c. some loans include no prepayment for specified time, then penalty for another time span and finally pay off any time thereafter
- B. Clauses to preserve a lender's safety
 - 1. Due-on sale clause
 - a. stipulates that borrower cannot sell or transfer collateral without prior written permission from the lender
 - b. if so, balance of loan becomes immediately due and payable
 - c. lender's may give permission but usually require credit approval and assumption fee
 - 2. Assumption versus subject-to
 - a. if no due-on-sale clause, loan is fully assumable
 - b. assumption puts new borrower in a position of liability along with the maker of the note and everyone else who had assumed
 - c. buying subject-to eliminates new borrower's liability
 - d. full substitution of liability on assumption called novation
- C. Other Clauses
 - 1. Subordination
 - a. places existing loan in lower priority to new loan
 - b. can be used land lease to subordinate fee simple ownership of landlord to new loan
 - 2. Release clause
 - a. used with blanket loans
 - b. to release one parcel from over-all lien
 - 3. Extensions and modifications
 - a. allows changes to be made over term of loan
 - (1) variable payment loans
 - (2) variable interest rate loans
 - (3) open end loans
 - (4) loans in trouble
 - b. problems of intervening lien priorities