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Carryback checklist

This is a guide of the disclosure aspects to be considered by agents, buyers and sellers in a carryback sale transaction.

Buyer credit checks — Accurate credit information on the buyer helps in the analysis of the risk of default on the carryback note and failure to maintain the property set by the trust deed. [See Chapter 4]

Carryback tax advantages — The seller automatically reports their profit on the carryback note over several years instead of entirely in the year of sale. However, tax knowledge of imputed interest rates, debt relief, assignments, all-inclusive trust deed (AITD) collection agents, alternative minimum tax (AMT), unrecaptured gains rate, tax reporting elections, etc., is required. [See Chapter 26]

Collateral assignment — Instead of selling the carryback note, the carryback seller may borrow against it, hypothecating the note and trust deed and triggering the payment of taxes on carryback profits. [See Chapter 8]

Co-owners, co-signers and guarantors — When the seller negotiates for third-party promises to pay or acquire the carryback note on a default, a guarantee agreement needs to be considered. [See Chapter 9]

Due-on sale restrictions —The carryback seller is advised to negotiate a waiver of the mortgage holder's due-on rights contained in the underlying trust deed. [See Chapter 11 and 12]

Foreclosure: 3 months, 21 days — The carryback seller's trust deed allows their to foreclose on the property by a trustees sale, a quick and efficient method, consuming at least 111 days once the process is started by recording a Notice of Default (NOD). [See Chapter 5]

Foreclosure and resale costs — If the buyer default on the carryback note, in addition to recovery of the cost to foreclose and resell the property, the seller may be unable to recover the total amount of the note due to waste. [See Chapter 21]

Imputed interest rates — If the interest rate charged on the carryback note is less than the note's Applicable Federal Rate (AFR), the seller reports interest income as though they charged the minimum rate and the mortgage balance as offset by the imputed interest. [See Chapter 25]

Land sales contracts and purchase-lease-options — The seller is advised to use a note and trust deed as the security device for the carryback sale. Other security devices such as land sales contracts and lease-options create misunderstandings, blurring the buyer's and seller's rights in title to the property.

Late charge enforcement — Late charges on carryback notes are governed by different rules for different types of property, some permit percentage formulas and others allow only out-of-pocket dollar losses.

Lock-in clauses — A mortgage lock-in clause is an unenforceable restraint on an owner's right to refinance their property, except in special circumstances. Enforceable prepayment penalties typically meet the same objective as sought by the use of a lock-in clause. [See Chapter 25]

No downpayment carryback sales —The seller who accepts a carryback note without a cash downpayment needs to be adequately secured by additional security and guarantees, or they assume a high risk of loss. [See Chapter 19]

Notices of Default and Delinquency — The seller needs to record and serve a Request for Notice of Default (NOD) and Notice of Delinquency (NODq) on all senior mortgage-holders. [See Chapter 5]

Partial release of security — A partial release addendum allows a buyer of two or more lots to resell individual lots either free of a blanket carryback trust deed or subject to it. The partial release terms need to be fair to the seller and complete in their terms to be enforceable by the buyer. [See Chapter 13]

Prepayment penalties — Sellers carryback paper to avoid profit taxes until the year the principal on the note is reduced. A prepayment penalty, not a lock-in clause in the carryback note and trust deed, meets sellers' tax reporting objectives by shifting the amount of taxes due on early pay off to the buyer.

Profit on repossession — Unlike a money lender, if the carryback seller has to foreclose and take back the property, no profit is reported except for any net proceeds from the downpayment or installments of principal not previously taxed. [See Chapter 21]

Sale of the carryback note — A carryback seller, intending to later dispose of the paper for cash or in an exchange, need to consider the most marketable mortgage documentation and payment terms negotiable for the note and trust deed. On the sale of the paper, a carryback seller needs to consider which method of assignment imposes the greatest liability on them if the borrower defaults. [See Chapter 6]

Shared appreciation mortgage — A seller may structure their carryback note as a shared appreciation mortgage (SAM) with both a low, fixed-rate interest and an additional contingent interest consisting of a percentage of either the property's future net appreciated value or the note balance. [See Chapter 7]

Subordination agreements — The seller may agree to subordinate their carryback trust deed to a mortgage to finance either the purchase price or a construction project. The subordination agreement needs to provide adequate safeguards regarding the terms of the mortgage to which the carryback seller will subordinate their carryback trust deed. [See Chapter 17]

Tax service — For an annual fee, a tax service can advise the seller whether the real estate taxes on the secured property have been paid.

The all-inclusive trust deed — When the seller wraps a senior trust deed with an all-inclusive trust deed (AITD), the seller retains responsibility for the underlying mortgage, the remaining balance of which is included in the amount of the AITD note. Responsibility for due-on acceleration, prepayment penalties, late charges and future advances are passed on to the buyer. An AITD can provide the seller with an interest rate override and, taxwise, avoids mortgage-over-basis debt relief and year-of-sale taxes. [See Chapter 13, 14 and 15]

The secured assumption agreement — A buyer's assumption of existing mortgages on the property sold may be entered into with the seller, not just the mortgage holder, and needs to be secured by a trust deed carried back on the property if the seller's equity is cashed out. [See **RPI** Form 432]

Underlying ARM loans — When the seller wraps an adjustable rate mortgage (ARM) with an all-inclusive trust deed (AITD), the interest rate on the AITD needs to conform to the variable rate on the wrapped morgage. This allows the seller to pass on to the buyer any increases in the interest rate on the underlying ARM.

Usury on modification — A carryback note is never subject to usury law limits on the rate of interest charged.

Waste and non-recourse notes — If the buyer neglects to maintain the property, resulting in a decrease in its value, the seller may foreclose and acquire the property by their underbid, then recover their losses due to waste, even though a deficiency is barred on the carryback note. [See Chapter 10]

Chapter 1

Carryback financing in lieu of cash

Learning Objectives

After reading this chapter, you will be able to:

- comprehend the financial benefits afforded sellers and buyers who enter into seller carryback finance arrangements;
- identify the seller's financial risks involved in carryback financing;
- advise on the various forms of documentation used to structure seller financing; and
- explain the tax advantages available to a seller for carrying back a portion of the sales price.

Key Terms

all-inclusive trust deed (AITD) note

nonrecourse mortgage

portfolio category income

private mortgage insurance (PMI)

seller financing

Seller financing supports the price

When mortgage money is plentiful and readily accessible, lenders are eager to make loans to nearly every buyer. This is the case no matter the type of property sought, its location or the buyer's creditworthiness.

However, when the availability of mortgages tightens, loan approvals become more elusive. Further, the definition of a "qualified buyer" becomes more restrictive. A seller hoping to locate a buyer amenable to the seller's asking price during a tight mortgage market needs to consider **seller financing**.

seller financing
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing. Also known as an installment sale, credit sale or carryback financing.

Seller financing is also known as:

- an installment sale;
- a credit sale;
- carryback financing; or
- an owner-will-carry (OWC) sale.

Seller financing occurs when a seller carries back a note and trust deed executed by the buyer to evidence a debt owed for purchase of the seller's property. The amount of the debt is the remainder of the price due to the seller after deducting:

- the down payment; and
- the amount of any existing or new mortgage used by the buyer to pay part of the price.

Rights and obligations

On closing, the rights and obligations of real estate ownership held by the seller are shifted to the buyer. Concurrently, the seller carries back a mortgage, taking on the rights and obligations akin to that of a mortgage holder.

Editor's note — Before making, offering or negotiating consumer mortgages for compensation, California brokers and agents need to first obtain a mortgage loan originator (MLO) license endorsement on their California Bureau of Real Estate (CalBRE) license. A consumer mortgage is a consumer-purpose loan secured by a one-to-four unit residential property.

A broker offering or negotiating a carryback consumer mortgage as part of a home sale transaction triggers the MLO license endorsement only if the broker or agent receives separate additional compensation for arranging the carryback, a fee beyond the fee collected for their role as seller's agent or buyer's agent in the real estate transaction.[1]

Marketing property: the seller will carry

The seller who offers a convenient and flexible financing package to prospective buyers makes their property **more marketable** and **defers the tax bite** on their profits.

Qualified buyers are willing to pay a higher price for real estate when attractive financing is available. This holds true regardless of whether financing is provided by the seller or a lender. For most buyers, the primary factors when considering their purchase of a property is:

- the amount of the down payment; and
- the monthly mortgage payments.

Seller's agents use these circumstances to inform their sellers about pricing arrangements in hyper-competitive buyer's markets.

1 Calif. Business and Professions Code §10166.01(b)(1)

Buyer willingness is especially apparent when the interest rate on the carryback mortgage is equal to or below the rates competitive lenders are charging on their purchase-assist loans. The lower the interest rate, the higher the price may be.

Flexible sales terms for the buyer

Seller financing also provides tangible benefits for buyers. For buyers, seller carryback financing generally offers:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification and documentation than imposed by traditional lenders; and
- no origination costs or lender processing hassle.

Lenders automatically require a minimum down payment of 20% if the buyer is to avoid **private mortgage insurance (PMI),** which adds over one percent to annual mortgage costs and reduces the maximum amount a homebuyer can borrow. Further, **Federal Housing Administration (FHA)**-insured mortgages include a **mortgage insurance premium (MIP)** regardless of the **loan-to-value (LTV)**.

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without the outside influences a traditional mortgage broker and buyer have to contend with.

Additionally, a *price-to-interest rate tradeoff* often takes place in the carryback environment. The buyer is usually able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price.

Tax benefits and earnings for the seller

Taxwise, it is preferable for a seller to carry back a portion of the sales price, rather than be cashed out when taking a significant taxable profit. [See Chapter 26]

The seller, with a reportable profit on a sale, is able to defer payment of a substantial portion of their profit taxes until the years in which principal is received from the buyer. When the seller avoids the entire profit tax bite in the year of the sale, the seller earns interest on the portion of the note principal that represents the tax not yet due and payable.

If the seller does not carry a note payable in future years, they will be cashed out and pay significant profit taxes in the year of the sale (unless the profit is exempt or excluded from taxation, such as occurs in a §1031 transaction).

What funds the seller has left after taxes are reinvested in some manner. These *after-tax sales proceeds* will be smaller in amount than the principal on the carryback note. Thus, the seller earns interest on the net proceeds of the carryback sale before they pay taxes on the profit allocated to that principal.

The tax impact the seller receives on their carryback mortgage is classified as **portfolio category income**. This is the case regardless of the fact the property sold was in another income category (passive/business/personal).

Proper documentation for carryback financing

portfolio category income
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

On closing the sale, the seller financing may be documented in a variety of ways. Common mortgage arrangements include:

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive. [See Chapter 2]

Legally, the **note and trust deed** provide the most certainty. Further, they are the most universally understood of the various documents used to structure seller financing. In this arrangement, **carryback documentation** consists of:

- a *note* executed by the buyer in favor of the seller as evidence of the portion of the price remaining to be paid for the real estate before the seller is *cashed out* [See **RPI** Form 421]; and
- a *trust deed lien* on the property sold to secure the debt owed by the buyer as evidenced by the note. [See **RPI** Form 450]

The note and trust deed are legally coupled. They are inseparable and function in tandem. The note provides evidence of the existence of the debt owed but is not filed with the County Recorder. The trust deed creates a *lien* on property as the source for repayment of the debt in the event of a default by the buyer. Together, they are referred to as a **mortgage**.

In addition, when the seller carries back a note executed by the buyer as part of the sales price for property containing one-to-four residential units, a **financial disclosure statement** needs to be prepared and handed to the buyer and seller. This statement is prepared by the broker who represents the person who first offers or counteroffers on terms calling for carryback financing.[2] [See **RPI** Form 300]

Regular and all-inclusive notes and trust deeds

The carryback note and trust deed may be structured in *regular* or *all-inclusive* terms to meet the financial needs of the buyer and seller. [See Chapter 13]

For instance, if the real estate is encumbered by a mortgage which a qualified buyer may **assume** with the mortgage holder, the seller may carry back a regular note secured by a second trust deed. The note will be for the balance of the seller's equity which remains unpaid after deducting the buyer's down payment.

2 Calif. Civil Code §2956

However, if the mortgage holder for the existing mortgage will not allow the mortgage to be assumed, the buyer may arrange a new mortgage to pay off the existing mortgage. Here, the lender of the new mortgage will need to approve of the seller carrying back a second mortgage.

Often, the seller's borrowing power is greater than the buyer's. Here, the seller may choose to refinance the existing mortgage on the property themselves and withdraw a portion of their equity by taking out a new mortgage on the property.

With the property properly financed, the buyer assumes the new mortgage and the seller carries back a regular note and second trust deed for the remainder of their unpaid equity in the property.

The wraparound security device and debt relief

An alternative mortgage is available to reduce the seller's risk of loss and defer more profit taxes than a regular second mortgage. This alternative is referred to as an **all-inclusive trust deed (AITD)**, also called a **wraparound mortgage** or **overriding note**. [See Chapter 14]

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

In an *AITD* carryback arrangement, the amount owed to the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property.

However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment. A regular note is limited to the amount of equity remaining unpaid after the down payment.

Thus, the AITD *"wraps"* the senior mortgage by including the dollar amount of the first mortgage in the principal amount of the all-inclusive note. The buyer makes payments to the seller on the all-inclusive note.

In turn, the seller continues to remain responsible for making payments on the senior mortgage from payments received on the AITD.

Carryback risks and responsibilities of the seller

A carryback seller assumes the **role of a lender** at the close of the sales escrow. This includes all the risks and obligations of a lender holding a secured position in real estate — a mortgage. [See Figure 1; see Chapter 4]

Being a mortgage holder is a fundamental real estate concept the seller's agent needs to understand when advising their seller on the nature and consequences of carrying a mortgage. Most sellers of homes are wage earners and are aware of debt obligations. However, few are aware of the management responsibilities of a person whose income is derived from the ownership of assets (the note), a *rentier* rather than one gainfully employed.

Figure 1

Federal and state Reg Z carryback exemptions

When a mortgage on a one-to-four unit residential property funds a consumer purpose, such as the acquisition of a buyer's family home or vacation home, it is classified as a ***consumer mortgage*** *and comes within the purview of federal* ***Truth-in-Lending Act (TILA) and Regulation Z (Reg Z)*** *rules. [12 Code of Federal Regulations §§1026 et seq.]*

Carryback sellers (and lenders) are not controlled by the federal Reg Z disclosure and ***ability-to-repay*** *rules when:*

- *they make five or less carryback consumer mortgages per calendar year;*
- *the terms of the carryback financing do not include a prepayment penalty; and*
- *the seller is not paid a fee for providing the carryback mortgage. [12 CFR §1026.43(c)(1); 12 CFR §1026.2(a)(17)(v)]*

Thus, until the seller's quantity (more than five) and terms (inclusion of a prepayment penalty) of carryback consumer mortgages subjects them to Reg Z, they may carryback a consumer mortgage without regard to federal requirements.

Further, a critical licensing and endorsement distinction exists between carryback sellers and ***mortgage loan originators (MLOs)****.*

An MLO is any person who charges a fee to make or arrange a consumer mortgage. For example, this includes a lender or broker who receives a fee, separate from a transaction agent's (TA's) fee on a sale, for arranging a purchase-assist mortgage (a loan or a carryback) for a buyer-occupant of a one-to-four unit residential property. These fee-based consumer mortgage arranging activities are controlled by state law regarding the need to be licensed by the California Bureau of Real Estate (CalBRE) and MLO-endorsed. [Official Staff Commentary to 12 CFR §1026.36(f)-3]

However, California rules only compel persons who ***arrange loans*** *for a fee to hold a CalBRE license, and if the loan arranged is a consumer mortgage, to also hold an MLO endorsement.*

Seller carryback consumer mortgages are not loans. Thus, carryback sellers are exempt from California's ***Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)*** *licensing and MLO endorsement requirements for consumer mortgages – even when the quantity and terms of a seller's carryback activity are considered a consumer mortgage under federal law. [Calif. Business and Professions Code §10166.01(d)]*

Risks of loss

Above all, the seller's agent needs to confirm the seller appreciates why they are receiving a **trust deed** as a lien on the property sold. The secured property described in the trust deed serves as collateral. It is the seller's sole source of recovery to mitigate the **risk of loss** on a default by the buyer. [See Chapter 4]

Another implicit risk of loss for mortgage holders arises when the property's value declines due to deflationary future market conditions or the buyer committing **waste**. The risk of *waste*, also called **impairment of the security**, is generally overlooked during boom times due to rising property values.

However, a decline in property value during recessionary periods due to the buyer's lack of funds — the vicious part of the business cycle — poses serious consequences for the seller when the buyer defaults on the payment of taxes, assessments, insurance premiums or maintenance of the property.

Thus, costs incurred to foreclose and resell property may quickly turn a sale from a low-down payment, high-interest-rate note into a cash drain for the seller. This is a potential condition any seller's agent needs to advise their seller on, prior to the seller agreeing to carry back a mortgage.

Concerns about the buyer's default

On a default by the buyer, the carryback seller may find themselves returned to their original position — owning property they do not want. Financially, they will own it subject to a senior mortgage. In the end, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property (taxes, insurance, maintenance and senior mortgage payments);
- any reduction in property value;
- reassessment to current value triggered by both the sale and foreclosure;
- a modified (higher) interest rate on the senior mortgage (foreclosure also triggers the due-on clause); and
- profit taxes on any previously untaxed principal received from the down payment and in amortized monthly payments. [See **RPI** Form 303]

Also, the seller needs to understand a carryback note secured solely by a trust deed lien on the property sold is a **nonrecourse mortgage**. Thus, the seller will be barred from obtaining a money judgment against the buyer for any part of the carryback mortgage not satisfied by the value of the property at the time of foreclosure — the unpaid and uncollectible deficiency.[3] [See Chapter 4]

nonrecourse mortgage
A mortgage subject to anti-deficiency laws which do not permit the mortgage holder (lender or carryback seller) to pursue a borrower to collect any loss due to a deficiency in the value of the secured property on foreclosure or a short payoff.

However, as with any lender, if the **risk premium** built into the price, down payment, interest rate and due date on the carryback note is sufficient, the benefits of carryback financing equal or outweigh the risks of loss.

3 Calif. Code of Civil Procedure §580b

Chapter 1 Summary

Seller financing, also known as carryback financing, occurs when the seller carries back a note for the unpaid portion of the price remaining after deducting the down payment and the amount of the mortgage the buyer is obtaining or assuming.

The seller who offers a convenient and flexible financing package to prospective buyers makes their property more marketable and defers the tax bite on their profits.

Qualified buyers are willing to pay a higher price for real estate when attractive financing is available.

For buyers, seller carryback financing generally offers:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification than those imposed by lenders; and
- no origination costs.

Seller financing is documented in a variety of ways, including:

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes.

Legally, the note and trust deed provide the most certainty. Further, they are the most universally understood of the various documents used to structure seller financing. The note and trust deed, referred to as a mortgage, are legally coupled.

A carryback seller assumes the role of a lender at the close of the sales escrow. This includes all the risks and obligations of a lender holding a secured position in real estate.

The secured property described in the trust deed serves as collateral. It is the seller's sole source of recovery to mitigate the risk of loss on a default by the buyer.

Another implicit risk of loss for mortgage holders arises when the property's value declines due to deflationary future market conditions or the buyer committing waste.

As with any lender, if the risk premium built into the price, down payment, interest rate and due date on the carryback note is sufficient, the benefits of carryback financing equal or outweigh the risks of loss.

Chapter 1 Key Terms

Chapter 2

The carryback purchase agreement

Learning Objectives

After reading this chapter, you will be able to:

- understand how to use installment sale provisions in a purchase agreement to negotiate the financing of a sale supported by the seller carrying back a mortgage;
- calculate and document the savings a buyer will realize on the proposed carryback transaction;
- determine when to use the statutory Carryback Disclosure Statement on an installment sale; and
- prepare a conventional purchase agreement to submit a buyer's written offer to purchase one-to-four unit residential property using conventional financing, an assumption of existing mortgages and a carryback mortgage.

Key Terms

listing agreement

subordination agreement

property profile

Negotiating the terms for seller financing

Consider a buyer who contacts a real estate agent to assist them to locate and purchase an income-producing four-unit residential property.

The agent obtains information about the buyer's financial status and general description of the real estate desired and the terms of its purchase — price and financing — preferred by the buyer.

The buyer is able to make a down payment of $100,000 and is prequalified to originate or assume a mortgage up to $1,100,000.

listing agreement
A written employment agreement used by brokers and agents when an owner, buyer, tenant or lender retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

Before the agent begins to locate suitable property, the agent presents the buyer with a fully prepared **Buyer's Listing Agreement**, also called a *written retainer agreement*, for review and signatures. [See Form 103 accompanying this chapter]

The agent explains the written retainer agreement is a requisite to their receiving full recognition from other brokers and agents of the existence of their agency relationship with the buyer. When authorized by a listing agreement to act on their buyer's behalf, sellers' brokers and agents readily provide the buyer's agent with information (disclosures) on their listed properties for review and analysis by the buyer and their agent. [See Form 103]

The buyer enters into the *Buyer's Listing Agreement*. Under the listing, the buyer's agent and their broker are obligated to work diligently to locate property on behalf of the buyer. In exchange, the buyer's agent will receive a fee, documented under the enforceable fee arrangement in the listing.[1] [See Form 103 §4]

Suitable property located

Continuing our previous example, the agent locates a property that meets the financial objectives and preferences of the buyer.

The listed sales price for the property is $1,100,000. After the agent's cursory review of the property's features with the buyer, the buyer requests more information about the condition of the property. The agent gathers all the basic property disclosures from the seller's agent. The buyer then reviews the disclosures with their agent to decide whether to make an offer and on what terms. [See **RPI** Form 304]

After receiving and reviewing the property disclosures, but before discussing the condition of the property and the purchase terms with their buyer, the agent prepares a *purchase agreement*. The proposed offer takes into consideration the buyer's financial condition and expectations known to the agent as a result of their prior *counseling* with the buyer. Over the course of their consultation, the agent learns the buyer is not risk averse.

The agent is ready to discuss the merits and reasons for entering into the proposed offer with the buyer. Together, the buyer and agent will mold the final purchase offer which will be signed and submitted to the seller. [See Figure 1, excerpt from **RPI** Form 150]

Installment sale provisions

The agent, on investigation, learns the seller received one other offer to purchase from a different buyer since they listed the property. It was a cash-out offer for $850,000, but called for the seller to pay all of the buyer's nonrecurring financing charges and closing costs. The seller countered at $900,000, calling for the buyer to pay their own costs and charges. The buyer rejected the counter offer and withdrew from further negotiations with the seller.

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1 **Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247

The property is encumbered with an existing mortgage of $450,000, at a fixed rate of 5.5% interest, fully amortized with 25 years remaining. The seller's agent failed to include the financing in the multiple listing service (MLS) data on the property, but supplied it on request by the buyer's agent.

Interest charged on a new mortgage the buyer qualifies for is currently at an interest rate of 7.25%, whether fixed or variable. Thus, the difference in payments between the existing mortgage and a new mortgage is nearly $6,000 in annual savings, comprised entirely of interest.

The buyer's agent recommends the buyer offer the seller $900,000 — the amount of the seller's counter offer to the previous buyer. However, in lieu of obtaining a new mortgage, the buyer's agent suggests the offer include an *assumption of the existing mortgage* and *seller carryback financing*.

Terms of the offer

Based on a review of recent comparable sales in the area, the buyer's agent informs the buyer the cash value of the property is probably less than $900,000. However, the agent notes that sellers typically resist trends in weakening prices, causing prices to be "sticky" in deteriorating markets in spite of fewer prospective buyers.

The terms suggested by the agent include savings to offset the higher price. These savings are due to:

- lower monthly payments and interest rate charges than those for a new mortgage;
- greater mortgage reduction (amortization);
- avoidance of new financing charges; and
- a reduction of the seller's closing costs by avoiding a prepayment penalty on the payoff of their mortgage.

The buyer's savings over the first five years of ownership will be approximately $36,000, which effectively places the *present worth* of the property below $900,000.

Terms for payment of price

The terms proposed by the buyer's agent for payment of the $900,000 price include:

- a cash down payment of $100,000;
- a takeover of the $450,000 existing mortgage on the property; and
- a carryback note for $350,000 executed by the buyer in favor of the seller, secured by a trust deed on the property.

The terms for payment of the $350,000 carryback note include:

- a 4.5% interest rate;
- a monthly payment (a 17-year and nine-month amortization schedule based on retaining the monthly payment equal to a 30-year amortization schedule at 7.25%); and

Form 103

Buyer's Listing Agreement

BUYER'S LISTING AGREEMENT

Exclusive Right to Buy, Exchange or Option

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: This form is used by a buyer's agent when employed by a prospective buyer as their sole agent, to prepare an offer to render services on behalf of the buyer to locate and acquire property for a fixed period of time.

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Buyer hereby retains and grants to Broker the exclusive right to locate real property of the type described below and to negotiate the terms and conditions for its purchase, lease or option, acceptable to Buyer, for the period beginning on ____________, 20_____ and terminating on ____________, 20_____.

2. BROKER'S OBLIGATIONS:

2.1 Broker to use diligence in the performance of this employment.

3. GENERAL PROVISIONS:

3.1 Buyer acknowledges receipt of the Agency Law Disclosure. [See **RPI** Form 305]

3.2 Buyer authorizes Broker to cooperate with other brokers and divide with them any compensation due.

3.3 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

3.4 The prevailing party in any action on a dispute will be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

3.5 This agreement will be governed by California law.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

4.1 Buyer agrees to pay Broker ☐ __________% of the purchase price, or ☐ ______________, IF:

a. Buyer, or any person acting on Buyer's behalf, purchases, leases, exchanges for or obtains a purchase option on real property sought under this agreement during the retainer period.

b. Buyer terminates this employment of Broker during the listing period.

c. Within one year after termination of this agreement, Buyer enters into negotiations which result in Buyer's acquisition of an interest in any property Broker has solicited information on or negotiated with its owner, directly or indirectly, on behalf of Buyer prior to this agreement's termination. Broker to identify prospective properties by written notice to Buyer within 21 days after termination. [See **RPI** Form 123]

4.2 Buyer's obligation to pay Broker a brokerage fee is extinguished on Broker's acceptance of a fee from Seller or Seller's Broker of property acquired by Buyer.

4.3 In the event this agreement terminates without Broker receiving a fee under §4.1 or §4.2, Buyer to pay Broker the sum of $______________ per hour of time accounted for by Broker, not to exceed $______________.

TYPE OF PROPERTY SOUGHT:

GENERAL DESCRIPTION ____

LOCATION ______________________________ SIZE ______________

RENTAL AMOUNT/TERM ____

I agree to render services on the terms stated above.

Date: ________, 20_____

Buyer's Broker: ______________________

Broker's CalBRE #: ______________________

Buyer's Agent: ______________________

Agent's CalBRE #: ______________________

Signature: ______________________

Address: ______________________

Phone: ____________ Cell: ____________

Email: ______________________

I agree to employ Broker on the terms stated above.

☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ________, 20_____

Buyer's Name: ______________________

Signature: ______________________

Buyer's Name: ______________________

Signature: ______________________

Address: ______________________

Phone: ____________ Cell: ____________

Email: ______________________

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- a final/balloon payment, due ten years after the close of escrow.

The agent prepares a worksheet to document the savings of $103,757.36 the buyer will realize over the first five years of ownership under the proposed carryback transaction.

The savings include:

- $39,162.11 on the takeover of the existing $450,000 mortgage at 5.5% versus the current market rate of 7.25% on that amount (both amortized over 25 years). This amount includes a savings in monthly payments over five years of $29,354.40 due to the differences in the dollar amount of payments ($2,763.39 versus $3,252.63, a $489.24 monthly saving), and additional principal reduction over five years of $9,807.71 ($401,721.86 at 5.5% versus $411,529.57 at 7.25%);

- $52,595.25 as the additional principal reduction over five years on the amortization of the $350,000 carryback at 4.5% ($277,730.47) versus current market rates of 7.25% ($330,325.72). This calculation is based on retaining the amount of the monthly payment set by a 30-year amortization at current 7.25% market rates ($2,387.62) as the monthly payment on the 4.5% carryback (amortizing the carryback over 17 years and nine months); and
- $12,000 (approximate) savings by avoiding the costs of originating an $800,000 purchase-assist mortgage with a lender with its associated costs, charges, discounts, fees, points, lender's title policy, etc.

Subordination agreement

The existing mortgage contains a **due-on clause** as disclosed by the trust deed accompanying the **property profile** the buyer's agent obtained from a title company. Under the terms of the due-on clause, on any takeover of an existing mortgage, the mortgage holder has the right to call or demand a **recast** of the terms for payment of the note.

property profile
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

As a result of the discussion with the buyer, a provision is added to the purchase agreement calling for the seller to enter into a **subordination agreement**. The buyer will need this arrangement if the mortgage holder calls the mortgage, or demands a modification of the note terms or an early payoff. If a payoff is required, the property will need to be refinanced to borrow sufficient funds to pay off the demand on the existing mortgage and cover the refinancing charges. [See Chapter 17]

subordination agreement
An agreement entered into by a mortgage holder to permit their security interest in title to the mortgaged property to take an inferior position to another encumbrance. [See **RPI** Form 281]

If the mortgage holder calls the mortgage or demands a modification, the seller will need to cooperate by entering into a *specific subordination agreement* at the time of the note modification or recording of the refinancing. To be assured the seller will cooperate, they need to sign an agreement consenting to the future subordination of the carryback mortgage on a modification or refinance of the first mortgage. [See Form 281 in Chapter 17]

Adjustments on closing for any difference between the balance on the existing mortgage at closing and as stated in the purchase agreement will be made into the principal amount of the carryback note. No adjustments will be made in the price or down payment amounts. [See Figure 1 §5.1]

Required financing disclosures

A buyer's or seller's agent negotiating a carryback offer needs to disclose to both the buyer and seller the various financial and legal features which influence prudent sellers and buyers in a carryback transaction. For offers involving one-to-four unit residential properties, the minimum carryback financing disclosures are **mandated by statute**, while disclosures for other types of property are imposed by case law. [See Form 300 in Chapter 3]

A statutory **Carryback Disclosure Statement** on a carryback sale of a one-to-four unit residential property is prepared and attached to the purchase agreement as an addendum. If it is not included with the purchase agreement, a statutory contingency is triggered giving the buyer the right to cancel the transaction until the disclosure form is signed by the buyer and the seller. [See Chapter 3]

Prior to submitting and negotiating an offer on a carryback sale of a one-to-four unit residential property, the buyer also needs to fill out a **Loan Purpose Statement.** The *Loan Purpose Statement* is used by a broker when arranging a mortgage secured by one-to-four unit residential property to determine the use of mortgage funds either as a **consumer purpose** or a business, investment or agricultural purpose. [See **RPI** Form 202-2]

Analyzing the purchase agreement

The conventional purchase agreement, **RPI (Realty Publications, Inc.)** Form 150, is used to prepare and submit the buyer's **written offer** to purchase one-to-four unit residential property. Terms for payment of the price in this purchase agreement are limited to:

- conventional financing;
- an assumption of existing mortgages; and
- a carryback mortgage.

Form 150 is also properly used by sellers in a counteroffer situation to submit their **fresh offer —** as a counteroffer — to sell the real estate.

The purchase agreement offer, if accepted, becomes the *binding written contract* between the buyer and seller. Its terms need to be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 150 is a comprehensive "boilerplate" purchase agreement. The purchase agreement serves as a **checklist** for the buyer's agent and the buyer, presenting the various conventional financing arrangements and conditions a prudent buyer considers when making an offer to purchase.

Preparing the purchase agreement's terms for paying the price

The following instructions are for the preparation of the terms for payment of the purchase price in the Purchase Agreement – One-to-Four Residential Units, **RPI** Form 150. Form 150 is designed for use by a broker or their buyer's agent as a checklist of practical provisions to be considered when preparing an offer for a prospective buyer who seeks to purchase conventionally financed, one-to-four unit residential property located in California. [See Figure 1]

The numbers on the instructions correspond to the numbers given provisions in the form.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Figure 1

Excerpt from Form 150

Purchase Agreement

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of .... $ ____

3.1 Other consideration to be paid through escrow ____ .... $ ____

4. Buyer to obtain a □ first, or □ second, trust deed loan in the amount of .... $ ____
payable approximately $____ monthly for a period of ____ years. Interest on closing not to exceed ____%, □ ARM, type ____. Loan points not to exceed ____.

4.1 □ Unless Buyer, within ____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **RPI** Form 183]

5. □ Take title subject to, or □ Assume, an existing first trust deed note held by ____ with an unpaid principal balance of .... $ ____
payable $____ monthly, including interest not exceeding ____%, □ ARM, type ____, □ plus a monthly tax/insurance impound payment of $____. ____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: □ cash, □ carryback note, or □ sales price.

5.2 The impound account to be transferred: □ charged, or □ without charge, to Buyer.

6. □ Take title subject to, or □ Assume, an existing second trust deed note held by ____ with an unpaid principal balance of .... $ ____
payable $____ monthly, including interest not exceeding ____%, □ ARM, type ____, due ____, 20 ____.

7. Assume an improvement bond lien with an unpaid principal balance of .... $ ____

8. Note for the balance of the purchase price in the amount of .... $ ____
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $____ monthly, or more, beginning one month after closing, including interest at ____% per annum from closing, due ____ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: □ due-on-sale, □ prepayment penalty, □ late charges, □ ____.

8.2 Loan Purpose Statement is attached. [See **RPI** Form 202-2]

8.3 Financial Disclosure Statement is attached as an addendum. [See **RPI** Form 300]

8.4 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]

8.5 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]

8.6 Within ____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.7 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **RPI** Form 183]

8.8 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **RPI** Form 436]

9. **Total Purchase Price is** .... $ ____

Terms for payment of the purchase price:

3. *Cash down payment*: **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment*: **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New mortgage*: **Check** the appropriate box to indicate whether any new mortgage will be a first or second trust deed loan. **Enter** the amount of the mortgage, the monthly principal and interest (PI) payment, the term of the mortgage and the rate of interest. **Check** the box to indicate whether the interest will be adjustable, and if so, **enter** the index name. **Enter** any limitations on loan points.

   4.1 *Buyer's qualification*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new mortgage and fails to deliver documentation from a lender indicating they have been qualified for a mortgage. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of their qualification for the mortgage.

Subject to or assume a first

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing first trust deed note or by an "assumption" of the first trust deed note if the buyer is to take over an existing first mortgage. **Enter** the mortgage holder's

name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable, and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment. **Enter** any due date or other terms unique to the mortgage.

5.1 *Loan balance adjustments*: **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

5.2 *Impound account*: **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

Subject to or assume a second

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing second trust deed note or by an "assumption" of the second trust deed note if the buyer is to take over an existing second mortgage. **Enter** the mortgage holder's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable, and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed*: **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos, 1915 Improvement Bonds or solar bonds) which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed by the buyer, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and properly charge the unpaid amount to the seller.*

Seller carryback provisions

8. *Seller carryback note*: **Enter** the amount of the carryback note to be executed by the buyer in favor of the seller as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

8.2 *Loan purpose:* **Fill out** and **attach** a Loan Purpose Statement as an addendum. [See Form 202-2]

8.3 *Carryback disclosure:* **Fill out** and **attach** a Seller *Carryback Disclosure Statement* as an addendum. [See Form 300 in Chapter 3]

Editor's note — Further approval of the carryback disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until the time of closing on any purchase of one-to-four unit residential property.

Further seller finance provisions

8.4 *Notice of Delinquency:* **Requires** the buyer to execute a Request for Notice of Default and Notice of Delinquency and pay the costs of recording and serving it on senior lenders or mortgage holders since they will have priority on title to the trust deed securing the carryback note. [See **RPI** Form 412]

8.5 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application on acceptance. [See Form 302 in Chapter 4]

8.6 *Approval of creditworthiness*: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.7 *Subordination*: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a mortgage with priority on title to the carryback mortgage are exceeded. [See **RPI** Form 183]

8.8 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 Financing Statement to provide additional security for any carryback note. [See **RPI** Form 436]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Chapter 2 Summary

A buyer enters into the Buyer's Listing Agreement, also called a written retainer agreement, authorizing their agent to act on their behalf and confirming the existence of their agency relationship to other brokers and agents. Under the listing, the agent and their broker are obligated to work diligently to locate property on behalf of the buyer in exchange for receiving an enforceable fee arrangement.

Together, a buyer and their agent prepare a purchase agreement which is signed and submitted to the seller. Due to a deteriorating market, the buyer's agent may recommend the offer include a takeover of the existing mortgage and seller carryback financing. However, on any takeover of an existing mortgage, the mortgage holder has the right to call or demand a recast of the terms for payment of the note.

When a seller's existing mortgage contains a due-on clause, the mortgage holder has the right to call or demand a recast of the terms for payment of the note on any takeover of mortgage. Thus, a provision is added to the purchase agreement calling for a subordination agreement which is required if the mortgage holder calls the mortgage, or demands a modification of the note terms or an early payoff. If a payoff is required, the property will need to be refinanced to pay off the demand on the existing mortgage.

A statutory Carryback Disclosure Statement on a carryback sale of a one-to-four unit residential property is mandated by statute, and is prepared and attached to the purchase agreement as an addendum. If it is not included with the purchase agreement, a statutory contingency is triggered giving the buyer the right to cancel the transaction until the disclosure form is signed by the buyer and the seller.

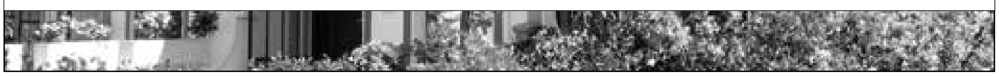
The conventional purchase agreement is used to prepare and submit the buyer's written offer to purchase one-to-four unit residential property. Terms for payment of the price in this purchase agreement are limited to:

- conventional financing
- an assumption of existing mortgages; and
- a carryback mortgage.

Chapter 2 Key Terms

Chapter 3

Disclosure on seller carrybacks



Learning Objectives

After reading this chapter, you will be able to:

- understand the different disclosure requirements for carryback mortgages on the sale of one-to-four unit residential property and other types of property;
- identify who is responsible for preparing and delivering the disclosures; and
- recognize the need for disclosures to both the buyer and the seller of the financial, legal and risk-of-loss mitigation aspects of a carryback mortgage.

Key Terms

affirmative duty
further-approval contingency
installment sale
masked security device
straight note

Advice by agents for risk assessment

Consider a seller who is willing to partially finance the sale of their one-to-four unit residential property by carrying back a mortgage.

The seller's agent locates a qualified prospective buyer who is not represented by a buyer's agent. The agent prepares an offer on a purchase agreement form and presents it to the buyer for their approval and signature. [See **RPI** Form 150]

Form 300

Financial Disclosure Statement

Page 1 of 2

FINANCIAL DISCLOSURE STATEMENT
For Entering into a Seller Carryback Note

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This form is used by an agent when preparing an offer or counteroffer to buy, sell, exchange or option a one-to-four unit residential property with seller carryback financing on a grant deed conveyance, to prepare an addendum to disclose the terms and conditions of the carryback note and trust deed.

DATE: ______________, 20____, at ______________________________, California.
Items left blank or unchecked are not applicable.

1. This is an addendum to the following agreement:
   ☐ Purchase Agreement ☐ Option to Purchase (with or without lease)
   ☐ Counteroffer ☐ Exchange Agreement
   1.1 dated ______________, 20_____, at ______________________________, California,
   1.2 entered into by______________________________, as the Buyer,
   1.3 and ______________________________, as the Seller,
2. This addendum was prepared by ______________________________.

DISCLOSURES:

3. **GENERAL INFORMATION CONCERNING THE TERMS OF PAYMENT:**
   3.1 The Note to be executed by Buyer is in the original amount of $______________, payable in constant monthly ______________ installments of $____________ to include _____ % per annum interest, with a final/balloon payment due on ____________, 20_____, in the approximate amount of $______________.
   3.2 The note will be secured by a trust deed on the property referred to as ______________________________.
   3.3 If the Note contains a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to Buyer.
   3.4 Unless stated and explained in an attached ARM addendum, the Note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in the negative amortization of the debt. [See **RPI** Form 155-1]
   3.5 Unless otherwise agreed, the original amount of the Note will be adjusted by endorsement at the close of escrow to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained.
   3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provisions passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbrance acceleration and future advances due on the underlying wrapped loans.
4. **SPECIAL PROVISIONS AND DISCLOSURES CONCERNING THE CARRYBACK NOTE AND TRUST DEED:**
   4.1 ☐ The all-inclusive Note and trust deed to be carried back by Seller contains provisions calling for Seller to place the Note on contract collection with any institutional lender or real estate broker, other than Seller, and the collection agent will be instructed to first disburse funds on payments due on senior encumbrances. **NOTE: Inclusion of this provision may cause adverse income tax consequences for Seller.**
   4.2 A joint protection policy of title insurance will be delivered to Buyer and Seller insuring their interests in title on the close of escrow.
   4.3 The trust deeds and grant deeds to be executed will be recorded with the county recorder at the close of escrow.
   4.4 Seller will be named, through escrow, as a loss payee under the hazard and fire insurance policy obtained by Buyer.
   4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assure themselves that real estate taxes have been paid while they hold the Note.
   4.6 ☐ Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrances senior to the carryback. [See **RPI** Form 412]
   4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, their sole source of recovery is limited to the net proceeds from a foreclosure sale or their subsequent resale of the real estate, and they are not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Code of Civil Procedure §580b]

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The terms offered for payment of the purchase price include a carryback mortgage, to be executed by the buyer in favor of the seller, for the amount of the price remaining to be paid after the down payment and an assumption of the existing mortgage on the property.

The seller's agent also prepares a **Financial Disclosure Statement** addressing the carryback mortgage, also known as a **carryback disclosure statement,** and attaches it to the purchase agreement as an addendum. The addendum contains numerous statements about the financial, legal and related risk-of-loss aspects of the carryback mortgage. If the statement is not

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4.8 Buyer ☐ will, or ☐ will not, receive net proceeds or cash back upon the close of escrow. Amount to be received is $______________; source of funds ____; reason for receipt ____.

4.9 The Note is to include the following provision: "This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note is to give written notice to the trustor, or their successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due."

5. ENCUMBRANCES SENIOR AND PRIOR TO SELLER'S CARRYBACK TRUST DEED AND NOTE:

5.1 Conditions of encumbrances, with priority over Seller's carryback Note and trust deed, which will remain or be placed of record at time of closing are as follows:

	First Trust Deed	Second Trust deed
Original balance	$____________	$____________
Current balance	$____________	$____________
Interest rate	______ % ☐ ARM Type: ________	______ % ☐ ARM Type: ________
Monthly payments	$____________	$____________
Due date	________, 20_____	________, 20_____
Final/balloon payment	$____________	$____________
Current defaults	$____________	$____________

5.2 If any of the senior encumbrances contain a due date, it may be difficult or impossible to refinance, modify or extend the final/balloon payment in the conventional mortgage market.

6. BUYER CREDIT INFORMATION (SUPPLIED BY BUYER):

6.1 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]

6.2 Seller may terminate the agreement within ______ days of receipt of the credit application by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **RPI** Form 183]

7. BROKER DISCLOSURES:

7.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning Buyer's credit information.

7.2 This statement and its contents are statutorily required disclosures and do not limit Broker's duties to disclose other material facts about Seller to Buyer or Seller about the carryback financing arrangements and which are known to Broker or their agent.

7.3 Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form need to be completed before signing below.

7.4 ☐ See attached addendum for additional disclosures which are part of this disclosure. [See **RPI** Form 250]

8. OTHER: ____

Date: ____________, 20____ Buyer's Broker: ____________________ CalBRE #: ____________________ By: ____________________ **I have and received a copy of this statement.** Date: ____________, 20____ Buyer: ____________________ Buyer: ____________________	Date: ____________, 20____ Seller's Broker: ____________________ CalBRE #: ____________________ By: ____________________ **I have and received a copy of this statement.** Date: ____________, 20____ Seller: ____________________ Seller: ____________________

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Form 300

Financial Disclosure Statement

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included as an addendum to the purchase agreement, a statutory **further-approval contingency** allows for later cancellation of the transaction. [See Form 300 accompanying this chapter]

The information entered in the *carryback disclosure statement* is based on the terms of the:

- purchase offer;
- title conditions;
- activities to be undertaken by the buyer and seller in escrow; and

further-approval contingency
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

- information obtained from the buyer.

Further, the carryback disclosure statement contains only the legislatively mandated **minimum disclosures**.[1]

Besides confirming delivery of the carryback disclosure statement to the buyer and the seller, the seller's agent, and any buyer's agent involved, need to also confirm that their respective clients understand the risks and consequences which rise out of the **financial and legal aspects** of the carryback transaction.

In addition to preparing a carryback disclosure statement, the seller's agent makes separate disclosures regarding conditions of the property which might also affect decisions of the buyer or the seller in the sales transaction. Also, both agents have a duty to disclose their knowledge about the **tax aspects** of the carryback transaction to their client based on:

- the type of property being sold; and
- the agent's willingness to express an opinion on the subject.

One-to-four unit carryback transactions

All brokers in transactions for the purchase of *one-to-four unit residential property* involving seller carryback financing are **mandated by statute** to:

- prepare a carryback disclosure statement; and
- present it to both the buyer and seller for their review and signatures.[2]

On the sale of other types of property, disclosures regarding aspects of carryback financing concerning material facts unknown to the client are imposed by case law.

masked security device
Alternative documentation for a carryback sale, substituted for a note and trust deed in a deceptive attempt to avoid due-on enforcement, Regulation Z, reassessment for property taxes, profit reporting and the buyer's right of reinstatement or redemption on default. [See **RPI** Form 300-1 and 300-2]

Even the use of a **masked security device** requires a written carryback disclosure statement before the buyer takes possession of the property. Examples of a masked security device requiring carryback disclosure include:

- a land sales contract;
- a lease-option; or
- an unexecuted purchase agreement with interim occupancy. [See Chapter 24]

When structuring a carryback sale using alternative documentation, the written disclosure statement informs the buyer and the seller about the extent of the risks presented by failing to use grant deeds, notes and trust deeds to evidence the **installment sale**. [See Figure 1 and Figure 2]

installment sale
Financing provided by a seller who extends credit to the buyer for future periodic payments of a portion of the price paid for real estate, also known as carryback financing.

On the sale of a one-to-four unit residential property, any *installment sale* arrangements created to accommodate the buyer's deferred payment of the purchase price requires a written carryback disclosure statement if the carryback arrangements include:

- interest or other finance charges;

1 Calif. Civil Code §2956
2 CC §§2956 et seq.

Figure 1

Form 300-2

Financial Disclosure Statement — Lease Option Sale

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Lease-Option Sale

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms

- five or more installments running beyond one year;
- an installment land sales contract;
- a purchase lease-option or a lease-option sale;
- a trust deed note given to adjust equities in an exchange of properties; or
- an all-inclusive trust deed (AITD) note.[3]

Carryback disclosure statements are optional in carryback transactions creating **straight notes** which do not:

- bear interest; or
- include finance charges.

straight note
A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

3 CC §2957

However, carryback disclosures for *straight notes* need to be prepared and reviewed with the client as a matter of *good brokerage practice*. The risks and issues for the buyer and seller under a straight note are similar and the duty owed the client is the same.

Consider a real estate agent who is acting as a property manager or leasing agent for the landlord of a single family residence (SFR) the landlord wants to sell.

A prospective tenant makes an offer to lease the property. The offer contains an option to purchase the property on expiration of the lease. The terms for payment of the price under the proposed option include:

- a **carryback note**, entered into by the tenant on exercise of the purchase option for the balance of the seller's equity in the property after the down payment; and
- a credit toward the price and down payment on the property equal to part or all of the rent paid by the tenant.

Here, the prospective tenant's offer to lease is coupled with a purchase option which includes a monthly credit toward the price. As applied, the credit *builds up equity* in the property for the buyer. As with a sales transaction involving a carryback mortgage, the agent prepares the mandated carryback financing disclosures on a written form as an addendum to the lease-option. [See Figure 1]

Who prepares the disclosure?

A carryback disclosure statement is *prepared and submitted* to all buyers and sellers in a carryback transaction on one-to-four unit residential property by:

- the real estate broker or their agent who **negotiated** the carryback sales transaction and prepared the buyer's purchase offer; or
- the buyer or seller who is a real estate licensee or attorney when neither the buyer nor the seller is represented by a broker.[4]

When both the buyer and seller are represented by **different brokers**, the carryback disclosure statement is prepared by the broker or agent who prepared the buyer's offer.

Many participants in a carryback transaction are not required to make carryback disclosures, including:

- escrow officers[5];
- an attorney representing a buyer or seller who is not also acting as a real estate licensee in the transaction[6]; and
- buyers and sellers acting without the assistance of a broker, unless they are real estate licensees or licensed attorneys.[7]

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4 CC §2957(a)(2)
5 CC §2957(a)(3)
6 CC §2957(a)(1)
7 CC §2957(a)(1)

Figure 2

Form 300-1

Financial Disclosure Statement — Land Sales Contract


FINANCIAL DISCLOSURE STATEMENT

For Entering Into a Land Sales Contract

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms

Offer includes up-front carryback disclosures

A *further-approval contingency*, established by statute, is avoided entirely when the carryback disclosure statement is *prepared and attached* to the buyer's offer as an addendum to the purchase agreement. If the disclosure statement is not attached to the purchase agreement, the *seller's agent* needs to include it as an addendum to a **counteroffer** to eliminate the contingency.[8]

Occasionally, neither the buyer's or seller's agent prepares and includes the disclosure statement as an addendum to the offers or counteroffers.

Here, as a minimum requirement, the *buyer's agent* is responsible for preparing the disclosure statement and submitting it to both the buyer

8 CC §2956

and seller for their review and approval **prior to closing**. Otherwise, the statutory contingency with the right to cancel due to the failure of an up-front disclosure is not eliminated.[9] [See Form 300]

After closing, the remedy available to the buyer or seller for inadequate or nonexistent financial disclosures is to pursue the brokers for any **money losses** actually incurred as a result of the nondisclosure of material facts not known to the buyer or seller at the time they entered into the purchase agreement. If a broker or their agent fails to provide the mandated carryback disclosures, they are liable to the buyer for the buyer's losses resulting from the nondisclosure.[10]

Contingency exercised by cancellation

Consider a buyer and seller of an SFR who enter into a purchase agreement. The terms call for carryback financing in the principal amount of $250,000 with an interest rate of 6%, payable in monthly installments amortized over 30 years with a final/balloon payment due in five years.

The purchase agreement does not state the dollar amount of the final/balloon payment due on the carryback note at the end of five years. The risks and consequences of the buyer's failure to meet the five-year due date payment are not brought to the buyer's attention prior to entering into the purchase agreement.

Further, a carryback financial disclosure statement is not presented to the buyer or seller for their signatures as part of the purchase agreement and counteroffer negotiations. Thus, closing is automatically contingent on the **further approval** by both the buyer and seller of the financial and legal aspects of the carryback note and trust deed as presented in the carryback disclosure statement.

Prior to closing, the buyer receives the carryback disclosure statement. They discover the final/balloon payment due at the end of five years will be $234,100. The buyer is now concerned about the financial risks of ownership since they have no assurance they will be able to refinance, modify or extend the note, much less have the ability to accumulate funds in the interim for payoff of the final/balloon payment.

Unable to negotiate an agreement with the seller for an extension of the due date, the buyer cancels the purchase agreement and escrow. The buyer claims they did not previously realize the extent of the financial risk created by the final/balloon payment due after five years under the terms of the carryback financing. They are now aware the due date forces them to either sell the property or lose it to foreclosure if they are unable to arrange new financing or an extension of the carryback note. [See **RPI** Form 418-3 §2.2]

Can the buyer cancel the transaction due to the contents of a delayed financial disclosure by the agents?

9 CC §2959
10 CC §2965

Yes! The buyer did not sign the carryback disclosure statement at the time they agreed to buy the property. This failure triggers the statutory further-approval contingency allowing the buyer to cancel the transaction. The risks of loss imposed by the amount of the final/balloon payoff – classified as a *material fact* – were significantly greater than the buyer realized when entering into the purchase agreement. Thus, the buyer has justification for exercising their right to cancel. The terms of the purchase agreement regarding the carryback financing did not meet their **reasonable expectations**.[11]

Approximations, when unsure

Consider a purchase agreement entered into by a different buyer and seller. The terms for payment of the price include:

- a 10% down payment;
- a new mortgage of no less than 60% of the purchase price; and
- a seller carryback mortgage for the balance of the purchase price at 6% interest, amortized monthly over 30 years with a ten-year due date.

Here, the precise amount of the carryback mortgage provided for in the purchase agreement may be any amount up to 30% of the purchase price, depending on the mortgage amount available from a lender.

When the agent prepares the carryback disclosure statement, the amount of the carryback mortgage and new mortgage may be disclosed as dollar figures the agent **reasonably believes** will exist at the time of closing. The carryback figures may be an **approximation** of the unknown amounts.

The *approximation* needs to be clearly identified as "approximate," or "approx.," in the carryback disclosure statement, and be based on the best information available to the agent. The approximation may not be used as an excuse to evade compliance with disclosure laws.[12]

Further, as amounts approximated in the original carryback disclosure statement become certain and are available to the buyer's agent, the agent is to promptly disclose the new, accurate figures in a written amendment signed by both the buyer and seller.[13] [See **RPI** Form 250]

However, if figures and facts presented in the carryback disclosure statement change due to actions taken by the buyer or seller after making the disclosures, the agent is not obligated to amend the carryback disclosure statement. Nevertheless, a prudent agent conforms all the paperwork to the transaction to contain the correct dollar amounts prior to closing.[14]

Carryback financing extended to an investor

Now consider a carryback business mortgage situation. A seller's agent locates an investor willing to purchase the seller's property on terms which include a carryback mortgage and assumption of the existing mortgage on

11 CC §2961
12 CC §§2960; 2961
13 CC §2962
14 CC §2960

the property. The agent advises the seller that the investor is financially qualified to handle the cash down payment and monthly payments on the carryback financing.

Relying on their agent's representations regarding the investor's financial qualifications, the seller agrees to extend carryback financing to the investor.

Before escrow closes, the investor tells the seller's agent they do not have the cash down payment needed to close and will need to obtain a loan. The seller's agent does not disclose the investor's lack of capital to the seller. Further, the agent makes a loan to the investor to help fund the down payment for the property acquisition.

Escrow closes and the investor takes title to the property. The investor defaults on the carryback mortgage held by the seller and the first mortgage they assumed. The seller suffers a total loss on their carryback note due to a foreclosure sale by the senior mortgage holder.

The seller then discovers their agent loaned the investor the money they needed for the down payment. The seller also discovers their agent knew the investor was financially unstable prior to closing the transaction.

Here, the seller's agent had a primary **agency duty** to advise the seller of the investor's financial inability to repay the carryback mortgage – a significant adverse fact brought to the attention of the seller's agent prior to closing which the seller's agent failed to disclose. Thus, the seller's agent and their broker are liable to the seller for the seller's money losses on the carryback mortgage.[15]

As carryback financing becomes more prevalent during cyclical periods of declining real estate prices and tight mortgage money conditions, more unqualified buyers appear with whom agents need to contend.

affirmative duty
An agent's obligation to voluntarily undertake an advisory activity when in a fiduciary relationship.

Even when the carryback financing is classified as a *business mortgage* excluded from adherence to ability-to-repay (ATR) rules, their agent has an **affirmative duty** to obtain written financial statements from the buyer and review them with the seller to confirm the buyer's financial ability to support the seller's decision to extend carryback financing. It is in the review of financial statements the seller and their agent are able to filter out unqualified buyers as part of the carryback documentation process. [See Form 300 §4]

The seller's increased risks on carrybacks

One purpose of a carryback disclosure statement is to inform a seller that:

- owners and lenders have differing rights and obligations; and
- each face different risks arising out of their respective possessory and security interests in the real estate.

For example, a buyer is primarily concerned with paying no more than the **fair market value (FMV)** for a property. However, a seller, intending to

15 **Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417

carryback a mortgage, needs to be primarily concerned with their **loan-to-value (LTV)** ratio and the buyer's ability to pay. Whatever the price may be, the carryback seller becomes a "financier" on the close of escrow, a lender once removed.

Typically, a seller seeks the highest sales price negotiable for their real estate. However, a seller who carries back a mortgage needs to make sure the buyer's down payment is a large enough percentage of the purchase price to ensure the buyer has **adequate equity** in the real estate. An adequate *LTV* ratio allows the seller to fully recover their entire carryback mortgage debt from the value of the property in the event the buyer goes into default and the seller needs to foreclose. Any lesser amount of down payment exposes the carryback seller to additional risk of loss.

Chapter 3 Summary

A carryback disclosure statement is attached to the purchase agreement as an addendum in the carryback sale of a one-to-four unit residential property. The addendum contains numerous statements on the financial, legal and risk-of-loss aspects of the carryback mortgage. If the statement is not included as an addendum to the purchase agreement, a statutory further-approval contingency allows for a later cancellation of the transaction.

In addition to preparing a carryback disclosure statement, the agent makes separate disclosures regarding conditions of the property which might also affect decisions of the buyer or the seller in the sales transaction. Also, both agents have a duty to disclose their knowledge about the tax aspects of the carryback transaction to their client.

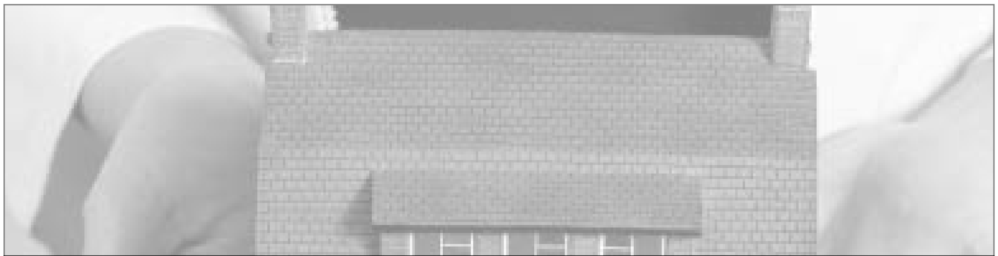
The use of a masked security device, such as a land sales contract, lease-option or unexecuted purchase agreement with interim occupancy, also requires a written carryback disclosure statement before the buyer takes possession of the property.

When both the buyer and seller are represented by different brokers, the carryback disclosure statement is prepared by the broker or agent who prepared the buyer's offer.

If a broker or their agent fails to provide the mandated carryback disclosures, they are liable to the buyer for the buyer's losses resulting from the nondisclosure.

A buyer's ability to meet the terms and conditions of a carryback mortgage is of financial importance to a seller who is carrying back a note on a sale. The seller's agent has an affirmative duty to obtain written financial statements from the buyer and review them with the seller.

Chapter 3 Key Terms



Chapter 4

Buyer's creditworthiness: seller's further–approval

Learning Objectives

After reading this chapter, you will be able to:

- understand the seller's agent's role in determining a buyer's creditworthiness in a carryback transaction;
- identify the disclosures and documentation required in carryback transactions;
- analyze the buyer's financial statements and credit report to determine their net worth and ability to repay the debt; and
- recognize the attributes which make a buyer a good credit risk.

Key Terms

debt service	**implicit rent**
further-approval contingency	**recourse**
impairment	**unsecured note**

A seller carries back based on documentation

Consider a buyer who submits an offer to purchase income-producing real estate to the seller's agent. The offer calls for the seller to carry back an **unsecured note** for a portion of the sales price. The balance of the price will be paid with a cash down payment and the assumption of an existing mortgage on the property. The seller is given ten days after acceptance of the offer to further approve of the buyer's creditworthiness and net worth, or cancel the transaction. [See Figure 1; see Chapter 2]

The buyer wants to acquire the property clear of any carryback encumbrance so the equity in the property can be used to finance the acquisition of other income-producing investment property.

unsecured note
A document evidencing a debt owed by one person to another where the debt is not secured by collateral, also called an unsecured promissory note. [See **RPI** Form 424]

On presentation of the offer to the seller, the seller's agent advises the seller that the buyer's financial statements indicate the buyer's **net worth**, as itemized on the balance sheet, includes the ownership of numerous properties. [See **RPI** Form 209-3]

Relying on their agent's representations of the buyer's *net worth*, the seller accepts the offer and approves the buyer's credit. Thus, the seller waives their **further-approval contingency**. [See **RPI** Form 182]

Cash back disclosure

Prior to the close of escrow, the buyer informs the seller's agent they have insufficient funds for the down payment — the source of funds for the seller's payment of the brokerage fee. To compensate for the lack of funds, the buyer asks the seller's agent to accept a promissory note from the buyer in payment of the brokerage fee which will replace the cash fee the seller has agreed to pay.

further-approval contingency
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

To close the transaction without bringing the buyer's lack of funds to the seller's attention by reducing the down payment and shifting payment of the fee to the buyer, the seller's agent enters into a "cash back" arrangement with the buyer leaving the buyer's acquisition cost for the property the same. This arrangement will help fund the buyer's down payment, which in turn will fund the seller's payment of the brokerage fee through escrow.

Under the arrangement, a check from the seller's agent payable to the buyer is exchanged for a note from the buyer payable to the seller's agent, both for the amount of the brokerage fee. On closing, the seller's agent will deposit the fee paid by the seller into the seller's agent's account to replace the funds the agent handed to the buyer. Thus, the brokerage fee paid by the seller on closing will cover the check issued by the seller's agent to the buyer.

No personal funds contributed by the buyer

Continuing our previous example, the buyer finances the remaining portion of the down payment through a new mortgage arranged by the seller's agent with a lender. Thus, the buyer has restructured funding of the entire down payment to avoid the investment of any of their **personal funds**.

The seller is not informed of the purchase-assist financing or the cash-back arrangement. Also, the seller's agent has become aware the representations of equity in the properties and the financing listed on the buyer's financial statement approved by the seller significantly overstate the buyer's net worth.

recourse
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

The transaction closes. Eventually, the buyer defaults on the unsecured carryback note — a **recourse debt** collectible by a money judgment.

Due to the buyer's insolvency, the seller is only able to recover a portion of the outstanding balance on the carryback note from the buyer.

Figure 1

Excerpt from Form 150

Purchase Agreement

8.5	Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]
8.6	Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

The seller now seeks to recover their loss on the carryback note from the seller's agent's broker, claiming the broker and the seller's agent wrongfully induced them to accept the unsecured carryback note.

Are the seller's broker and their agent liable for the seller's losses due to the buyer's default?

Yes! The seller's broker and their agent are both liable for the seller's losses. The seller's agent intentionally misrepresented the buyer's ability to perform on the carryback note to induce the seller to enter into the installment sale with the buyer.[1]

Broker's agency duty

The duty owed a carryback seller by their agent to disclose the **buyer's credit status** includes:

- correctly representing the buyer's *ability to pay* the obligations undertaken by entering into a carryback note;
- disclosing *relevant information* about the prospective buyer's identity, occupation, employment, income, and credit data as known to the broker and their agent;
- disclosing the buyer's *existing and future loan obligations,* including payment history and any pending bankruptcy known to the broker and their agent; and
- affirmative advice on any need to conduct a *credit investigation*.

Also, written disclosures itemizing the buyer's credit information are mandated on all sales involving one-to-four unit residential properties when the seller carries back a portion of the sales price.[2] [See Chapter 3]

All disclosures need to be made in *good faith* by the buyers, brokers and agents to meet the objective of the credit investigation.[3] [See Form 302 accompanying this chapter; see **RPI** Form 207 and 207-1]

To properly determine the buyer's ability to repay the debt, the seller's agent needs to obtain and provide the seller with documentation of the buyer's income, credit and assets. This includes copies of the buyer's:

- Internal Revenue Service (IRS) tax returns;
- IRS Form W-2s;

1 **Alhino** v. **Starr** (1980) 112 CA3d 158

2 Calif. Civil Code §§2956 et seq.

3 CC §2961

- federal, state, or local government agency benefits and entitlements; and
- relevant asset information, such as funds held in accounts with financial institutions, equity ownership interests, or rental property.

With this information, the seller makes an informed decision to either proceed with the carryback transaction or cancel it under a *further-approval contingency* in the purchase agreement. [See **RPI** Form 158 §8.5]

Any real estate agent who misrepresents a buyer's credit information or makes false statements to the carryback seller about the buyer's ability to repay the carryback mortgage is not only liable for money damages, but faces suspension or revocation of their license for committing fraud.[4]

The need for credit checks

The right to obtain credit information also applies to private parties such as carryback sellers. A carryback seller reviews the creditworthiness of the buyer for the same reason a landlord obtains reliable credit information on prospective tenants — to determine if they are willing and able to pay as agreed. Accurate credit information on the buyer is critical for the seller to analyze the **risk of default** that exists when extending credit to the buyer.

In addition, the seller needs to assure themselves the buyer will **maintain the property unimpaired** under the carryback trust deed and not commit *waste*. Thus, if the buyer does not meet all these qualification standards, the seller may justifiably cancel the transaction under the contingency.

The buyer needs to have the financial ability and credit history to pay both the senior mortgage and the seller's carryback mortgage before the seller approves and closes the sale. Any default by the buyer on the senior mortgage jeopardizes the seller's security interest in the property under their second mortgage.

The seller's agent checks the buyer's creditworthiness and ability to perform by:

- analyzing the buyer's application for credit, along with credit reports and a criminal background check [See **RPI** Form 203 and 302];
- reviewing the buyer's operating statement (profit and loss statement) and a balance sheet (net worth statement), and confirming their bank balances [See **RPI** Form 207 and 207-1];
- contacting the buyer's creditors (landlords, mortgage holders) and document their experiences with the buyer's payment history; and
- inspecting properties owned by the buyer to determine the level of care and maintenance the properties receive under the buyer's ownership and management.

All carryback sellers face the risk a buyer will default, no matter how wealthy, conscientious and qualified the buyer appears to be.

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4 Calif. Business and Professions Code §10176

On any default in payments on a carryback mortgage, the seller's **sole source of recovery** is the mortgaged property, unless the mortgage is subordinated to a construction loan or additionally secured by property other than the property sold (as it then becomes recourse debt).

Even an existing mortgage holder has a right to obtain credit information from the buyer on a change of ownership. The mortgage holder, like a carryback seller, needs to make an informed decision as to whether the risk of default in the payments or care and management of the property will increase under the new ownership, called **impairment**.[5]

impairment
The act of injuring or diminishing the value of a fee interest.

The creditworthiness contingency

A seller's agent has the duty to obtain credit information from a buyer and disclose any material facts known or readily available to them about the buyer which might affect the seller's decision to carry back a mortgage on a sale.

Also, for the seller's agent to properly disclose the separate financial, tax and risk-of-loss aspects to a seller, a **carryback disclosure statement** needs to be attached to any purchase agreement which calls for a carryback mortgage. The *carryback disclosure statement* is mandated on the sale of a one-to-four unit residential property. However, a prudent seller's agent will also include a disclosure statement in carryback transactions on all types of property.[6] [See Form 300 in Chapter 3]

Both the carryback disclosure statement and the purchase agreement include a credit approval provision known as a *further-approval contingency*. The credit approval provision calls for the buyer to hand the seller a completed **credit application**. [See Form 302]

A prudent buyer's agent preparing a purchase agreement calling for seller financing will have their buyer fill out a *credit application* prior to commencement of negotiations and attach it to the buyer's offer as an addendum. Early disclosure helps the seller determine the buyer's sincerity and good-faith willingness to cooperate in the credit analysis process.

A review of the buyer's financial statements and the verification of earnings and funds by the seller's agent are completed during the contingency period. [See **RPI** Form 208 through 213]

Cancellation on disapproval

The credit provision also allows the carryback seller to terminate the purchase agreement by a written **Notice of Cancellation** if they disapprove of the buyer's creditworthiness. [See **RPI** Form 150 §10.5]

However, the credit contingency does not give the carryback seller the unrestricted right to withdraw from a binding and otherwise enforceable purchase agreement without good cause.

5 **Santa Clara Savings and Loan Association** v. **Pereira** (1985) 164 CA3d 1089
6 CC §§2956 et seq.

Consider a carryback seller who enters into a purchase agreement containing a credit approval contingency provision giving them the right to cancel the transaction based on the buyer's lack of creditworthiness. [See Figure 1 §8.5]

During the contingency period and before the seller approves the buyer's credit, the seller changes their mind about selling the real estate. They decide to cancel the transaction by using the credit contingency as a "back door provision" in an attempt to escape enforcement of the purchase agreement. The seller has no grounds for disapproving the buyer's credit since they have received no derogatory information about the buyer's creditworthiness or ability to perform on the purchase agreement or the carryback note.

The seller has to have *good reason* to disapprove the buyer's credit and cancel the transaction. Any reason to cancel the transaction needs to relate to the unacceptable status of the buyer's creditworthiness under the credit contingency provision. Without good reason, the seller who cancels has breached the purchase agreement in *bad faith*.[7]

The consumer credit report

A review of a buyer's creditworthiness requires **credit history** on the buyer from a **consumer credit report**.

A *consumer credit report* contains information about a buyer's credit standing supplied by consumer credit reporting agencies. The credit application form may require the buyer to cover the cost of the credit report. [See **RPI** Form 202]

A credit report does not assure future performance by the buyer to repay the mortgage, nor does the report demonstrate the buyer's ability to pay.

Properly reviewed, a credit report helps to establish the buyer's past performance in repaying money obligations. Money obligations include amounts owed on:

- loans or financing agreements;
- judgments or tax liens; or
- retail and bank credit accounts.

The credit report is used to establish an individual's eligibility for:

- credit for personal, family or household purposes;
- employment; or
- rental of a dwelling unit.[8]

When the sales transaction involves a mortgage of $150,000 or more, whether originated by a lender or carryback seller, a consumer credit report will also contain information not otherwise available in a credit report, regarding:

- bankruptcies predating the report by more than ten years;

7 **Lyon** v. **Giannoni** (1959) 168 CA2d 336
8 CC §1785.3(c)

- civil suits and judgments, and records of arrest predating the report by more than seven years;
- paid tax liens predating the report by more than seven years;
- accounts placed for collection or charged to profit and loss predating the report by more than seven years; and
- records of criminal activity predating the report by more than seven years.[9]

Request for a copy

If a credit report is used by the seller to cancel the transaction under the **credit approval provision**, the buyer may request a written copy of the credit report from the carryback seller.

Credit reporting agencies are prohibited from attempting to circumvent this rule by blocking or dissuading a carryback seller (or a lender or landlord) from providing copies of credit reports to consumers.[10]

- Persons seeking credit information need to: identify themselves to the reporting agency;
- state their purpose for seeking the information; and
- certify the information will be used for no other purpose than what is stated.[11]

An agent seeking credit report information on a buyer receives authorization through an information release form signed by the buyer to be investigated. A provision referencing the release of information is typically included in credit application forms. However, the release requirement is waived if the broker is a member of a credit reporting agency's credit association.

Credit reports are provided at a preset cost-per-request by the agency to the broker or agent member for a one-time membership fee and a minimum monthly billing.

Getting a copy

Membership in a credit association requires applicants (brokers or agents) to have their own creditworthiness reviewed by the agency.

The credit reporting agency will provide the necessary notice of the investigation to the buyer.

Although necessary for completing a credit clearance, a credit report does not contain information on the buyer's:

- *net worth*; or
- *propensity to commit a crime.*

9 15 United States Code §1681c (a-b)

10 CC §1785.10.1

11 CC §1785.14

Form 302

Credit Application

Page 1 of 2

CREDIT APPLICATION
Individual

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: This form is used by a loan broker or carryback seller and their agent when arranging a mortgage loan or carryback note on a sale and needing a determination of the borrower's/buyer's creditworthiness, to authorize a credit reporting agency to complete a consumer report on the borrower/buyer.

DATE: ____________, 20____, at ______________________________, California.
THIS CREDIT APPLICATION is for the amount of $______________.
Property address: ______________________________
Received from Applicant(s) $______________, ☐ cash, or ☐ check, for a consumer credit report which is a non-refundable cost and not a deposit.
Applicant(s):
Applicant One ______________________________
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)
Social Sec. # ______________ Drivers Lic. # ______________ State______
Applicant Two ______________________________
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)
Social Sec. # ______________ Drivers Lic. # ______________ State______
Additional Occupant(s): Name ______________________________
Name ______________________________
Rental History: Have you ever been party to an eviction? ☐ Yes ☐ No Filed bankruptcy? ☐ Yes ☐ No
Present Address ______________________________
City ______________________ Zip ______________
Length of Residency ____________ Monthly Rent $____________
Landlord/Agent ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Reason for Moving ______________________ Moving Date ____/____/____
Previous Address ______________________________
City ______________________ Zip ______________
Length of Residency ____________ Monthly Rent $____________
Landlord/Agent ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Employment:
Applicant One
Employer ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Length of Employment ____________ Position ______________ Wages ____________
Pay Period ____________ Union ______________________
Previous Employer ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Applicant Two
Employer ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Length of Employment ____________ Position ______________ Wages ____________
Pay Period ____________ Union ______________________
Previous Employer ______________________________
Address ______________________________
City ______________ Zip ____________ Phone ______________
Additional Income Amount $______________ Source ______________________
Recipient ______________________________

PAGE 1 OF 2 — FORM 302

Financial statements for income and net worth

implicit rent
The dollar value of the use of a property by the owner.

For income-producing property, two additional financial aspects of a buyer's ability to perform on the carryback mortgage need to be investigated by all principals and agents involved:

- the ability of the property's income to cover the **expenses** and carry the **debt service**; and
- the ability of the buyer to personally service any **negative cash flow** resulting from the debt burden, lack of rental income or the owner's use of the property, called **implicit rent**.

PAGE 2 OF 2 — FORM 302

General Credit Information:

Automobile One: Make ______
Year ______ Model ______ Lic. #/State ______
Lender ______
Automobile Two: Make ______
Year ______ Model ______ Lic. #/State ______
Lender ______
Bank/branch ______
Check Acc. # ______ Savings Acc. # ______
Bank/branch ______
Check Acc. # ______ Savings Acc. # ______
Credit References:
1. ______
Address ______
Account # ______ Balance due $ ______ Phone ______
2. ______
Address ______
Account # ______ Balance due $ ______ Phone ______
Personal Reference ______
Address ______ Phone ______
Personal Reference ______
Address ______ Phone ______
Nearest Relative (name/relationship) ______
Address ______ Phone ______

I/We declare all information given in this application is true and correct. I/We authorize your credit reporting agency to obtain and verify a complete consumer report and supply the information obtained to you.
This information is not privileged.

Date: ______, 20____
Name: ______

Signature: ______
(Applicant 1)

Name: ______

Signature: ______
(Applicant 2)

I acknowledge receipt of this credit application and accompanying payment.
Seller or Lender: ______

Signature: ______
Phone: ______

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Form 302

Credit Application

Page 2 of 2

To investigate the property's ability to carry its *debt service*, the property's income and expenses are analyzed by using the **Annual Property Operating Data Sheet (APOD)**. [See **RPI** Form 352]

debt service
The amount of principal and interest paid on a debt periodically, also referred to as the loan payment amount.

If the property's income is unable to support its operating expenses and debt service, the seller and their agent need to look for other abilities of the buyer to carry the negative cash flow caused by the debt.

The buyer's personal capacity to pay is investigated by a review of financial statements delivered by the buyer itemizing their income, expenses and net worth.

The buyer's income includes their:

- base salary, overtime and bonuses;
- commissions;
- interest earned;
- dividends; and
- rental income.

Income which does not have to be reported on financial statements, if the buyer does not want it to be considered as available for repayment of the debt, includes:

- alimony;
- child support; or
- other separate maintenance income such as social security or military benefits.

Buyer's expenses

The buyer's *personal expenses* are classified as:

- housing expenses; or
- all other expenses.

The buyer's monthly housing expenses include:

- mortgage payments;
- rent;
- property taxes, including Mello-Roos and special assessment bonds;
- homeowners' association (HOA) charges;
- hazard, liability and renter's insurance premiums; and
- utilities.

The buyer's total expenses are determined by adding housing expenses to all other expenses, such as:

- other installment payments, such as credit cards and auto loans; and
- alimony and child support. [See **RPI** Form 203]

Conversely, the buyer may be self-employed, or involved in a business, rental or investment activity which provides the buyer with their primary source of income.

For a self-employed buyer, **financial statements**, including **profit and loss statements** and **balance sheets** on each business, rental or investment activity, are needed to determine their income and net worth. Financial statements coupled with the previous two years' tax returns confirm the information on the *financial statements*. [See **RPI** Form 209-2 and 209-3]

Assets minus liabilities equal net worth

When determining the buyer's **net worth**, the buyer's assets and liabilities are analyzed on a financial statement.

The buyer's assets include:

- cash balances in checking, savings and other accounts receivable;
- the current market value of stocks, bonds, personal property, businesses and real estate owned by the buyer; and
- the current values of vested interests in retirement funds such as 401Ks and IRAs and insurance policies.

The buyer's liabilities include the balance owed and monthly payments on:

- credit cards;
- open lines of credit;
- alimony and child support; and
- loans secured by the buyer's assets.

A buyer's net worth is the total value of their assets minus their total debt obligations or liabilities. Net worth is the bottom line shown on the financial statement entitled the *balance sheet*.

Evaluating credit information

Once a seller's agent has obtained a buyer's credit application and financial statements, the data needs to be evaluated by the seller and their agent.

When evaluating the financial and credit information received by the buyer, the seller's agent and seller are not to conduct themselves in a manner which discriminates against the buyer based on their:

- race, color, religion, national origin, or ancestry;
- sex, gender, gender identity, gender expression, or sexual orientation;
- marital status or familial status;
- source of income; or
- disability or genetic information.[12]

The buyer's representations of employment, cash deposits and loans with existing lenders need to be verified, as is documented by any mortgage lender. [See **RPI** Form 210 through 215-1]

Formulas for determining a buyer's ability to pay for any negative cash flow generated by the purchase of the property are structured as **expense-to-income** ratios. [See **RPI** Form 230]

For example, **Federal Housing Administration's (FHA's)** maximum ratio for housing expenses and mortgage payment to gross income is 31%. The maximum ratio for total expenses and payments on all debt to gross income is 43%.

Institutional lenders generally vary the ratio of housing expenses to gross income to around 30%, and the ratio of total expenses to gross income to around 40%. However, when applying ratios as guidelines to determine a buyer's creditworthiness, each buyer is to be treated individually. A buyer who does not meet the standard *expense-to-income* ratio is not necessarily an increased credit risk if other compensating factors exist.

Income-to-debt ratios assume all non-conforming individuals are unable to pay based on arbitrary mathematical formulas.

12 Calif. Government Code §12955

All things considered

Qualifying ratios cause the more complete credit reviews of a prospective buyer to be sacrificed for a quick and easy test of their financial ability. By the use of such qualifying ratios, some buyers who may qualify are not actually good credit risks and some disqualified buyers are actually good credit risks.

Also, requiring employment to be a qualification for prospective buyers unfairly discriminates against *rentiers*, individuals who receive income from sources other than their own labor, such as:

- businesses;
- investments;
- annuities;
- retirement pay;
- family support; or
- private subsidies.

The carryback seller needs to consider all credit information supplied by the buyer and look for a reason why the buyer qualifies as a good credit risk.

Only after all credit information has been reviewed — and creditworthiness has not been established — may the seller reasonably cancel the carryback transaction due to the buyer's lack of credit.

Chapter 4 Summary

The seller's agent owes a duty to the carryback seller to disclose the buyer's credit status. Written disclosures itemizing the buyer's credit information are mandated on all sales involving one-to-four unit residential properties when the seller carries back a portion of the sales price.

In addition, a seller who extends carryback financing on the sale of a one-to-four unit residential property intended for use or occupancy by the buyer or their family is required to determine and document the buyer's reasonable ability to repay the debt.

When the seller's agent becomes aware the representations made by a buyer overstate their creditworthiness and net worth, the seller's broker and their agent are both liable for the seller's losses if the buyer defaults on the note due to their inability to perform. In addition, the agent also faces suspension or revocation of their license for committing fraud.

Accurate credit information on the buyer helps the seller and their agent analyze the risk of default when extending credit to the buyer.

For the seller's agent to properly disclose the separate financial, tax and risk-of-loss aspects to a seller, a carryback disclosure statement needs to be attached to any purchase agreement which calls for a carryback mortgage. Both the carryback disclosure statement and the purchase agreement include a credit approval provision. The credit approval provision calls for the buyer to hand the seller a completed credit application.

The credit provision allows the carryback seller to terminate the purchase agreement by a written Notice of Cancellation if they disapprove of the buyer's creditworthiness.

A review of a buyer's creditworthiness requires credit history on the buyer from a consumer credit report.

For income-producing property, two additional financial aspects of a buyer's ability to perform on the carryback mortgage need to be investigated by all principals and agents involved:

- the ability of the property's income to cover the expenses and carry the debt service; and
- the ability of the buyer to personally service any negative cash flow resulting from the debt burden, lack of rental income or the owner's use of the property, called implicit rent.

Formulas for determining a buyer's ability to pay for any negative cash flow generated by the purchase of the property are structured as expense-to-income ratios. By the use of such qualifying ratios, some buyers who may qualify are not actually good credit risks and some disqualified buyers are actually good credit risks.

The carryback seller needs to consider all credit information supplied by the buyer and look for a reason why the buyer qualifies as a good credit risk.

Chapter 4 Key Terms

Chapter 5

Requests for notices of default and delinquency

Learning Objectives

After reading this chapter, you will be able to:

- explain when requests for notice of default and delinquency are used by holder of a junior mortgage to receive early notice of a delinquency or commencement of foreclosure on a senior mortgage;
- properly prepare and record requests for notice; and
- understand the process and timelines a senior mortgage holder or trustee needs to follow when notifying persons of a delinquency or recording of a Notice of Default (NOD).

Key Terms

beneficiary	**redeem**
Notice of Default (NOD)	**reinstatement**
Notice of Delinquency (NODq)	**trustee (on a mortgage)**

Risk mitigation by prior planning

A carryback seller or a lender who finances a portion of the price paid by a buyer to acquire a parcel of real estate typically holds a *security interest* in the property under a trust deed mortgage which is junior to a **senior mortgage** with priority on title.

The carryback seller holding a **junior mortgage**, like an equity lender or long-term tenant, needs to protect themselves against the foreseeable risk of the loss of their security interest in the property due to a delinquency by the owner and later foreclosure by the senior mortgage holder. A foreclosure sale of the property by the senior mortgage holder eliminates the carryback seller's or equity lender's trust deed lien on the property, called **exhaustion of the security**.

Notice of Delinquency (NODq)
The notice sent by a mortgage holder to a person who requested the notice within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on their mortgage.

Two risk-mitigation procedures are available to a junior lienholder and to a tenant with a subordinate leasehold interest in the property.

Structured as requests, persons with a junior interest in title to real estate receive notices from the senior mortgage holder regarding any **default** by the owner or **foreclosure** proceedings on the senior mortgage.

These procedures are:

- **Request for Notice of Delinquency (NODq)** — notice will be sent to the person requesting the notice within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on the senior mortgage [See **RPI** Form 412-2]; and
- **Request for Notice of Default (NOD)** — notice is sent to the person requesting the notice within 10 business days after a senior mortgage holder initiates foreclosure by recording an NOD. [See **RPI** Form 412-1]

Who may record a request?

Anyone, whether or not they hold an interest in the property, may *record a request* to receive a copy of any *NOD* which is later recorded under the trust deed identified in the request. This includes:

- a carryback seller;
- a junior lender;
- a tenant of the property; or
- a participant in any entity with an interest in title.

Notice of Default (NOD)
The notice filed to begin the nonjudicial foreclosure process. Generally, the NOD is filed following three or more months of delinquent mortgage payments.

The request does not require the consent of the property owner (or anyone else) and may be recorded at any time.

Conversely, to process a *Request for NODq*, the carryback seller, junior lender or tenant needs to first obtain the consent of the buyer or owner of the property. Consent is best obtained by including a provision in the purchase agreement, loan documents or lease agreement entered into with the buyer or owner, or on a later modification. [See **RPI** Form 150 §8.4 and 426 §7.6]

The buyer or owner consents to the NODq and the release of information by signing the request form. The request form is then recorded and a copy is served on the senior mortgage holder through escrow or other closing agent. [See Form 412 accompanying this chapter]

The senior mortgage holder will only release delinquency information if the request form is signed by the person who originated or assumed the mortgage.

Use of the Request for NODq is only available to persons with an ownership interest (co-owners and tenants) or security interest in the property.[1]

The NOD request

Unlike a Request for NODq, anyone may record a Request for NOD.

1 Calif. Civil Code §2924e(b)

Form 412

Request for Notice of Default and Notice of Delinquency

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF DELINQUENCY

By Junior Trust Deed Beneficiary

NOTE: This form is used by an escrow, lender or carryback seller when recording a junior trust deed or a change of address, to request a senior lienholder to send the junior lienholder a copy of any notice of default (NOD) the senior lienholder may record and a notice of delinquency (NODq) on a default in payments owed the senior lienholder.

Request for Notice of Default

Under Calif. Civil Code §2924b, request is hereby made for a copy of any Notice of Default (NOD) and a copy of any Notice of Sale under the Trust Deed recorded on ______________________, as Instrument No. ______________________, Official Records of ______________________ County, California, executed by ______________________, as the Trustor, in which ______________________ is the Beneficiary, and ______________________ is the Trustee, to be mailed to ______________________, as the Requester, whose address is ______________________.

NOTICE: A copy of any Notice of Default and of any Notice of Sale will be sent only to the address contained in this recorded request. If your address changes, a new request must be recorded.

Request for Notice of Delinquency

Under Calif. Civil Code §2924e, request is hereby made for Notice of Delinquency (NODq) under the above described Trust Deed being a lien on property commonly referred to as ______________________, and being your Loan No. ______________________, to be mailed to ______________________, as the Requester, whose address is ______________________. Requester is Beneficiary under a Trust Deed recorded on ______________________, as Instrument No. ______________________, in the Officials Records of ______________________ County, California, securing a note which will be due______________, 20________.

Consent of Trustor

As Trustor(s) under the above described Trust Deed, I/we hereby consent to this Request for Notice of Delinquency.

Trustor: ______________________ *(Signature)* Trustor: ______________________ *(Signature)*

The property is legally referred to as ______________________

Date: ______________20________ Requester: ______________________

Date: ______________20________ Requester: ______________________

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA

COUNTY OF ______________________

On ______________ before me, ______________________ *(Name and title of officer)*

personally appeared ______________________,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

(This area for official notarial seal)

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ______________________ *(Signature of notary public)*

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A recorded Request for NOD identifies:

- the person requesting a copy of the NOD, called the **requestor**, by name and mailing address; and
- the trust deed on which a copy of the NOD commencing foreclosure is requested.

To be valid, the Request for NOD needs to be recorded in the county where the property is located. No service of the request on the mortgage holder or trustee is required.

trustee (on a morgage)
A party to a mortgage who, as a legal fiction, holds title to property as security for the performance of an obligation with the authority to sell the property or reconvey the trust deed on instructions from the mortgage holder.

Consider these facts: To initiate foreclosure by a trustee's sale, the **trustee**, on instructions from the mortgage holder, records the NOD. The NOD states the nature of an owner's money default, and what can be done (if anything) to bring the debt current, called **reinstatement**.

Within 10 business days following the recording of the NOD, the *trustee* is required to *mail two copies* of the NOD to each person who recorded a request for notice, by:

- registered or certified mail; and
- first-class mail.[2]

redeem
The clearing of title to a parcel of real estate of a monetary lien, such as a mortgage, through payment of the debt in full as is required during a redemption period to avoid loss of the property either at a trustee's foreclosure sale or following a judicial foreclosure sale.

A carryback seller or private lender who have not recorded a Request for NOD and whose mortgage is junior to another on which an NOD has been recorded will still be sent two copies of the NOD by certified or registered mail and first-class mail *within one month* after the NOD is recorded. The tenant will not receive a copy of an NOD, unless their lease agreement is recorded.[3]

By recording the Request for NOD, the person making the request is sent notice of the NOD in 10 days, not 30 days. Thus, they are given a 20-day head start to either *reinstate* the delinquent mortgage or **redeem** the property by a payoff of the mortgage, if the owner does not.

However, the act of the trustee mailing a copy of the NOD, the minimum attempt required for service, and the requestor's receiving a copy of the NOD are entirely different events requiring further analysis.

Receiving an NOD

At commencement of the foreclosure process, the trustee mails a copy of the recorded NOD to the last address of record or the present address of the property owner or junior lienholders if it is known to the mortgage holder or trustee.[4]

For example, consider a Request for NOD which is recorded by a carryback seller to reflect their **change of address** from the address given in their recorded junior trust deed. The request calls for a copy of any NOD recorded under the senior mortgage identified in the NOD request form to be sent to the carryback seller at the address of their place of business. [See Form 450 §7 in Chapter 10]

reinstatement
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

Later on, the carryback seller has another change of address. But this time, they fail to record another Request for NOD stating their new address. The buyer's mortgage payments to the senior mortgage holder become delinquent and they fail to bring the mortgage current.

The trustee records an NOD. A copy of the NOD is mailed to the carryback seller at their current address which was known and provided by the mortgage holder. The buyer cures the default during the **reinstatement period**.

2 CC §§2924b(b)(1),(e)
3 CC §2924b(c)
4 CC §2924b(b)

Later, the buyer again becomes delinquent on their mortgage payments. An NOD is again recorded on instruction from the same **beneficiary**, but by their use of a different, substitute trustee.

beneficiary
One entitled to the benefits of properties held in a trust or estate, with title vested in a trustee or executor.

However, the mortgage holder does not provide the substitute trustee with the carryback seller's current address. The substitute trustee sends the NOD, and later the **notice of trustee's sales (NOTS)**, to the carryback seller's old address which was the last address of record. The notices are returned to the substitute trustee by the postal service as undeliverable, and thus are never forwarded to the carryback seller at their new address.

Outdated or incorrect address

Continuing our previous example, having never received an NOD, the carryback seller only learns of the NOD and the NOTS during the five-business-day redemption period preceding the date scheduled for the trustee's sale, after expiration of the *reinstatement period*.

The carryback seller seeks to have the substitute trustee rescind the NOD and cancel the trustee's sale, claiming the failure to send them notice of the NOD and NOTS to their address which was known to the mortgage holder invalidates the foreclosure process.

Did the mortgage holder properly follow statutory mailing requirements?

No! Here, the mortgage holder did not follow the statutory mailing requirements. The mortgage holder failed to advise the foreclosing substitute trustee of the carryback seller's current address which was known to them by prior correspondence.

However, the substitute trustee properly followed the statutory mailing requirements. The notification was sent to the carryback seller at their last address of record as reflected in the sale guarantee issued by the title company or known to the substitute trustee.

Failure to instruct

When a mortgage holder initiating foreclosure knows an interested person's current address (by correspondence to that address or otherwise), the mortgage holder is required to advise the substitute trustee to mail the notice to that address. If the trustee's sale does occur, money losses can be recovered by the junior mortgage holder from the foreclosing mortgage holder for failure to instruct the substitute trustee to mail the notice to the current address of the junior mortgage holder as known to the mortgage holder.[5]

Documents of record often have outdated or incorrect addresses. However, foreclosure trustees themselves are not required to engage in further efforts to investigate **unrecorded information** to see if the notice is mailed to the most current address for the person entitled to notice. In an effort to protect

5 CC §2924b (b)(3)

all interested persons, the trustee needs to inquire into the mortgage holder's knowledge of the current address of persons known to hold interests in the property and entitled to receive a copy of the NOD.[6]

Whenever an owner, carryback seller or tenant has a **change of address**, good practice compels them to record a new Request for NOD. When a new Request for NOD is recorded, the trustee foreclosing is required to send notices to the mailing address given in the new request for notice.

NODq protection

Recall that a recorded Request for NOD containing a current address assures a carryback seller they will be sent notice of the commencement of a trustee's foreclosure process within 10 days of the NOD being recorded.

However, by the time a senior mortgage holder records an NOD, the mortgage is often several months in arrears, or worse. The amount needed to be advanced by the carryback seller to reinstate the mortgage may be economically infeasible after a long-standing, continuing default.

Further, delays may occur before an NOD is recorded when mortgage holders are overwhelmed with defaults and modification efforts during recessionary periods, as occurred in recent years. These delays occasionally last a year or more.

Unable or unwilling to reinstate a hugely delinquent first mortgage, the carryback seller loses their second trust deed lien through *exhaustion of the security* when it is wiped out by the senior mortgage holder's foreclosure.

The Request for NODq assures the junior lienholder, who in this scenario is the carryback seller, that they will be notified **within 15 days** following the end of a **four-month period** of delinquent installment payments.[7]

Good brokerage practice when negotiating a carryback note or a private money loan secured by a junior trust deed includes the buyer's or owner's consent to use a combined **Request for Notice** form which includes both the NOD and NODq requests. The same advice holds for leasing agents assisting tenants when entering into long-term lease agreements. [See Form 412]

Recording and receiving a Request for NODq

A Request for NODq may be recorded by a junior lienholder and served on a senior mortgage holder — if agreed to by the buyer or owner — when the secured property is:

- a one-to-four unit residential property, for a junior mortgage with an original balance of any amount; or
- any other type of real estate, for a junior mortgage with an original balance not exceeding $300,000.[8]

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6 **I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281

7 CC §2924e(c)

8 CC §2924e(a)

For property other than one-to-four unit residential property, the senior mortgage holder is not required to respond by giving notice if the original principal balance of the junior mortgage was greater than $300,000.[9]

A Request for NODq is to include:

- the name and address of the carryback seller or private lender as the **requestor**;
- their security interest in the property as the **beneficiary of a trust deed;** and
- identification of the senior mortgage.

Written consent

The buyer or owner needs to **consent** to the Request for NODq by signing it as the **trustor** before the mortgage holder is required to comply with the request. The consent to the Request for NODq is best bargained for as part of the terms negotiated for the carryback note, loan origination or lease agreement. [See **RPI** Form 150 §8.4 and 426 §7.6; see Chapter 2]

The written consent of the buyer or owner may be either in:

- a separate document, such as the Request for Notice form; or
- included with the request in the body of the junior trust deed.

The latter is a complicated alternative since a copy of the trust deed containing the request is then required to be served on the senior mortgage holder.[10]

The properly prepared Request for NODq is served on the mortgage holder, together with a $40 fee, by regular mail addressed to the mortgage holder at the address where mortgage payments are received.[11]

For example, if the carryback seller is secured by a third trust deed, the first and the second mortgage holders are each entitled to $40 on their receipt of the Request for NODq.

The Request for NODq is prepared, recorded and served on the mortgage holder by escrow under instructions from the buyer and the carryback seller. In the case of a loan escrow, the instructions are from the owner and the private lender. All costs to prepare and record the notice are paid by the buyer or owner.

Length of validity and renewal

The Request for NODq is **valid for five years** from the date it is mailed to the mortgage holder or recorded, whichever event occurs last.[12]

Prior to the five-year expiration of the Request for NODq, it may be **renewed** for five additional years by recording and mailing the senior mortgage holder a copy of the original Request for NODq, together with a written statement of renewal and a fee of $15.

9 CC §2924e(a)
10 CC §2924e(a)
11 CC §2924e(b)
12 CC §2924e(b)

A renewal of the request may be sent no sooner than six months before the expiration date of the five-year period for the original request.[13]

Prompted by a Request for NODq from the carryback seller or private lender, the senior mortgage holder sends them a notice by regular mail within 15 days following a four-month delinquency in the payments of any monies due the mortgage holder which remains unpaid. The notice will include the status of the delinquency and the amount required to cure it.[14]

If the senior mortgage holder fails to give notice to the requester and a subsequent foreclosure or trustee's sale of the mortgaged property occurs due to the failure to provide notice within the required time period, the senior mortgage holder is:

- liable to the requester for any monetary losses they sustained from the date on which notice was to be given to the earlier of:
  - the date on which the notice is given; or
  - the date the NOD is recorded; and
- subject to a forfeiture of $300 to the requestor.[15]

Final considerations

The Request for NODq scheme, with its four month and 15 day delay before delivery of the notice of any delinquency, provides only limited protection. Thus, the carryback seller, private lender or tenant need to maintain sufficient **money reserves** to:

- cover future costs and advances required to reinstate the first mortgage on a default by the owner; and
- carry the payments on the first mortgage (and any delinquent taxes and insurance premiums) until the carryback seller or private mortgage holder are able to complete a foreclosure or pre-foreclosure workout with the owner.

An additional and more fundamental protection for the carryback seller who is subordinate to a senior mortgage is to consider the use of an **all-inclusive trust deed (AITD)**. As holder of an *AITD*, the carryback seller, not the buyer, is obligated to make payments on the first mortgage, provided the buyer pays the carryback seller on the AITD. [See Form 421, 442, and 443 in Chapter 15 and Form 450 in Chapter 10]

When an AITD is used, the need for information on delinquencies in underlying, wrapped mortgages is reversed between the buyer and the seller. It is now the buyer who needs to generate the Request for Notice as the *requestor*. Without the Request for Notice, the buyer will not receive early notice of a default on the wrapped mortgage if the seller fails to meet their obligations under the AITD to make timely payments.

The same consideration for an NODq needs to be given to a tenant's interest

13 CC §2924e(b)
14 CC §2924e(c)
15 CC §2924e(d)

under a lease with the owner. Here, the owner implicitly agrees to do nothing to interfere with the tenant's leasehold interest in the property such as failure to make mortgage payments – an impairment of the tenant's leasehold estate in the property.

Chapter 5 Summary

The holder of a junior lien or a long-term tenant needs to protect themselves against the foreseeable risk of the loss of their security interest in the property due to a delinquency and foreclosure by a senior mortgage holder. A foreclosure sale of the property by the senior mortgage holder eliminates the junior trust deed lien and lease on the property.

Two risk-mitigation procedures are available to junior lienholder and to a tenant with a subordinate leasehold interest in the property. These procedures are Request for Notice of Delinquency (NODq) and Request for Notice of Default (NOD).

Anyone may record a request to receive a copy of any NOD. Conversely, to process a Request for NODq, the requestor needs to first obtain the consent of the buyer or owner of the property.

By recording the Request for NOD, the requestor is sent notice of the NOD in 10 business days, as opposed to 30 days without a recorded Request for NOD.

The foreclosure trustee is required to mail two copies of the NOD to each person who recorded a request for notice, by registered or certified mail, and first-class mail.

At commencement of the foreclosure process, the trustee mails a copy of the recorded NOD to the last address of record or the present address of the property owner or junior lienholders if it is actually known to the mortgage holder or trustee.

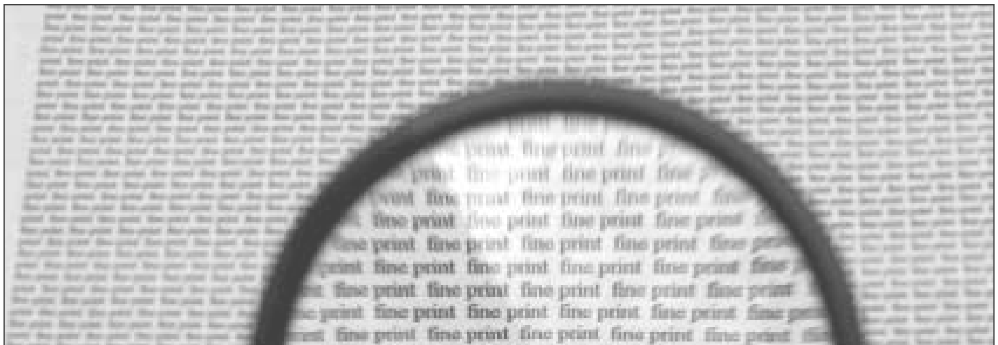
The Request for NODq assures the junior lienholder that they will be notified within 15 days following the end of a four-month period of delinquent installment payments.

When an all-inclusive trust deed (AITD) is used, the need for information on delinquencies in underlying, wrapped mortgages is reversed between the buyer and the seller. It is now the buyer who needs to generate the Request for Notice as the requestor to protect themselves if the seller defaults on the underlying mortgage.

Chapter 5 Key Terms

beneficiary	**pg. 49**
Notice of Default (NOD)	**pg. 46**
Notice of Delinquency (NODq)	**pg. 46**
redeem	**pg. 48**
reinstatement	**pg. 48**
trustee (on a mortgage)	**pg. 48**

Chapter 6



Evaluating the carryback note

Learning Objectives

After reading this chapter, you will be able to:

- discuss the rationale underlying an investor's purchase of a trust deed note at a discount; and
- calculate the discount needed to produce the yield desired by an investor.

Key Terms

carryback mortgage	**long-term rate**
deficiency	**note rate**
hypothecate	**short-term rate**
installment sale	**yield**

The financial function of a purchase discount

Consider a trust deed investor who conducts a due diligence investigation on real estate securing a trust deed note which is for sale. On determining the rate of return they need to make this investment, called the **yield**, the investor *calculates the discount* needed to establish the price they will offer to purchase the trust deed note.

Most trust deed notes offered for sale to trust deed investors are **carryback mortgages** created to finance the sale of real estate. Typically, carryback mortgages are junior in priority to an existing first mortgage.

yield
The interest earned by an investor on an investment (or by a bank on the money it has loaned). Also, called return.

A **discount** on the sale of a *carryback mortgage* is demanded by investors when it is necessary to deliver the investor a market-level *yield*. A discount is necessary when the carryback mortgage:

- bears interest at a rate below the private-money market rate;

- has low periodic (monthly) payments based on a long amortization period or interest only;
- has a medium- or long-term due date; or
- has a **loan-to-value ratio (LTV)** which presents a risk of loss due to deficient property value as security for repayment of the note.

short-term rate
A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.

long-term rate
An interest rate fixed for the duration of the loan.

Also, the market rate of interest sought by investors in second mortgages is influenced by the risks of loss and management requirements of holding a junior mortgage. The **short-term rates**, used to set rates on adjustable rate mortgages (ARMs) which are influenced by the over-night rate offered by the Federal Reserve (the Fed), and **long-term rates**, used to set rates for fixed rate mortgages (FRMs) which are influenced by anticipated future inflation as perceived by bond market investors, are not the basis used for setting rates charged by trust deed investors on second mortgages. These trust deed investors are not much concerned or involved with the money markets which set the *short-term* and *long-term rates*.

note rate
The interest rate agreed to between the homebuyer and the lender on the promissory note. Contrast with real interest rate.

Trust deed investors who invest in second mortgages demand a yield on their investment which is higher than either the current short-term or long-term rate, whether these rates are currently high, low, or have inverted.

carryback mortgage
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

Thus, interest rates in the second mortgage resale market are considerable higher than the interest rates on typical carryback mortgages. As a result, investors demand a higher yield than earned on the note's principal at the stated **note rate** — which leads directly to the *discount*.

The price a trust deed investor will pay for a note, called the note's **cash value**, moves contrary to the direction of the yield sought by the investor. The higher the investor's yield, the greater the discount. Thus, the lower the price paid for the note.

The discount based on uncertainties

The *cash value* paid by a trust deed investor to purchase a second mortgage is viewed as a percentage of the principal balance remaining on the note, such as 80% of its *face value*, or a 20% discount. [See Figure 1]

The present cash value an investor pays for a note is calculated based on:

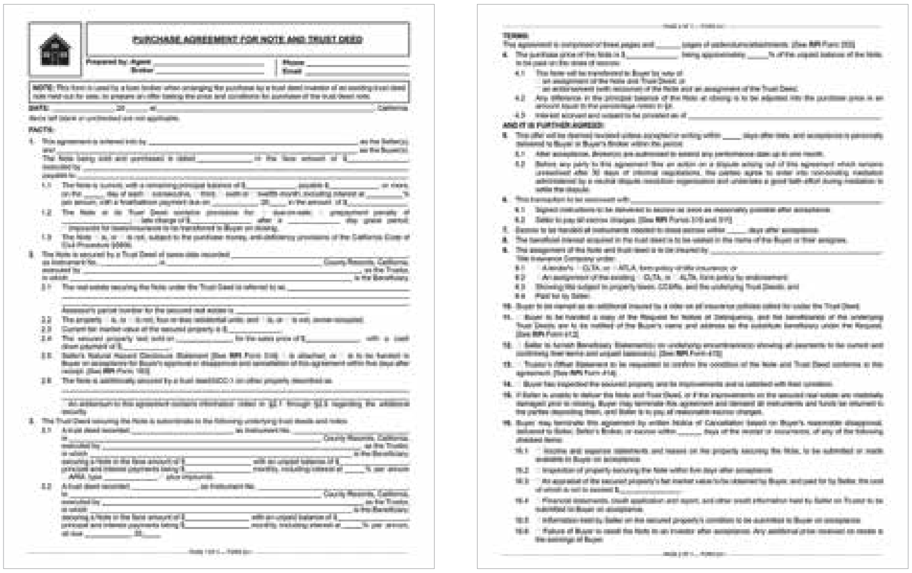
- the *dollar amount* of the regularly scheduled payments;
- the *principal balance* remaining and payable as the final/balloon payment on the note's due date; and
- the *yield sought* by the investor on the amount they pay for the note.

The discount, of course, is the percentage of the note's principal balance which is not paid to buy the note, such as 20%.

deficiency
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

The amount of a discount is influenced by the exposure of the investor's capital to the risk of loss arising out of *uncertainties*, including:

- the inadequacy of the value of the **equity position** in the real estate to fully secure repayment of the note in the event of a default, called a **deficiency**, based on the *LTV*;



PURCHASE AGREEMENT FOR NOTE AND TRUST DEED

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Figure 1

Form 241

Purchase Agreement for Note and Trust deed

- a delinquent **payment history** on the note;
- **nonrecourse** collection enforcement limited to the property's value;
- the lack of **guarantees,** private mortgage insurance (PMI) or letters of credit;
- unusual terms of the underlying senior mortgage, taxes or bond assessments which may tend to additionally impair the second trust deed lien;
- the priority of homeowners' association (HOA) assessments;
- questionable **creditworthiness** and unverifiable **net worth** and cash reserves held by the owner of the real estate securing the mortgage; or
- the occupant's use and rental terms for the secured real estate.

Carryback economics affect discount

A seller *maximizes the sales price* of their real estate by agreeing to carry a trust deed note containing:

- a **high LTV** for the principal amount of the carryback note, usually due to a small down payment;
- a **low interest rate** which does not compensate for the risk of loss inherent in the highly leveraged junior carryback mortgage; and
- a **medium-term due date** of four to nine years, or more.

Thus, a carryback mortgage provides attractive financing for buyers. Sellers often offer carryback financing to *facilitate the sale* of their property when a buyer is unable or unwilling to borrow sufficient funds which they do not have to cash out the sale at the seller's asking price.

installment sale
Financing provided by a seller who extends credit to the buyer for future periodic payments of a portion of the price paid for real estate, also known as carryback financing.

hypothecate
To pledge a thing as security without the necessity of giving up possession of it. To mortgage a property. [See **RPI** Form 242]

As for the financial benefits to a seller besides ridding themselves of their property, a carryback mortgage contains profit from the sale. As an **installment sale,** it produces the financial benefit of a deferred tax liability until the principal balance is paid, or the seller sells or **hypothecates** the note by an assignment.[1]

Taxwise, an above-market price for a parcel of real estate and a carryback note with a below-market interest rate and a long-term due date translates, respectively, into:

- *greater profit* to be reported in the future at lower capital gains rates; and
- *lesser interest income* to be reported in the future at higher standard income tax rates.

The savings in reduced overall income taxes the seller will experience by deferring the profit tax liability on an enlarged profit and reporting interest income on a below-market rate on the carryback mortgage is additional compensation for providing the financing.

Editor's note — The principal amount of the note (as reported by the seller only) is subject to reallocation to interest under Internal Revenue Service (IRS) imputed reporting rules based on the Applicable Federal Rate (AFR) for the note on the date the purchase agreement is accepted. [See Chapter 25]

However, while a seller structures carryback terms in order to boost the sales price of the real estate, they are reducing the interest rate on the note. Thus, this trade off presents **drawbacks** for the carryback seller if the note is to be sold or *hypothecated*.

LTV leverage concerns

When the equity remaining in the secured property over and above the amount of the carryback note is unacceptably small — a risk-of-deficiency situation referred to as a high LTV — the note's cash value paid by a trust deed investor is adversely affected.

1 26 United states Code §453

A prudent investor interested in buying a trust deed secured by a single family residence will require the secured real estate to have at least a **20% gross equity** — over and above the secured position held by the trust deed note offered for sale.

In the event of a default on the note, a gross equity smaller than 20% of the property's value is entirely consumed (and most likely exceeded) by the:

- cost to foreclose;
- amount of cash advanced to carry the senior mortgage and pay taxes; and
- expenses incurred to resell the property . [See **RPI** Form 303]

Further, property owners with larger equities in their properties are more motivated to keep their mortgage payments current than owners with a smaller equity. Thus, an insufficient LTV for a note secured by real estate causes an investor to further discount the note to cover the additional risk of loss of the note's principal due to a *deficiency* in the property's value in the event the trust deed investor needs to foreclose.

As an alternative, a seller holding a trust deed note on a property with an LTV in excess of 80% needs to consider a **collateral loan** secured by the carryback note, rather than selling the carryback note at a drastic discount. By borrowing against the note using it as security for repayment, the discounting is entirely avoided.

Discounting the balloon payment note

The **present cash value (PV)** of a note based on the yield sought by the investor is easily established by use of a handheld financial calculator. By entering the note's current principal balance, interest rate, amount of scheduled installments and due date, an investor calculates the amount they will pay.

Consider an investor who purchases a note with a long-term due date, one beyond nine years. If the investor expects consumer inflation to rise during the long payoff period, the *real* rate of return on their invested funds falls as inflation rises. Thus, excessive inflation erodes the future **purchasing power** of the principal balance owed on the note.

Also, unforeseeable events in the future may render the secured real estate obsolete or less valuable due to changing demographics of its location or maintenance, which will impair the value of the note.

The longer the time period for payment of the note's scheduled installments before the due date for payoff of the principal balance, the greater the discount and the lower the note's present value. Thus, you have the method of accounting for the increased risk of loss due to inflation and obsolescence.

An investor wants compensation for the additional risks that may present themselves while waiting for the return of their invested cash.

Figure 2 and 3

The Balloon Payment

and

The Cash Value

The balloon payment on the note is calculated on a standard financial calculator as follows:

- *Enter the number of monthly payments [60 N].*
- *Enter the monthly interest rates [10% g i], or [10/12 i].*
- *Enter the amount of the note's remaining principal [$60,000 PV].*
- *Enter the amount of the payment [$600 CHS PMT]. This will be displayed as a negative.*
- *Request the final/balloon payment of principal due on the note [FV]. $52,256.29 is due with the 60th payment.*

Retain the entries from Figure 2 above and make the following subtitutions to compute the discount neccessary to receive the desired 18% yield:

- *Enter the desired yield [18% g i].*
- *Request the note's present cash value [PV]. The present cash value of the note is $45,016.45.*

Due to discounts, the actual final/balloon payment amount on a note is often greater than the note's present cash value. When the difference is significant, a carryback seller avoids a discount entirely by borrowing against the note, using it as collateral, called hypothecation. Thus, the seller retains the right to receive the final/balloon payment.

Occasionally, investors erroneously perceive a collateral loan as a purchase of the note's monthly payments, a flow of cash. This type of transaction does not occur, no matter the documentation. The holder of a note cannot sever payments from the principal of the note and separately sell payments to an investor. It is the note which the borrower assigns as collateral, not its interwoven, inseparable parts. On a default in payments, it is the principal in the note that the lender recovers, not the payments.

Before an investor calculates the discount to set the price they will pay for a note, the investor needs to:

- *calculate the amount* of the final/balloon payment due on the note; and
- *set the yield* sought on their investment in the trust deed note.

The balloon payment (Figure 2)

Consider an investor who investigates a carryback note which is offered for sale. The note has a remaining principal balance of $60,000, an interest rate of 10%, monthly payments of $600, and a final/balloon payment due in five years.

Before purchasing the note, the investor needs to establish the amount of the final/balloon payment.

The entries in Figure 2 are used to calculate the final/balloon payment. [See Figure 2]

The cash value (Figure 3)

Continuing with our previous example, the investor wants an 18% yield on their investment in the $60,000 trust deed note, not the interest rate stated on the face of the note. The entries in Figure 3 establish the cash value the investor will pay to acquire the note. [See Figure 3]

Chapter 6 Summary

Most trust deed notes offered for sale to trust deed investors are carryback mortgages created to finance the sale of real estate.

A discount on the sale of a carryback mortgage is demanded by investors when it is necessary to deliver the investor a market-level yield. The market rate of interest sought by investors in second mortgages is influenced by the risks of loss and management requirements of holding a junior mortgage.

Trust deed investors who invest in second mortgages demand a yield on their investment which is higher than either the current short- or long-term rates.

The cash value paid by a trust deed investor to purchase a second mortgage is viewed as a percentage of the principal balance remaining on the note. Thus, the amount of a discount is influenced by the exposure of the investor's capital to the risk of loss arising out of uncertainties.

As an installment sale, carryback financing produces the financial benefit of a deferred tax liability. The savings in reduced overall income taxes the seller will experience by deferring the profit tax liability on an enlarged profit and reporting interest income on a below-market rate on the carryback mortgage is additional compensation for providing the financing.

When the equity remaining in the secured property over and above the amount of the carryback note is unacceptably small, the note's cash value paid by a trust deed investor is adversely affected. Thus, an insufficient LTV for a note secured by real estate causes an investor to further discount the note to cover the additional risk of loss of the note's principal due to a deficiency in the property's value in the event the trust deed investor needs to foreclose.

Chapter 6 Key Terms

Chapter 7

The promissory note

Learning Objectives

After reading this chapter, you will be able to:

- understand the function of a promissory note;
- identify the different types of promissory notes and debt repayment arrangements; and
- determine the relationship between a promissory note and a trust need.

Key Terms

adjustable rate mortgage (ARM)

all-inclusive trust deed (AITD) note

Applicable Federal Rate (AFR)

balloon payment

graduated payment mortgage

installment note

promissory note

reconveyance

shared appreciation mortgage

straight note

usury

Evidence of the debt

Most real estate sales hinge on financing some portion of the purchase price, stated as a contingency to the buyer's closing of escrow. In these *purchase-assist* mortgage financing arrangements, a lender funds the buyer's purchase price.

In exchange for receiving the mortgage, the buyer promises to pay a sum of money to the lender either in:

- installments; or
- a single payment at a future time.

Sidebar

Buyer or borrower?

*RPI uses both the term "buyer" and "borrower" in this material depending on the fact situation presented. **Buyer** describes a person involved in the purchase of real estate. **Borrower** describes any person who promises to repay a loan which funds the purchase or refinance of real estate. When acquiring ownership of a property, a person acts both as a buyer and a borrower. In these instances, we use the term most reflective of the person's role with others (seller or lender) in the transaction.*

In an installment sale, the buyer makes payments to the seller under a **carryback financing arrangement** negotiated in a purchase agreement.

In either arrangement, the promise to pay the debt created by the funds advanced or property conveyed is set out in a written document called a **promissory note**. A *promissory note* is a document given as evidence of a debt owed by one person to another.[1]

promissory note
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

To be enforceable, the promissory note needs to be signed by the buyer, also known as the **borrower**, **debtor** or **payor**. On closing the sale, the buyer's note is delivered to the lender or carryback seller, called the **payee**.

A note may be **secured** or **unsecured**. A *secured note* is a note evidencing debt which is backed by an asset, known as the **security,** also called **collateral**. The note is attached to property as a lien on title through the use of a *security device.*

installment note
A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final balloon payment. [See **RPI** Form 420, 421 and 422]

If the note is secured by real estate, the security device used is a **trust deed,** commonly called a **mortgage**. When secured, the debt evidenced by the note becomes a voluntary lien on real estate described in the *trust deed* that references the note.

The promissory note

Notes are categorized by the method for repayment of the debt. Thus, they are either:

- **installment notes**; or
- **straight notes**.

An *installment note* calls for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final/ balloon payment.

straight note
A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

The two major variations of the installment note are the:

- **interest-included notes** [See Form 420 in Chapter 8]; and
- **interest-extra notes.** [See Form 422 in Chapter 8]

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1 Calif. Code of Civil Procedure §1933

Installment note, interest included

The *interest-included installment note* is the most commonly used note for real estate financing. Interest-included installments notes are the standard for consumer mortgage financing.

An interest-included installment note produces a schedule of constant periodic payments which amortize the principal. In doing so, the constant amount of scheduled payments contains diametrically varying amounts of principal and interest from payment to payment. With each payment, the amount of principal reduction increases and the amount of interest paid decreases. [See Form 420 in Chapter 8]

Each payment is applied first to the interest accrued on the remaining principal balance during the period between payments, typically a month. The portion of the payment remaining is applied to reduce the principal balance. Interest accrues on this reduced principal amount for the next payment.

Interest-included installment notes are paid off through:

- constant periodic payments of principal reduction until the principal has been fully repaid, a process called **amortization**; or
- a period of constant installment payments followed by a final lump sum payment of principal, called a **final/balloon payment**, on a **due date** specified in the note.

However, final/balloon payments on consumer mortgages are only allowed under the general **ability-to-repay (ATR)** rules or small creditor balloon **qualified mortgage (QM)** rules.

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

Installment note, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid separately, typically together with payment of the principal installment.

The principal payments remain constant until the periodic principal reductions fully pay the principal or a *due date* calls for a final/balloon payoff of principal. After each payment of principal, future interest is calculated as accruing on the remaining balance, decreasing the interest payment. [See Form 422 in Chapter 8]

Thus, unlike an interest-included note with constant periodic payments, the amount of each scheduled payment of principal and interest on an interest-extra note declines in amount from payment to payment.

For example, the first payment of interest is based on the entire original unpaid balance of the interest-extra note. The second interest payment will be on the principal amount remaining after the principal reduction resulting from the first payment. To set the amount of each periodic payment, the accrued interest due to be paid with each principal payment is recalculated for each payment until the principal is paid off. This type of payment schedule is typically used in *land sales transactions*.

Straight notes

A **straight note** calls for the entire amount of its principal together with accrued interest to be paid in a single lump sum when the principal is due. Unlike in the installment note variations, a *straight note* does not include periodic payments of principal. [See **RPI** Form 423]

Interest usually accrues unpaid and is due with the lump sum principal installment. Thus, this form of real estate financing is sometimes referred to as a **sleeper trust deed**. Occasionally, the accruing interest is paid periodically during the term of a straight note when principal is not due for a year or two.

The straight note is typically used by lenders or carryback sellers to evidence short-term debt. Straight notes are rare in real estate transactions since most mortgages are long-term debts. However, straight notes are used to evidence short-term real estate obligations, like **bridge loans** used to purchase a property when the buyer's funds needed for closing will not be available until later.

Even if a bridge loan is a consumer mortgage secured by a one-to-four unit residential property, it is not subject to *ATR* rules if the term is 12 months or less.[2]

Payment variations

shared appreciation mortgage
A type of split-rate note calling for the proprty owner to periodically pay interim interest at a fixed rate, and when the balance is due, to further pay the holder of the note as additional interest an agreed fraction of the property's increased value. [See **RPI** Form 430]

A note with a fixed interest rate, commonly called a **fixed rate mortgage (FRM)**, provides the classic method for calculating interest that accrues on principal. With an FRM, the interest rate remains fixed for the life of the mortgage.

However, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the special needs of the lender and borrower. Variations include the:

- **adjustable rate mortgage (ARM);**
- **graduated payment mortgage (GPM);**
- **all-inclusive trust deed (AITD) note;** and
- **shared appreciation mortgage (SAM)**.

Adjustable rate mortgage

adjustable rate mortgage (ARM)
A variable interest rate note, often starting out with an introductory teaser rate, only to reset at a much higher rate in a few months or years based on a particular index. [See **RPI** Form 320-1]

The *ARM*, as opposed to an *FRM*, calls for periodic adjustments to the interest rate. In turn, the amount of the scheduled payments fluctuates with each interest rate adjustment based on the original amortization period of the note. The interest rate adjusts based on movement in an agreed-to index, such as the *Cost of Funds Index (COFI)* for the *11th District Federal Home Loan Bank*. [See Chapter 16]

Editor's note – Charts of the COFI and other indexes used for ARM adjustments are available with updated figures at realtypublications.com/charts.

The ARM interest rate formula delivers greater revenue to the mortgage holder when short-term interest rates trend upward above the initial note rate on origination. With an FRM, the lender's yield (and the borrower's monthly payment) is constant for the full term of the mortgage.

2 12 CFR §1026.43(a)(3)(ii)

When an interest rate adjustment occurs, the note's repayment provisions call for an increase or decrease in the monthly payment to maintain the original amortization period. In the interest rate cycle of rising short-term rates, if the amount of the original monthly payment is not adjusted to reflect an increase in the amount of interest due at the adjusted rate, one of two things happens:

- the amortization period is extended; or
- the principal balance owed increases when the amount of interest accruing exceeds the monthly payment, called **negative amortization**.

graduated payment mortgage
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

For consumer mortgages, *negative amortization* is only allowed under the general ATR rules, and is not allowed under *QM* rules.

Graduated payment mortgage

With a *GPM*, payments increase periodically by predetermined amounts until the payment fully amortizes the principal over the remaining life of the mortgage without a further increase in payments, the interest rate on the note being fixed. GPMs are in demand when interest rates or home prices rise too quickly and ARMs are disfavored by the buyer. The graduated payment schedule allows buyers time for their income to increase and cover mortgage payments when they reach the level that will fully amortize the principal without a further graduation in payments.

For example, a borrower takes out a GPM. The initial low monthly payments on origination are less than the interest that accrues on the principal balance. The payments are gradually increased over the first three to five years of the mortgage until the payment amortizes the principal over the remaining term.

However, the monthly interest accrued and remaining unpaid each month is added to the principal balance. This results in *negative amortization* since the principal is increasing rather than decreasing with each payment. Thus, the negative amortization causes the unpaid interest to bear interest as principal, called **compounding**.

All-inclusive trust deed note

The AITD variation of a note is common in carryback transactions. The AITD note, also known as a **wraparound** or **overriding note**, typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays the installments as they become due on the underlying (senior) mortgage, generally out of the payments received on the AITD note. [See Chapter 14]

AITDs become popular in times of recession and rising mortgage rates due to tight credit.

Shared appreciation mortgage

The *SAM* repayment schedule variation is designed to help carryback sellers attract buyers at lower prices during times of tightening mortgage money conditions. The SAM, a type of **split-rate note,** calls for the buyer to periodically pay interim interest at a fixed rate, then when the principal balance is due, to further pay the mortgage holder additional interest calculated as a fraction of the property's increased net value since origination. [See Form 430 accompanying this chapter]

Applicable Federal Rate (AFR)
Rates set by the Internal Revenue Service for carryback sellers to impute and report income at the minimum interest when the note rate on the carryback debt is a lesser rate.

Under a SAM note, the buyer pays an initial fixed interest rate, called a **floor** or **minimum rate.** The floor rate charged is typically two-thirds to three-fourths of the prevailing market rate, but not less than the **Applicable Federal Rate (AFR)** for reporting imputed interest.

In return, the carryback seller receives part of the property's appreciated value as additional interest, called **contingent interest**, when the property is sold or the carryback SAM is due.

Financial aspects

A *note* documents the terms for repayment of a mortgage, including:

- the amount of the principal to be paid;
- the interest rate charged on the remaining principal;
- the periodic payment schedule; and
- any due date.

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

For carryback mortgages, the dollar amount of the note depends on whether the carryback is evidenced by:

- an *AITD* note; or
- a regular note.

Using an AITD note to evidence a carryback debt always results in a greater face value than structuring the carryback using a regular note. The AITD note includes the principal amount remaining unpaid on the existing mortgage encumbering the property and the amount remaining unpaid on the seller's equity in the property after the down payment.

In contrast, a regular note in the same scenario is for the amount of the unpaid portion of the purchase price remaining after deducting the down payment and the principal remaining unpaid on the mortgage taken over by the buyer.

Interest rate limitations on mortgages

For *consumer mortgages* made by a lender or non-exempt carryback seller, ATR rules require establishment of the borrower's ability to repay the mortgage. While setting the payment amount does not impose interest rate limitations, the ATR rules set the maximum monthly payment the borrower is qualified to pay on the consumer mortgage based on their **debt-to-income**

SHARED APPRECIATION NOTE
Installment — Contingent Interest Extra

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

$______________, dated ______________, 20______, at ______________________________, California.

Items left blank or unchecked are not applicable.

1. In installments, I promise to pay to ______________________________________, as the Payee , or order, at ____,
   1.1 the sum of ____ DOLLARS,
   1.2 with interest from ____________, 20______, on unpaid principal,
   1.3 at the rate of ______ % per annum, plus any contingent interest provided for below.
2. Principal and interest payable in installments of $______________, or more,
   2.1 on the ____________ day of every ☐ month ☐ quarter ☐ year, beginning on the ____________ day of ____________, 20______,
   2.2 and continuing until ____________, 20______, when the principal is due and payable.
3. **CONTINGENT INTEREST:**
   3.1 Contingent interest shall be due on any of the following events:
      a. maturity of the note;
      b. resale of the property;
      c. prepayment of the note; or
      d. acceleration of the note.
   3.2 Contingent interest shall be payable only from the net appreciated value of the secured property.
   3.3 Contingent interest is computed as follows:
      a. ______% of the net appreciated value of the property when the contingent interest is due; or
      b. ______% annually on the original note amount, compounded annually at the aggregate note rate until the contingent interest is paid.
4. **NET APPRECIATED VALUE:**
   4.1 The net appreciated value is the fair market value of the property when the contingent interest is due, less Payor's original acquisition costs, the value of additional capital improvements made by Payor, and customary resale costs including a brokerage fee.
   4.2 Payor's original acquisition cost of the property includes the total purchase price, plus customary escrow and recording fees, title insurance premiums, notary fees, legal fees, credit report fees, appraisal fees, broker fees, loan origination or assumption fees, inspection fees and all other customary costs incurred in acquiring the security.
      a. Payor must document the above costs within two months after close of escrow by delivering their escrow closing statement and other supporting documents to Payee.
5. **FAIR MARKET VALUE:**
   The fair market value of the property shall be determined as follows:
   5.1 When the security is not being resold, by appraisal on the following method:
      a. Payor to obtain and pay the costs of an appraisal of the property value prepared by a certified residential real estate appraiser within three months prior to payment of the contingent interest.
   5.2 On resale of the property, the sales price shall be deemed the fair market value, unless Payee contests the sales price in writing within 10 days after receipt of written notification of the sale from Payor. If Payee contests the sales price, fair market value will be the greater of the sales price or the amount determined by appraisal under Section 5.1.
   5.3 Payor and Payee may at any time establish the fair market value by mutual agreement.
6. **ADDITIONAL CAPITAL IMPROVEMENTS:**
   Payor may have the value of capital improvements added to his cost of the property by mailing to Payee a cost breakdown for approval prior to undertaking the improvement. If approval is withheld, the value of capital improvements shall be determined by appraisal at the time of improvement under Section 5.1.

———————— PAGE ONE OF TWO — FORM 430 ————————

Form 430

Shared Appreciation Note

Page 1 of 2

(DTI) ratio. In turn, when the maximum qualifying payment is coupled with the interest rate charged, the result sets the limit for the amount of principal debt the borrower may incur in the transaction.[3]

In addition, California's **usury law** limits the interest rate on *non-exempt* real estate loans to the greater of:

- 10%; or
- the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%.[4] [See Chapter 23]

usury
A limit on the lender's interest rate yield on nonexempt real estate loans.

3 12 CFR §1026.43(a)
4 Calif. Constitution, Article XV

Form 430

Shared Appreciation Note

Page 2 of 2

PAGE TWO OF TWO — FORM 430

7. PREPAYMENT: (check one only)

7.1 ☐ For owner-occupied, one-to-four residential units: If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

7.2 ☐ For all other residential and nonresidential property: Privilege is reserved to prepay all or part of this note at any time by paying principal, accrued interest, and six months' unearned interest.

8. LATE PAYMENT:

If any installment payment under this note is not paid within ______ days after its due date, a late charge of $______________ shall be incurred by Payor and be due and payable upon Payee's demand.

9. BALLOON/FINAL PAYMENT NOTICE:

☐ This note is to contain the following balloon payment notice provision (mandatory on sales of four-or-less residential units): This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 days and not more than 150 days before any balloon payment is due.

10. GENERAL PROVISIONS:

10.1 Any unpaid interest shall be added to the principal and thereafter bear interest as the principal.

10.2 Should default occur on any installment of principal or interest when due, then the whole sum of principal and interest shall be due at the option of Payee.

10.3 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

10.4 Principal and interest payable in lawful money of the United States of America.

10.5 This note is secured by a DEED OF TRUST.

Payor's Name: ______________	Payor's Name: ______________
Payor's Signature: ______________	Payor's Signature: ______________
Payor's Name: ______________	Payor's Name: ______________
Payor's Signature: ______________	Payor's Signature: ______________

FORM 430 02-16

Usury laws apply only to a **loan of money** or the **forbearance of payment** on a money loan.[5]

Seller carryback notes are not money loans. Rather, they are installment sales that extend credit for payment of the price on a sale. Thus, they are not covered by usury law.[6]

A loan, if not exempt, is usurious if the note rate exceeds the ceiling rate on the day the note is entered into. Further, other benefits received by the lender may make a loan usurious when the terms on the face of the note are not usurious. [See Chapter 23]

Importantly, real estate loans *made or arranged* by a real estate broker are exempt from the state usury restriction.

The trust deed

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold as security for payment of the portion of the price left to be paid. [See Chapter 10]

5 Calif. Const. Art. XV §1

6 **Boerner** v. **Colwell Company** (1978) 21 C3d 37

The trust deed is recorded to give public notice and establish priority of the seller's security interest in the property.[7]

A trust deed without a monetary debt is worthless since it secures nothing as a lien to the property described. Although the note and trust deed executed by a buyer in favor of a lender or seller are separate documents, a trust deed is only effective when it provides security for an existing promise to pay or perform any lawful act that has a *monetary value*.[8]

Though they are separate documents, the note and trust deed for the same transaction are considered one contract to be read together.[9]

Satisfaction of the debt

When a debt secured by a trust deed lien on real estate has been fully paid, the lien is removed from title.

To release the lender's trust deed lien from the real estate, a process called **reconveyance**, the trustee under the trust deed needs to:

- obtain the original note from the lender; and
- complete a request for *reconveyance*.[10]

If the lender or the trustee fails to reconvey the security interest after full payment, either may be subject to:

- a criminal fine of $400; and/or
- six months' imprisonment.[11]

reconveyance
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

7 **Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454
8 **Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543
9 Calif. Civil Code §1642
10 CC §2941
11 CC §2941.5

Chapter 7 Summary

A promissory note is a document given as evidence of a debt owed by one person to another. To be enforceable, the promissory note needs to be signed by the payor and delivered to the lender or carryback seller on closing the sale.

A note may be secured or unsecured. If the note is secured by real estate, the security device used is a trust deed, commonly called a mortgage. When secured, the debt evidenced by the note becomes a voluntary lien on the real estate described in the trust deed that references the note. Even though they are separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together.

Notes are categorized by the method for repayment of the debt as either installment notes or straight notes. The installment note is used for debts paid periodically in negotiated amounts and at negotiated frequencies. A straight note calls for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due.

An interest-included installment note produces a schedule of constant periodic payments which amortize the mortgage principal. Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid separately, typically concurrent with payment of the principal installment.

Variations exist on the interest rate and repayment schedules contained in installment and straight notes, including the:

- adjustable rate mortgage (ARM);
- graduated payment mortgage (GPM);
- all-inclusive trust deed (AITD); and
- shared appreciation mortgage (SAM).

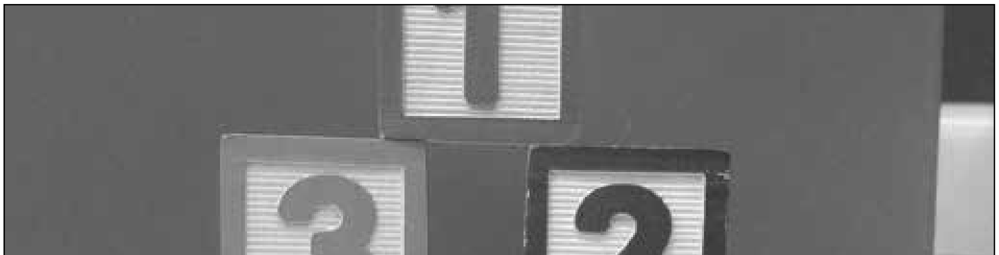
California's usury law limits the interest rate on non-exempt real estate loans to the greater of:

- 10%; or
- the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%.

When a debt secured by a trust deed lien on real estate has been fully paid, the lien is removed from title, a process called a reconveyance.

Chapter 7 Key Terms

Notes:



Chapter 8

Basic provisions in trust deed notes

Learning Objectives

After reading this chapter, you will be able to:

- identify the basic provisions in a note;
- explain the function of each provision in a note; and
- understand how a note is coupled with a trust deed to become secured by a lien on real estate.

Key Terms

acceleration	**hypothecate**
accrual note	**imputed interest rate**
add-on note	**interlineation**
allonge	**nonrecourse mortgage**
consumer mortgage	**note**
exculpatory clause	**reinstatement**
grace period	

Minimum elements for a note to be enforceable

A **note,** commonly called a **promissory note**, needs to contain the following provisions to be enforceable:

- the amount of principal owed;
- the interest rate charged on the principal;
- the schedule for repayment of the debt; and
- who is responsible for repayment.

note
A document, often secured by a trust deed on real estate, evidencing an obligation to pay money to a creditor, usually a lender or carryback seller. [See **RPI** Form 421 and 424]

The *note* is not the debt itself. Rather, the note is *evidence* of the existence of a debt created by an underlying agreement to pay money. To be enforceable, the terms spelling out the repayment of a debt need to be **definite** and **certain**. [See Form 420 accompanying this chapter]

The typical note secured by real estate provides for installment payments of principal and interest (PI). Payments are usually based on a debt **amortization schedule**.

Occasionally on land sales, the terms for repayment of a debt call for principal to be paid in installments with accrued interest paid in addition to the principal installment. [See Form 422 accompanying this chapter; see **RPI** Form 168]

A note also provides a checklist of the minimum fundamental elements of a debt which need to be agreed to for the note to be enforceable.

The following analyses and instructions are for the preparation and use of **RPI (Realty Publications, Inc.)** Form 420, **Note Secured by Deed of Trust – Installment – Interest Included**. It is designed for use by real estate brokers, their agents and escrow officers when documenting a debt created by a purchase agreement, loan agreement or escrow instructions.

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

Editor's note — If a mortgage on a one-to-four unit residential property funds a consumer purpose such as the acquisition of a buyer's family home or vacation home, it is classified as a ***consumer mortgage****. Consumer mortgages are controlled by the federal Truth-in-Lending Act (TILA) and Regulation Z (Reg Z). Any real estate licensee making or arranging a consumer mortgage for a fee is required to have a mortgage loan originator (MLO) endorsement on their California Bureau of Real Estate (CalBRE) license.*[1]

When a note is prepared for a debt to be secured by real estate, a trust deed is also prepared to impose a lien on the real estate for the amount of the debt evidenced by the note. The note is signed by those who agree to repay the debt, called the **payors**.

The numbers on the following instructions correspond to the numbers given provisions in Form 420.

Identification of the note

The *dollar amount* of the debt is entered at the top left corner of the note for identification and reference purposes only.

Additionally and separately, the actual *principal amount* of the debt to be paid appears:

- in the body of the note at §1.3;
- by **endorsement**; or
- in an **allonge**.

1 Calif. Business and Professions Code §10131.1(b); 12 Code of Federal Regulations §1026.36

The principal amount of the debt promised to be paid may be different from the dollar amount entered to identify the note. The differing amounts are generally due to adjustments and prorations made to the principal debt at the close of escrow on the transaction creating the debt. The dollar amount entered to identify the note remains unchanged since it is for identification purposes and not for setting the amount of the debt promised to be repaid in §1.3.

The dollar amount entered at the top of the note for identification purposes is also entered in the note's trust deed to cross reference the note. On closing, the debt becomes secured by the real estate described in the trust deed.

Additional identification

Consider a trust deed securing a debt which makes reference to a note "of same date" to the identification date of the trust deed. In this scenario, the identification dates in the top of the note and trust deed are identical.

However, if the trust deed is not prepared on the same date as the identification date for an existing note, the words "same date" are *stricken* from the trust deed and the date of the note is entered to identify the note secured by the trust deed. This activity is called **interlineation**. [See Form 450 in Chapter 10]

interlineation
The process of modifying boilerplate wording in a form by inserting additional language between the printed lines.

The *location* where the note is prepared is also entered at the top of the note, again for identification purposes only. The location of preparation may differ from the place the payments on the debt are to be made as called for in §1.2.

The entries for the dollar amount, date and city are used when referencing the note. Identification of the note is required on the note's trust deed or on a later assignment of the note and trust deed.

1. Consideration for the note

The person signing the note, called the **debtor** and entitled the *payor*, needs to receive something of value in exchange for their promise to pay given in the note. In the context of real estate finance, the consideration for the promise to pay is the money lent or property sold on credit to the borrower.

The words "for value received" is boilerplate wording for the borrower's acknowledgement of their receipt of **consideration** given by the lender (in the form of money) or carryback seller (in the form of property) in exchange for the borrower's promise to pay. A note is unenforceable by its holder unless valid consideration is given to the borrower in exchange for signing and handing over the note, a process called **execution of the note**.[2]

The borrower *promises to pay* the debt owed to the mortgage holder according to the terms for repayment *memorialized* in the note. Payments are made on an installment basis, occasionally including a lump sum installment as a **final/balloon payment**.

2 **Doria** v. **International Union, Allied Industrial Workers of America, AFL-CIO** (1961) 196 CA2d 22; Calif. Commercial Code §3303

An unconditional promise to pay is essential for the note to be negotiable by the carryback seller — transferable on the sale of the note by assignment.

A promise to pay is considered *unconditional***,** unless the promise states:

- a condition to payment exists;
- the promise is governed by another contract; or
- the rights and obligations concerning the promise are contained in another contract.[3]

The note needs to be negotiable if the seller is to sell or borrow against the note and trust deed, called **hypothecation** or **collateral assignment**.[4]

hypothecate
To pledge a thing as security without the necessity of giving up possession of it. To mortgage a property. [See **RPI** Form 242]

nonrecourse mortgage
A mortgage subject to anti-deficiency laws which do not permit the mortgage holder (lender or carryback seller) to pursue a borrower to collect any loss due to a deficiency in the value of the secured property on foreclosure or a short payoff.

exculpatory clause
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **RPI** Form 418-5]

However, the borrower's promise to pay on a note secured by a trust deed may or may not be enforceable against them personally. When a borrower defaults on a **nonrecourse mortgage,** the promise to pay money is only enforceable by foreclosure on the real estate. A mortgage is *nonrecourse* when it funds:

- a buyer-occupant's purchase of a one-to-four unit residential property;
- a carryback note secured solely by the real estate acquired;
- a carryback note with a lien on other property in addition to the property purchased with the inclusion of an **exculpatory clause** in the note; or
- a refinance or subsequent refinance of a purchase-assist mortgage if no new principal is advanced or equity cashed out.[5]

As a nonrecourse mortgage, the debt is not enforceable against the borrower since a money judgment on the debt is barred. [See Chapter 18]

1.1 Identification of the lender or carryback seller

The *unconditional* promise to pay is made by the payors to a specific person or persons, known as the *payee*.

The *name of the lender* or carryback seller is entered in the note as a condition of enforceability, unless their identity is apparent from their later conduct by their receipt and acceptance of payment.[6]

The words "or order" immediately follow the name of the payee (the lender or carryback seller). These words alone allow the lender or carryback seller to *assign* the note to others. The borrower not only promises to pay the payee, but the words "or order" extend this promise to whomever the payee assigns the note and trust deed. [See **RPI** Form 445]

The "or order" provision also allows the payee to designate someone to collect payments and service the note (and trust deed) on their behalf, called **contract collection.** [See **RPI** Form 237]

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3 Com C §3106
4 Com C §3104
5 Calif. Code of Civil Procedure §580b
6 **Schweitzer** v. **Bank of America N. T. & S. A.** (1941) 42 CA2d 536

1.2 The place of performance

The note needs to specify the place where payment will be made, usually the city or county in which the payee lives or conducts business.

If the *place of performance* (delivery of the payments) is not clear, the location of the payee is the appropriate place for performance.

For litigation concerning the terms of the note, the place of performance determines the proper court for the dispute, called **venue**, when:

- the note is unsecured and in default, or
- the note evidences a recourse debt which was secured by a trust deed that has been eliminated from title by the foreclosure of a senior mortgage.

When a lawsuit involves the real estate securing the note, such as a judicial foreclosure or receivership action, the location of the real estate, called **situs**, determines the county where the action will be filed, not the place of performance where the payments are sent.[7]

Thus, if the action only involves a dispute over the terms of the note, not the trust deed, then the place of performance or the location of the payee is considered a proper venue.[8]

1.3 The amount of the principal debt

When the dollar amount of the **principal debt** is not stated in the body of the note, by *endorsement* or in an *allonge*, the note is unenforceable due to the uncertainty of the amount due. Also, a note which does not specify the dollar amount of the debt is nonnegotiable.[9]

allonge
An attachment to a note occurring between preparation of the note and closing the transaction providing information necessary to update entries on the note at the time it becomes effective. [See **RPI** Form 250]

Occasionally, the dollar amount entered on the note for identification and the amount of the principal debt to be repaid at §1.3 are not the actual amounts of the debt incurred. Here, the actual principal amount of the debt differs from the dollar amounts entered on the note due to adjustments and prorations in the escrow creating the note.

If the amount has been previously entered at §1.3 but does not ultimately reflect the correct principal amount to be paid at time of closing, then the actual principal amount of the debt needs to be entered on the back of the note by endorsement or attached to the note in an allonge.

To avoid confusion about the principal amount of the debt incurred, escrows generally prepare a note which is signed before the debt amount is entered at §1.3 in the body of the note. In this situation, escrow is instructed to enter the actual principal amount of the debt in the body of the note at §1.3 at the close of escrow when the amount is known.

The dollar amount entered to identify the note at the time of preparation is not altered at any time as it is used primarily to reference the note in the trust deed created to secure the debt.

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7 CCP §392

8 **Dawson** v. **Goff** (1954) 43 C2d 310

9 Com C §3104

Form 420

Note Secured by Deed of Trust — Interest Included

NOTE SECURED BY DEED OF TRUST
Installment — Interest Included

Prepared by: Agent ______________________ **Phone** ______________________
Broker ______________________ **Email** ______________________

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to evidence the debt owed by the borrower or buyer on terms calling for installment payments of principal and interest.

$__________, dated __________, 20____, at ______________________________, California.

1. In installments, for value received, I, jointly and severally, promise to pay to
- 1.1 ______________________________, as the Payee, or order,
- 1.2 at ______________________________.
- 1.3 the sum of ______________________________ DOLLARS,
- 1.4 with interest from __________, 20_____, on unpaid principal,
- 1.5 at the rate of ______% per annum.

2. Principal and interest payable in installments of ______________________ DOLLARS, or more,
- 2.1 on the __________ day of every ☐ month, ☐ quarter, ☐ year,
- 2.2 beginning on the __________ day of __________, 20_____,
- 2.3 and continuing until __________, 20_____, when the principal is due and payable.
- 2.4 Principal and interest payable in lawful money of the United States.
- 2.5 Each payment is to be credited first on interest then due and the remainder on principal.

3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder

4. ____

5. In any action to enforce this Note, the prevailing party will receive attorney fees.

6. This Note is secured by a DEED OF TRUST.

7. ☐ See attached Signature Page Addendum. [**RPI** Form 251]

Payor's Name: ______________	Payor's Name: ______________
Signature ______________	Signature ______________
Payor's Name: ______________	Payor's Name: ______________
Signature ______________	Signature ______________

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1.4 The date interest begins to accrue

A rate of interest does not need to be charged to make a note enforceable. If any interest is charged, which is generally the case, the note sets the date it will begin to accrue on the principal debt.

Usually, interest begins to accrue on the date escrow closes. However, at the time the note is prepared, the date escrow will actually close is not yet known.

If the exact date interest is to begin to accrue has not been set by prior agreement, the space for the date interest is to commence is left blank when the note is prepared. Escrow is then instructed to fill in the date when closing occurs, or correct the date by endorsement or an allonge.

1.5 The interest rate provision

The note specifies the annual interest rate charged by the lender or carryback seller.

However, when an interest rate is not set forth in the note and the payment becomes delinquent, interest will accrue at the legal rate (7%) after the due date for payment of the principal.[10]

A lender or a carryback seller does not need to charge any rate of interest at all, in which case the rate of interest entered is zero. However, the carryback seller will report interest income at an **imputed interest rate**, the Applicable Federal Rate (AFR) for the note, when the rate they charge is less than the AFR. When interest is *imputed*, the principal amount of the note is reduced and allocated to interest for the seller's tax reporting purposes only. The borrower and the note are unaffected by the seller's handling of the taxes.[11] [See Chapter 25 and 26]

imputed interest rate
The Applicable Federal Rate (AFR) set by the Internal Revenue Service (IRS) for carryback sellers to impute and report as minimum interest income a portion of principal when the note rate on a carryback debt is a lesser rate.

Also, instead of a fixed interest rate, the parties may agree to a different method of figuring interest, such as an adjustable rate mortgage (ARM) or a shared appreciation at maturity (SAM) note. [See Chapter 16]

2. The provision for installments

The dollar amount of each installment of principal and interest is entered in this section of the note.

Only the amount of the constant regular installments is stated in the body of the note. Additional amounts of principal only payments, any accrued and unpaid interest, or a final/balloon payment are entered elsewhere on the face of the note.

Also, by the terms of the note, the borrower promises to pay installments in the amount stated, "or more."

The "or more" clause, unless deleted or restricted by the entry on the note of other provisions, allows the borrower to prepay a portion or all of the debt at any time by making principal payments larger than the amount of principal in regular periodic installments. Other prepayment provisions added to the note may bar the use of the "or more" clause, or place a dollar penalty on any payment of additional principal as otherwise allowed by the "or more" clause.

The lender may charge and enforce a dollar penalty for early payment of principal, within statutory and case law limitations on penalty amounts, but only if the penalty is provided for in the note.

However, for *consumer mortgages,* a prepayment penalty provision may only be added to a qualified mortgage (QM) with a fixed- or step-rate of interest. Here, a prepayment penalty is limited in duration to the first three years of the mortgage term and in amount by percentage caps. Additionally, a lender

10 Calif. Constitution, Article XV §1; **In re Estreito** (9th Cir. BAP 1990) 111 BR 294
11 26 United States Code §483

offering a consumer mortgage with a prepayment penalty is required to also offer the borrower an alternative consumer mortgage without a prepayment penalty.[12]

When a prepayment provision is added to a note for other than a consumer mortgage (i.e., for business purposes), the lender or carryback seller may negotiate for deletion of the words "or more" to prohibit the borrower from prepaying the note. Thus, the borrower is *locked into paying only* the agreed-to installments even though a prepayment provision may exist.

2.1 The times for performance

This section of the note sets out the day of the month payments are due and the period of time between installments. The installment period establishes the periodic frequency of payments entered as one or more month's separation.

Installment payments are typically due on a monthly basis, payable on the first day of each consecutive month. Thus, the payment period entered on the note is "consecutive" when the installments are due every month. If they are due every other month, the period entered is "second," or "third" if due quarterly, etc.

grace period
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

A payment becomes delinquent the day after its due date, unless a **grace period** is provided by agreement in the note or a governing statute or case. A *grace period* extends the time after the due date for the payee to *actually receive* the payment before it becomes delinquent. Only after the grace period has run may the payee impose a late charge and commence foreclosure.

2.2 The date of the first payment

The date for payment of the first installment is entered in this section of the note. Occasionally, the date of the first payment is 30 days after escrow closes. Alternatively, as with most lenders, payments begin on the first day of the month first following 30 days after the close of escrow.

To avoid the accrual of more than 30 days interest before the first payment, escrow is instructed to credit the lender or carryback seller with an interest adjustment for prepayment of interest accruing for the days between closing and the end of the month.

2.3 The date of the final/ balloon payment of principal

Installment payments continue until the note principal is:

- due as a final/balloon payment; or
- paid in full though amortization.

Unless prior agreements call for a final/balloon payment, the note is to read: "*and continuing until paid,"* with the word "paid" entered in the space provided for a date.

12 12 CFR §1026.43(g)

If a final/balloon payment has been negotiated, enter the date of its payment. Often the due date is set as a fixed period of years after the close of escrow. In this case, escrow is instructed to enter the date of this anniversary when the closing date becomes known to escrow.

2.4 Form of payment

All payments made on a promissory note entered into in the United States, unless agreed to the contrary, are to be made in United States currency, either by:

- cash;
- check;
- money order;
- cashier's check; or
- electronic transfer.

If a foreign currency or other medium of exchange (such as a weight of a commodity) is to be used, the note needs to provide for it.

accrual note
An installment note calling for payments to be credited first to accrued interest with the remainder to principal. [See **RPI** Form 420]

2.5 Interest accrual

The note provides for installment payments to be credited first toward interest accrued and then the remainder to principal, called an **accrual note**.

On an *accrual note*, interest is charged only on *unpaid* principal. Interest due is calculated and paid periodically after the interest has been earned (accrued).

Interest is not prepaid by the terms of an accrual note.

An accrual note differs from an **add-on note**. Interest on an *add-on note* is charged on the original principal amount for the entire term of the mortgage.

The entire amount of interest is then added to the original principal amount to set the total amount to be paid over the life of the note, payable in equal monthly installments.

add-on note
A note in which interest is charged on the original loan amount for the entire term of the loan, then added to the original loan amount to set the total amount of principal and interest to be paid over the life of the note, payable in equal monthly installments.

3. A default provision triggers a call

Computation for early payoffs on add-on notes are controlled by the **Rule of 78**, an expression referring to a method of calculating yearly interest. The failure of the borrower to timely pay an installment on the note or within the established grace period allows the mortgage holder to declare the note due, called **acceleration**.

The right to *accelerate the mortgage balance* is exercised by calling the unpaid principal due. *Acceleration* does not operate automatically on the occurrence of a triggering event, namely a **material default**. Thus, the mortgage holder acts to call the mortgage by making a demand on the property owner to pay all sums due.[13]

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

13 **Green** v. **Carlstrom** (1963) 212 CA2d 240

reinstatement
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

However, a call on a mortgage debt is unenforceable until after a foreclosure has been commenced and the **reinstatement period** for curing the default has expired, unless the breach is incurable by reinstatement.

Incurable breaches include:

- a breach of a due-on clause; or
- waste which significantly damages the value of the real estate.

A debt secured by a trust deed on real estate allows the property owner up to five business days before the trustee's sale to cure the monetary default and pay the statutorily authorized costs of foreclosure, called *reinstatement* of the mortgage.[14]

A similar reinstatement right exists for notes secured by mobilehomes and automobiles.[15]

However, when the note is secured solely by a security interest in personal property other than a mobilehome or automobile, the note holder may accelerate the entire balance due on any default. The terms of the note allowing the personal-property note holder to call (except in the instance of mobilehomes and automobiles) do not permit a reinstatement of the note and no statutory right to a reinstatement period exists.[16]

Further, when the note is *unsecured*, the option to accelerate is not restricted. Any reinstatement permitted needs to be voluntarily agreed to by the note holder.[17]

4. Additional provisions

Optional provisions to be considered for use in the note may be negotiated in purchase agreements, loan agreements, and escrow instructions, such as:

- additional principal payments;
- a prepayment penalty [See **RPI** Form 418-2];
- late charges and grace periods [See **RPI** Form 418-1];
- compounding on a default [See **RPI** Form 418-1];
- a final/balloon payment notice [See **RPI** Form 418-3 and 419];
- extension of the due date [See **RPI** Form 418-3 and 425];
- an option for a payoff discount [See **RPI** Form 418-2];
- the right of first refusal on the sale of the note [See **RPI** Form 418-4];
- reference to a guarantor [See **RPI** Form 418-5];
- an exculpatory clause [See **RPI** Form 418-5]; and
- governing law. [See **RPI** Form 418-5]

An all-inclusive provision is added to a note when the remaining balance of an existing encumbrance on real estate that is sold is included in the

14 Calif. Civil Code §2924c
15 CC §2983.3; Calif. Health and Safety Code §18037.5
16 Com C §9623
17 **Messner** v. **Mallory** (1951) 107 CA2d 377

NOTE SECURED BY DEED OF TRUST
Installment Note — Interest Extra

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to evidence the debt owed on terms calling for installment payments consisting of a fixed principal amount together with accrued interest.

$__________, dated __________, 20____, at ______________________________, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to
   1.1 ______________________________, as the Payee, or order,
   1.2 at ______________________________,
   1.3 the sum of ______________________________ DOLLARS,
   1.4 with interest from __________, 20____, on unpaid principal,
   1.5 at the rate of _____ % per annum.
2. Interest payable on the __________ day of every ☐ month, ☐ quater, ☐ year,
   2.1 beginning on the __________ day of __________, 20____,
3. Principal payable in installments of ______________________________ DOLLARS, or more,
   3.1 on the __________ day of each __________ month.
   3.2 beginning on the __________ day of __________, 20____,
   3.3 and countinuing until __________, 20____, when the principal is due and payable.
4. Principal and interest payable in lawful money of the United States.
5. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.
6. ______________________________
7. In any action to enforce this Note the prevailing party will receive attorney fees.
8. This Note is secured by a DEED OF TRUST
9. ☐ See attached Signature Page Addendum. [RPI Form 251]

Payor's Name: ____________	Payor's Name: ____________
Signature ____________	Signature ____________
Payor's Name: ____________	Payor's Name: ____________
Signature ____________	Signature ____________

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Form 422

Note Secured by Deed of Trust — Interest Extra

principal of a carryback note secured by a second trust deed on the property. In this case, payments on the existing mortgage remain the responsibility of the seller to pay, called an **all-inclusive trust deed (AITD)**. [See Chapter 15]

5. Attorney fees

The note includes a promise to pay **attorney fees** if legal action is necessary to enforce or interpret the note.

Although the wording in some *attorney fees* provisions may appear to be one-sided against the borrower, California law automatically makes the recovery of attorney fees *reciprocal*. Thus, when the borrower prevails in litigation on the note and trust deed, they will recover their legal fees from the mortgage holder, even though the mortgage holder, under the words of the provision, did not promise to pay the borrower's attorney fees.[18]

Further, an attorney fees provision applies not only to the original borrower and lender or carryback seller, but also to their grantees and assignees. For example, a buyer who acquires property subject to an existing mortgage without entering into a mortgage assumption agreement is not the named borrower on the note. However, they may recover their legal fees on their success in a lawsuit against the mortgage holder since the mortgage holder is able to collect their attorney fees if they prevail.[19]

Additionally, the attorney fees provision permits the person who prevails to recover their attorney fees even if the note and trust deed are declared void or unenforceable.[20]

6. Identification of real estate as the security

The note states the debt is secured by a deed of trust.

However, neither the trustee under the trust deed nor the real estate which is the security need to be identified in the note. The link to the security is made by reference in the trust deed to a note of the same date (or other date entered) and the dollar amount of the note.

7. Borrower identification and signature

At the bottom of the note, the borrower or the buyer, also known as *debtor, payor, obligor* or *trustor*, is named where they sign the note. Thus, the person identifies themselves as the one promising to pay money to the mortgage holder.

The mortgage holder does not sign the note or the companion trust deed.

18 CC §1717

19 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309

20 **Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503

Chapter 8 Summary

A note is evidence of the existence of a debt created by an underlying agreement to pay money. The note contains the minimum provisions to be enforceable, including the:

- amount of principal owed;
- interest rate charged on the principal;
- schedule for repayment of the debt; and
- who is responsible for repayment.

To be enforceable, the terms spelling out the repayment of a debt need to be definite and certain.

The typical note secured by real estate provides for installment payments of principal and interest based on a debt amortization schedule.

A note is used to document the amount of the debt and terms for its repayment. A note also provides a checklist of the minimum fundamental elements of a debt which need to be agreed to for the note to be enforceable.

When a note is prepared for a debt to be secured by real estate, a trust deed is prepared concurrently to impose a lien on a parcel of the real estate for the amount of the debt evidenced by the note.

A note is unenforceable by its holder unless valid consideration is given to the borrower in exchange for signing and handing over the note.

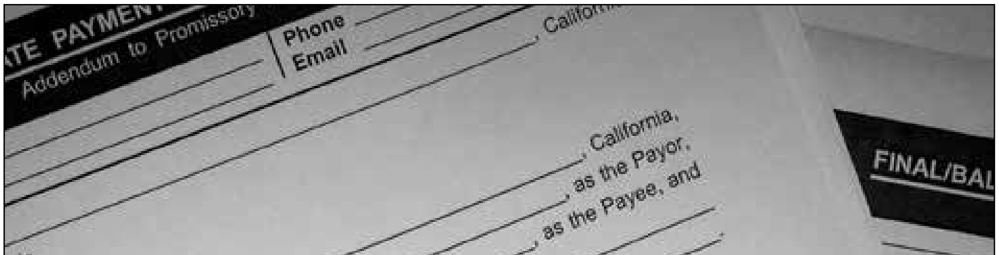
An unconditional promise to pay is essential for the note to be negotiable by the carryback seller — transferable on the sale of the note by assignment. However, the borrower's promise to pay on a note secured by a trust deed may or may not be enforceable against them personally.

An accrual note provides for installment payments to be credited first toward interest accrued and then the remainder to principal. Conversely, interest on an add-on note is charged on the original principal amount for the entire term of the mortgage.

The failure of the borrower to timely pay an installment on the note allows the mortgage holder to declare the note due, called acceleration.

The borrower or the buyer, also known as debtor, payor, obligor or trustor, is named where they sign the note, identifying themselves as the one promising to pay money to the lender or carryback seller.

Chapter 8 Key Terms



Chapter 9

Special provisions for a note

Learning Objectives

After reading this chapter, you will be able to:

- understand the use of special provisions in a note to address a mortgage holder's risk-of-loss and assignment issues; and
- distinguish the purposes and limitations of each special provision in a note.

Key Terms

balloon payment
siness mortgage
call provision
compounding on default
conforming loan
consumer mortgage
exculpatory clause
grace period
guarantee agreement
prepayment penalty
prime offer rate
promissory note
qualified mortgage (QM)

Beyond fundamental debt obligations

A **note**, sometimes called a **promissory note**, contains a borrower's *promise to pay* the lender or carryback seller — the mortgage holder – the principal amount of the debt entered into, plus any interest. The note is not the debt itself, but *evidence of the existence* of a debt created in an underlying transaction.

The schedule and conditions for payment of principal and interest are also contained in the *note*.

promissory note
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

In contrast, provisions in a **trust deed**, besides referencing the *note* and describing the real estate liened to secure payment of the debt, primarily address the *maintenance and preservation* of the mortgage holder's *security interest* in the real estate. Together, the note and trust deed are called a **mortgage**.

Special provisions added to a note serve to:

- protect the mortgage holder against risk of loss due to late payments, early payoff or other defaults on the note;
- comply with rules for consumer mortgage transactions; and
- give the property owner payoff flexibility and limited liability.

Special provisions to be considered for inclusion in a note include:

- a **prepayment penalty**, when allowed [See Figure 1];
- a **due date extension** [See **RPI** Form 418-3 §2.2 accompanying this chapter; see **RPI** Form 425];
- **compounding on default** [See Figure 2 §2.6];
- a **final/balloon payment notice**, when a balloon payment is included [See Form 418-3];
- a **grace period** and late charges [See Figure 2];
- a **payoff discount option** [See Figure 3 §2.4];
- a **right of first refusal** on the sale of the note [See **RPI** Form 418-4 accompanying this chapter];
- reference to a **guarantee agreement** [See Figure 4 §2.1];
- an **exculpatory clause** [See Figure 4 §2.2]; and
- **governing law.** [See Figure 4 §2.3]

compounding on default
An interest provision triggered by a delinquency in a payment causing interest to accrue on the amount of interest contained in the delinquent installment at the note rate until the delinquent payment is paid, a type of late charge. [See **RPI** Form 418-1]

Classifying mortgages as consumer or business

Whether a special provision may be included in the note and to what extent it can then be used depends on:

- the purpose financed by the mortgage, consumer or business;
- the security for the mortgage, one-to-four residential units or any other type property;
- the mortgage volume of the lender or carryback seller; and
- the borrower.

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

Some provisions are restricted by the federal *Truth-in-Lending Act (TILA)* and its Regulation Z (Reg Z) on consumer-purpose debts secured by one-to-four unit residential property, called a **consumer mortgage**. A *consumer mortgage* is a loan or carryback note originated for an individual for a personal, family or household purpose and secured by one-to-four unit residential property. [See **RPI** Form 202-2]

Lenders who originate consumer mortgages are subject to federal **ability-to-repay (ATR)** rules, which restrict the use of some special provisions.[1]

California mortgage laws apply to all aspects of mortgage originations not covered by federal rules, the result of *preemption*. Thus, California lending laws apply to:

- **business mortgages** secured by any type of property;
- consumer-purpose debts secured by real estate other than one-to-four unit residential property; and
- mortgages made to entities.

business mortgage
A debt incurred for other than personal, family or household (consumer) purposes and secured by any type of real estate.

Prepayment penalties

A *prepayment penalty* is a charge a property owner voluntarily incurs by prior agreement when they pay off the principal balance on a mortgage before it is due under the payment schedule in the note.

For consumer mortgages, prepayment penalties are only allowed if:

- the *annual percentage rate (APR)* does not increase after closing (i.e., prepayment penalties are not allowed on adjustable rate mortgages (ARMs));
- the APR does not exceed the average **prime offer rate** for a comparable consumer mortgage by:
  - **1.5%** on a first mortgage with a principal amount no more than the **conforming loan limits** set by Freddie Mac;
  - **2.5%** or more on a first mortgage with a principal amount more than the *conforming loan limits* set by Freddie Mac; and
  - **3.5%** or more on a second or other subordinate mortgage;
- the loan is a **qualified mortgage (QM)**; and
- the loan is not a Section 32 high-cost mortgage.[2]

prepayment penalty
A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision. [See **RPI** Form 418-2]

prime offer rate
A base rate used by banks to price short-term business loans and home equity lines of credit, set 3% above the federal funds rate.

For consumer mortgages which qualify to include a prepayment penalty, the terms of the prepayment penalty are limited to:

- payoffs during the three-year period following closing;
- **3%** of the outstanding balance on the loan during the 1st year of payment following the mortgage origination;
- **2%** of the outstanding balance on the loan during the 2nd year of payment; and
- **1%** of the outstanding balance on the loan during the 3rd year of payment.[3]

conforming loan
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac, excluding FHA/VA or other government-insured mortgages.

When including a permissible prepayment provision on a consumer mortgage, MLOs are required to offer comparable alternative mortgage arrangements which do not contain prepayment provisions.[4]

1 12 Code of Federal Regulations §1026.43
2 12 CFR §§1026.43(g)(1); 1026.32(d)(6)
3 12 CFR §1026.43(g)(2)
4 12 CFR §1026.43(g)(3)

qualified mortgage (QM)
A home mortgage which meets ability-to-repay rules under the Truth in Lending Act (TILA).

Further, under state law, any mortgage with a prepayment penalty which is secured by an owner-occupied, one-to-four unit residential property may be prepaid up to 20% of the original principal balance in any 12-month period without penalty.

When more than 20% of the original amount of the note is prepaid in any 12-month period, the prepayment penalty is limited to no more than six months' advance interest on the excess, unless limited to a lesser rate under consumer mortgage rules.[5] [See Figure 1 §2.1]

Prepayments under federal law

A mortgage holder who enforces a prepayment penalty provision on any prepaid principal on a mortgage originated with an owner-occupant of a one-to-four unit property needs to calculate the penalty to be charged under both the "six months' advance interest" and the percentage caps set by the ATR rules. The penalty charged is limited to the lesser of the two penalty amounts.

For *business mortgages*, a prepayment penalty is enforceable if it is reasonably related to money losses suffered by a mortgage holder. Reasonably related money losses include the payment of an amount equal to the profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff if called for in the note.[6]

However, on both business and consumer mortgages secured by one-to-four unit residential property, if the mortgage holder intends to collect a prepayment penalty on a call under a due-on clause in their trust deed, the property owner needs to have agreed in a separate prepayment penalty provision that they waive their right to prepay without a penalty.[7] [See Figure 1 §2.3]

Late charges and grace periods

A **late charge** provision in a note permits collection of an additional one-time fee or interest accrual on the amount of interest in the delinquent payment. A typical late charge provision takes the form of a flat fee or a percentage of the monthly payment or mortgage balance.

On consumer mortgages other than *home equity lines of credit (HELOCs)*, mortgage holders are required to provide the borrower with a periodic mortgage statement each billing cycle. The periodic mortgage statement will include:

- the payment due date;
- the amount of any late charge and the date it will be imposed; and
- the amount due, shown more prominently than other disclosures on the statement.[8]

5 Calif. Civil Code §2954.9(b)
6 **Williams** v. **Fassler** (1980) 110 CA3d 7
7 CC §2954.10
8 12 CFR §1026.41(d)(ii)

Figure 1

Excerpt from Form 418-2

Prepayment of Principal Provisions

2.1 *For owner-occupied, one-to-four residential units:*

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property:*

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

Editor's note — Mortgage holders who service 5,000 or fewer consumer mortgages, such as small lenders and carryback sellers, need not provide a periodic statement to the borrower. However, a late charge may not be collected until the borrower is given notice.[9]

Additionally, on a consumer mortgage secured by the borrower's principal residence, late charges may only be imposed for delinquent principal and interest payments. A late charge may not be imposed for nonpayment of late charges, a practice called **pyramiding**.[10]

For business mortgages and consumer mortgages secured by property other than owner-occupied single family residence (SFR) or not arranged by a mortgage loan broker, the *late charge* assessed for the delinquent payment of an installment is required to be an amount *reasonably related* to:

- the mortgage holder's actual out-of-pocket losses incurred in pre-foreclosure collection efforts; or
- the value of the lost use of the delinquent funds.[11] [See Figure 2 §2.3]

A late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is an unenforceable forfeiture. Here, the late charge is a disguised penalty provision. The rate of interest on a default may only be applied to the delinquent principal and interest payment since only an installment is delinquent, not the entire principal balance of the note.[12]

Further, a penalty provision is *void* if it fails to reasonably estimate compensation for the mortgage holder's losses caused by the default.

9 12 CFR §1026.41(e)(4); CC §2954.5

10 12 CFR §1026.36(c)(2)

11 CC §1671; **Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731

12 **Walker** v. **Countrywide Home Loans, Inc.** (2002) 98 CA4th 1158

Form 418-3

Final/Balloon Due Date Provisions

FINAL/BALLOON DUE DATE PROVISIONS

NOTE: This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to include final/balloon payment provisions in the promissory note.

DATE:__________, 20____, at ____________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note
   1.1 ☐ of same date, or dated __________, 20____, at ________________, California,
   1.2 entered into by ____________________, as the Payor,
   1.3 in favor of ____________________, as the Payee, and
   1.4 secured by a trust deed on real estate referred to as ____________________.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:
   2.1 *For final/balloon payment notes secured by one-to-four unit residential property.*
   ☐ This note is subject to Calif. Civil Code §2966, which provides that the holder of this note is to give written notice to Trustor, or their successor(s) in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due.
   2.2 *For extending the due date for a final/balloon payment:*
   ☐ The due date will be extended for ______ year(s) if:
   a. ☐ all monthly installments due within ______ month(s) of the final/balloon payment due date have been received prior to their delinquency.
   b. ☐ ____________________

Payor's Name __________	Payor's Name __________
Signature __________	Signature __________
Payor's Name __________	Payor's Name __________
Signature __________	Signature __________

FORM 418-3 12-14 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

The amount of a late charge on any note secured by an *owner-occupied SFR* is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5.[13] [See Figure 2 §2.1]

For loans made or arranged by a real estate broker and secured by *any type of real estate*, a late charge on delinquent monthly payments is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5.[14] [See Figure 2 §2.2]

A default on the final/balloon payment

When a consumer or business mortgage is arranged by a broker and contains a due date for a *final/balloon payment*, a **late charge** may be assessed if the final/balloon payment is not received within ten days after the due date.

13 CC §2954.4

14 Calif. Business and Professions Code §10242.5(a)

2.1 *For an owner-occupied, single family residence:*
☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:
☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans:*
☐ If any installment on this note is not received ☐ when due, or ☐ within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_______________, or ☐ ______% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:
☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans:*
☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.

2.6 *For compounding interest on a default on other than one-to-four residential units:*
☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

Figure 2

Excerpt from Form 418-1

Late Payment Provisions

The maximum enforceable late charge assessed on the delinquency of a final/balloon payment on a *broker-arranged loan* is an amount equal to the maximum late charge imposed on the *largest installment payment scheduled* in the note.

A late charge may be further assessed for each month the final/balloon payment remains unpaid.[15] [See Figure 2 §2.4]

On an installment sale of real estate, except for a buyer-occupied SFR, an **increased interest rate** on the remaining principal triggered by a delinquency of the final/balloon payment is an acceptable late charge provision.[16] [See Figure 2 §2.5]

However, any increase in the interest rate triggered by a delinquency is still controlled by reasonableness standards, similar to the handling of a late charge.[17]

For carryback SFR notes and broker-arranged loans, an installment is not late if paid within ten days after the installment is due, called a **statutory grace period**.[18]

Also, on an SFR mortgage or broker-arranged mortgage, the mortgage holder is not allowed to charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent.[19]

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

grace period
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

15 Bus & P C §10242.5(c)
16 **Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701
17 Garrett, *supra*
18 CC §2954.4; Bus & P C §10242.5
19 CC §2954.4(a); Bus & P C §10242.5(b)

Form 418-4

Right of First Refusal to Buy Note

RIGHT OF FIRST REFUSAL TO BUY NOTE

NOTE: This form is used by an agent of a property owner or buyer, or an escrow officer when originating a mortgage with a lender or carryback seller, to grant the owner/buyer a right of first refusal to purchase the note and trust deed.

DATE:______________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note
 1.1 ☐ of same date, or dated ______________, 20______, at ______________________, California,
 1.2 entered into by ____, as the Payor,
 1.3 in favor of ____, as the Payee, and
 1.4 secured by a trust deed on real estate referred to as ______________________
 ____.

AGREEMENT:

2. In addition to the terms of the above referenced Note and Trust Deed, Payor agrees to the following:

Right of first refusal to buy:

3. Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

4. If Payee decides to sell an interest in the Note and Trust Deed, Payee is to notify Payor of the terms on which Payee is willing to sell and assign the Note and Trust Deed.
 4.1 Payor has the option, for a period of ________ days after receiving notice, to purchase the Note and Trust Deed on the terms stated in the notice.
 4.2 If Payor fails to exercise the option within the option period, Payee has the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor.
 4.3 Any sale on different terms reinstates the right of first refusal.

5. If the Note and Trust Deed is not sold and assigned within six months after Payor's receipt of notice, the right of first refusal is reinstated.

6. ____

Payor: I agree to the terms stated above.	**Payee: I agree to the terms stated above.**
Date: ______________, 20_____	Date: ______________, 20_____
Payor's Name ______________________	Payee's Name ______________________
Signature ______________________	Signature ______________________
Payor's Name ______________________	Payee's Name ______________________
Signature ______________________	Signature ______________________

FORM 418-4 03-11

Compounding on default

A *compounding-on-default* interest provision is triggered by a delinquency in a payment. Compounding is the accrual of interest on the amount of interest contained in the delinquent installment at the note rate until the delinquent payment is paid. [See Figure 2 §2.6]

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

A compounding interest provision is a type of *late charge* since it penalizes the borrower and is triggered by a delinquency in a payment. As a late charge, the limitations on amounts and grace periods for late charges and a demand for the late-payment fee apply to the enforcement of provisions calling for compounding on default.

Balloon payment notice

A *balloon payment* is a final lump sum payment of remaining unpaid principal which is due on an earlier date than had the principal been fully amortized by periodic payment terms.

A balloon payment note secured by an owner-occupied, one-to-four unit residential property contains provisions for:

- a *final payment* more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or
- a **call provision**.[20]

A *call provision* gives the mortgage holder the right to demand final payment at any time after a specified period.

call provision
A provision in a note giving the mortgage holder the right to demand full payment at any time or after a specified time or event, also called an acceleration clause. [See **RPI** From 418-3]

All balloon payment notes secured by an owner-occupied one-to-four unit residential property are to include a reference to the borrower's right to receive a balloon payment notice 90 to 150 days before the due date.[21] [See Form 418-3]

Failure to include the balloon payment notice provision in the note does not invalidate the debt. Further, if the notice is not timely delivered, the note's balloon payment due date is extended and enforcement delayed until the 90-day notice requirements have been met.[22]

Extension of due date

A provision in a note may grant the borrower an extension of the due date for a final/balloon payment.

For example, a due date by prior agreement may be extended on the borrower's payment of all scheduled installments without delinquency, or on other consideration agreed to, such as a charge or change of terms. [See Form 418-3 §2.2]

In the instance of a due date on a carryback note, the buyer needs to consider negotiating a provision to extend the due date when:

- the term of the note is for a short period of time (less than seven years); and
- the buyer is uncertain about the source and availability of funds for payoff.

Discount for early payoff

Typically in carryback financing situations, either on a consumer or business mortgage, a buyer's right to pay off the note early is usually documented as an option to buy the note at a discount. [See Form 418-4]

A carryback seller who prefers to be cashed out before the due date set in the note may include a discount provision to encourage the buyer to pay off the

20 CC §2924i(d), 2957(b),(c)
21 CC §2924i(c), 2966(a)
22 CC §2966(d)

Figure 3

Excerpt from Form 418-2

Late Payment Provisions

2.4 *Discount for early payoff provision:*

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring ____________, 20______.

Figure 4

Excerpt from Form 418-5

Note Enforcement Provisions

2.1 **Guarantee provision**

☐ The Note is guaranteed by ______________________________, under a Guarantee Agreement dated ____________, 20______, at ____________________________, California. [See ft Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of California Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

note within a lesser time period than the due date period. The provision may be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note may either:

- buy the note and trust deed from the seller by an assignment; or
- request a reconveyance of the trust deed.

Right of first refusal

When the mortgage holder, typically limited to a carryback seller, decides to sell the note, a *right of first refusal* provision contained in the note or a separate agreement allows the owner of the mortgaged real estate to purchase or pay off the note. [See Form 418-4]

If the mortgage holder decides to sell the trust deed note, the borrower is notified of the amount necessary to purchase or pay off the note.

The *payoff amount* will be the sales price of the note and is set based on the lesser of either:

- the mortgage holder's listing of the trust deed note for sale, or their offer to sell the note [See **RPI** Form 112]; or
- an offer from an investor to purchase the note, which, if accepted, is to be contingent on the borrower declining to exercise their *right of first refusal* to pay off the note.

The borrower, to exercise the right of first refusal, then matches the price.

However, when granting the right of first refusal, the mortgage holder needs to be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

Guarantor

To protect the mortgage holder from loss due to a default on the trust deed note, they may require a third-party **guarantor** with sufficient assets to become *liable on call* for all amounts due under the mortgage, called a **put option**.

By guaranteeing the mortgage, a *guarantor* literally agrees to buy the note from the mortgage holder in the event of default, a legal process called **subrogation** or **equitable assignment**.

The mortgage holder has three types of third-party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by someone other than the borrower.

When a third party signs the note, the third party becomes *liable for repayment* of the note, subject to anti-deficiency rules protecting:

- co-owners on any type of foreclosure; and
- non-owner co-signers on a trustee's foreclosure.[23]

guarantee agreement
An agreement to be obligated to pay the debt or perform on a contract of another person if that person defaults or does not perform. [See **RPI** Form 439]

However, if a third party agrees to guarantee the mortgage, a *guarantee agreement* is signed by the third party and is *enforceable separately* from the mortgage. [See **RPI** Form 439]

Guarantors on a consumer mortgage are not required to meet ATR or QM debt or credit requirements.[24]

If the mortgage is guaranteed, a provision is included in the note to reference the separate guarantee agreement. [See Figure 4 §2.1]

By referencing the separate guarantee agreement in the note, everyone involved is on notice of the additional security for the mortgage provided by the guarantee.

Exculpatory clause

exculpatory clause
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **RPI** Form 418-5]

An *exculpatory clause* in a note converts a mortgage holder's **recourse paper** into **nonrecourse paper**. [See Chapter 18]

When the carryback mortgage is either separately or additionally secured by property other than the property sold, the note automatically becomes *recourse paper*. Thus, the buyer providing other security needs to consider negotiating for inclusion of an exculpatory clause as a provision in the note. [See Figure 4 §2.2]

23 Calif. Code of Civil Procedure §580b

24 Official Interpretation of 12 Code of Federal Regulations §1026.43(c)(2)(vi)

When an exculpatory clause is included in a note, the mortgage holder may not obtain a money judgment for any deficiency on a judicial foreclosure of the mortgaged properties. Thus, the exculpatory clause in the note provides the buyer with anti-deficiency protection.

Governing law

A lender or carryback seller involved in negotiating a mortgage with an out-of-state buyer needs to include a *choice-of-law provision* to assure judgments arising from disputes on the mortgage will be based on existing California law. [See Figure 4 §2.3]

If the state law to be applied is not agreed to, the state law applied will be based on the state with the greater interest in the result.

Editor's note — The governing law provision has no impact on federal laws and regulations which pre-empt state laws.

Chapter 9 Summary

A note contains a borrower's promise to pay a mortgage holder (a lender or carryback seller) the principal amount of the debt agreed to, plus interest. The note is not the debt itself, but evidence of the existence of the debt. It contains the minimum required provisions to describe:

- the amount owed;
- interest rate; and
- repayment schedule of the debt.

In contrast, provisions in a trust deed primarily address the maintenance and preservation of the mortgage holder's security interest in the real estate.

Special provisions added to a note serve to:

- protect the mortgage holder against risk of loss due to late payments, early payoff or other defaults on the note; and
- comply with statutorily mandated provisions for consumer transactions.

Special provisions to be considered for inclusion in a note, if allowed, include:

- a prepayment penalty;
- a due date extension;
- compounding on default;
- a final/balloon payment notice;
- a grace period and late charges;

- a payoff discount option;
- a right of first refusal on sale on the note;
- a guarantee agreement;
- an exculpatory clause; and
- governing law.

Inclusion of these special provisions in the note depends on the type of mortgage being evidenced, the security for the mortgage, the activities of the person making the mortgage and the borrower.

Chapter 9 Key Terms

Notes:

Chapter 10

The trust deed as a contract

Learning Objectives

After reading this chapter, you will be able to:

- understand how a trust deed is used by carryback sellers and private lenders operating outside the national secondary mortgage market; and
- recognize the use and limitations of each trust deed provision.

Key Terms

acceleration
adhesion contract
alienation clause
dragnet clause
due-on clause
eminent domain
privity of estate

The limits on mortgage holder enforcement

Provisions of a **trust deed** allow private lenders and carryback sellers to contractually restrict as many aspects of *ownership and possession* of the liened property as they are legally able to control.

At first glance, the list of rights given to a private lender or carryback seller, also known as a **mortgage holder**, seems to authorize their use of tremendous *discretionary powers* over activity normally conducted only by owners of real estate.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

dragnet clause
A provision in a trust deed that purports to use the mortgaged real estate as security for all debts between the parties to the security agreement.

For example, trust deeds routinely purport to give the mortgage holder the unhindered ability to:

- automatically accelerate the balance of the loan on the transfer of any interest in the property, such as an owner's sale, further encumbrance, lease over a three-year term or a lease with a purchase option, called a **due-on clause** [See Chapter 11 and 12];
- determine the allocation of **eminent domain** proceeds after a condemnation action;
- apply all fire insurance proceeds to the mortgage balance; and
- call the loan if it or any other loan between the parties is in default, called a **dragnet clause**.

Fortunately for owners of property encumbered with a trust deed lien, California law curbs the *mortgage holder's* ability to strictly enforce discretionary provisions, as well as many other clauses which appear in some trust deeds.

Imbalance of bargaining power

adhesion contract
An agreement in which one party has dramatically superior bargaining strength, forcing the weaker party to either accept or reject all the agreement's stated terms, a dynamic present to some degree in all lender/borrower relationships.

Trust deeds are recognized as **adhesion contracts.** Here, one person or party (the lender) has superior bargaining power over a weaker person (the borrower), usually on a "take it or leave it" basis.

A prospective borrower typically has no power to negotiate better terms than the boilerplate provisions in regular trust deeds, with the lender adamant that "it's my way or no way." The printed terms of the trust deed will be adhered to in their entirety by the borrower when arranging financing.

This imbalance in bargaining power led California courts to develop special *adhesion contract* rules for interpreting rights and obligations under trust deeds. These special rules are a judicial step toward limiting the results of lender bargaining power.[1]

One rule of the adhesion theory requires a trust deed to be interpreted in light of the *reasonable expectations* of the weaker party. On the context of a trust deed, this is always the borrower.[2]

Further, as the discussion of each individual trust deed provision below shows, many of the rights claimed by the mortgage holder are restricted, if not entirely unenforceable for lack of any basis for protecting the lender or carryback seller against a risk of loss on the debt.

The purported rights of the lender or carryback seller, agreed to by the buyer or owner when entering into trust deed financing, are controlled by:

- statutes;
- case law interpretations regarding fairness, good faith and reasonable expectations; and

1 **Steven** v. **Fidelity and Casualty Company of New York** (1962) 58 C2d 862
2 **Yeng Sue Chow** v. **Levi Strauss & Co.** (1975) 49 CA3d 315

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DEED OF TRUST AND ASSIGNMENT OF RENTS
Securing a Promissory Note

NOTE: This form is used by a transaction agent, loan broker or escrow officer when in a sale or loan transaction a mortgage is created evidenced by a note, to secure the performance of the note by a lien on described real estate which restricts aspects of its ownership.

This Deed of Trust, made this ____________ day of ________________, 20____,
between ______________________________
______________________________, as the Trustor,
whose address is ______________________________,
(Number and street) (City) (State) (Zip)
______________________________, a California corporation, as the Trustee, and
______________________________, as the Beneficiary.

1. Trustor hereby **IRREVOCABLY GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE,**

1.1 The real property in the City of ______________________________,
County of ______________________________, California, referred to as:

APN: ______________

1.2 TOGETHER WITH the rents, issues and profits of the real property, subject to the provisions of §3.4, herein to collect and apply the rents, issues and profits,

1.3 **For the purpose of securing payment of:**

a. the indebtedness evidenced by a promissory note of same date executed by Trustor, in the sum of $__________;

b. any additional sums and interest hereafter loaned by Beneficiary to the then record Owner of the real property, evidenced by a promissory note or notes, referencing this Deed of Trust as security for payment;

c. the Beneficiary's charge for a statement regarding the secured obligations requested by or for Trustor; and

d. the performance of each agreement contained in this Deed of Trust.

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Trust Deeds and Assignment of Rents

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- historical common law doctrines governing the conduct of persons holding interests in real estate.

As a result of California's **mortgage law**, an otherwise valid and enforceable **contract clause** in a trust deed is restricted in its use as parameters are set for the mortgage holder's enforcement of the powers given.

The provisions in a modern trust deed

The following is an analysis of a trust deed's necessary and enforceable provisions to secure performance of a note. Section references are to **RPI (Realty Publications, Inc.)** Form 450 — Deed of Trust and Assignment of Rents. [See Form 450 accompanying this chapter]

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2. To protect the security of this Deed of Trust, Trustor agrees:

2.1 **CONDITION OF PROPERTY —** To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

2.2 **HAZARD INSURANCE —** Trustor will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which Beneficiary requires insurance. The insurance will be maintained in the amounts and for the periods Beneficiary requires. The insurance carrier providing the insurance will be chosen by Trustor, subject to Beneficiary's approval, which will not be unreasonably withheld. All insurance policies will be acceptable to Beneficiary, and contain loss payable clauses in form acceptable to Beneficiary. Beneficiary will have the right to hold policies and renewals.

In the event of loss, Trustor will give prompt notice to the insurance carrier and Beneficiary. Beneficiary may make proof of loss if not made promptly by Trustor. Beneficiary may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Trustor fails to reconstruct, Beneficiary may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

2.3 **ATTORNEY FEES —** To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Beneficiary or Trustee; and to pay all costs and expenses, including cost of evidencing title and attorney fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear.

2.4 **TAXES AND SENIOR ENCUMBRANCES —** To pay at least 10 days before delinquency: all taxes and assessments affecting the property, including water stock assessments when due, all encumbrances, charges and liens, with interest, on the property which are or appear to be senior to this Deed of Trust; and all expenses of this Deed of Trust.

2.5 **ACTS AND ADVANCES TO PROTECT THE SECURITY —** If Trustor fails to make any payment or to perform any act provided for in this Deed of Trust, then Beneficiary or Trustee may, without obligation to do so, and with or without notice or demand upon Trustor, and without releasing Trustor from any obligation under this Deed of Trust:

a. make or do the same to the extent either deems necessary to protect the security, Beneficiary or Trustee being authorized to enter upon the property to do so;

b. appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Beneficiary or Trustee;

c. pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this Deed of Trust.

In exercising the power of this provision, Beneficiary or Trustee may incur necessary expenses, including reasonable attorney fees.

Trustor to immediately pay all sums expended by Beneficiary or Trustee provided for in this Deed of Trust, with interest from date of expenditure at the same rate as the principal debt hereby secured.

3. It is further mutually agreed that:

3.1 **ASSIGNMENT OF DAMAGES —** Any award of damages made in connection with:

a. condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. injury to the property by any third party;

is assigned to Beneficiary, who may apply or release the proceeds of such award in the same manner and with the same effect as above provided for the disposition of hazard insurance proceeds.

3.2 **WAIVER —** By accepting payment of any sum due after its due date, Beneficiary does not waive Beneficiary's right to either require prompt payment when due of all other sums or to declare a default for failure to pay. Beneficiary may waive a default of any agreement of this Deed of Trust, by consent or acquiescence, without waiving any prior or subsequent default.

3.3 **DUE-ON-SALE —** If Trustor decides to sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, then Beneficiary may, at Beneficiary's option, declare all sums secured by this Deed of Trust immediately due and payable.

3.4 **ASSIGNMENT OF RENTS —** Trustor hereby assigns and transfers to Beneficiary all right, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

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2.1 — Condition of property

A **condition of property provision**, also called a **nonwaste provision**, obligates the owner to maintain the property in good physical condition. It covers two events.

In its purpose for providing protection, the *nonwaste provision* is a redundant recital. An owner of mortgaged property is barred by statute from intentionally or negligently impairing the mortgage holder's security interest in the property, called *waste*.[3]

However, inclusion of the nonwaste provision is necessary to give the mortgage holder the *right to call* the mortgage on a breach of the owner's

3 Calif. Civil Code §2929

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a. Prior to a default on this Deed of Trust by Trustor, Trustor will collect and retain the rents.

b. On default by Trustor, Beneficiary will immediately be entitled to possession of all unpaid rents.

3.5 **ACCELERATION** — If payment of any indebtedness or performance of any agreement secured by this Deed of Trust is in default, Beneficiary may at Beneficiary's option, with or without notice to Trustor, declare all sums secured immediately due and payable by:

a. commencing suit for their recovery or for foreclosure of this Deed of Trust; or

b. delivering to Trustee a written notice declaring a default with demand for sale; a written Notice of Default and election to sell to be recorded by Trustee.

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

3.7 **TRUSTOR'S OFFSET STATEMENT** — Within 10 days of Trustor's receipt of a written request by Beneficiary, Trustor will execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of Beneficiary: the then owner of the secured property; the terms of the secured note, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured note is valid and the Trustor received full and valid consideration for it; and that Trustor understands the note and this Deed of Trust are being assigned.

4. **ADDENDA** — If any of the following addenda are executed by Trustor and recorded together with this Deed of Trust, the covenants and agreements of each will incorporate, amend and supplement the agreements of this Deed of Trust (check applicable boxes):

☐ Owner-occupancy rider [See **RPI** Form 202-3]; ☐ All-inclusive trust deed addendum [See **RPI** Form 442 and 443];

☐ Impounds for taxes and insurance addendum; ☐ Private Mortgage Insurance (PMI) rider;

☐ ____

5. **RECONVEYANCE** — Upon written request from Beneficiary stating that all sums secured by this Deed of Trust have been paid, surrender of this Deed of Trust and the note to Trustee for cancellation, and payment of Trustee's fees, Trustee will reconvey the property held under this Deed of Trust.

6. **SUCCESSORS, ASSIGNS AND PLEDGEES** — This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary will mean the holder and owner of the secured note, or, if the note has been pledged, the pledgee.

7. **TRUSTEE'S FORECLOSURE NOTICES** — The undersigned Trustor requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Trustor at the address herein set forth.

☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ____________, 20______. Trustor: ______________________________
(Signature)

Date: ____________, 20______. Trustor: ______________________________
(Signature)

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ______________________________
On ____________________ before me, ______________________________
(Name and title of officer)

personally appeared ______________________________,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ______________________________
(Signature of notary public)

(This area for official notarial seal)

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statutory obligation to maintain the mortgaged property in an unimpaired condition. If the loan is not paid in full on the call, the mortgage holder may commence foreclosure when the owner fails to pay on the call. Without the provision, under the waste statute, the mortgage holder is limited to a court action for:

- money losses;
- an injunction; and
- a receivership of the property.

Conversely, a nonwaste provision in the trust deed is unenforceable if it is used based on conduct of the owner that is unrelated to protecting the value of the mortgage holder's security. The owner of the mortgaged real estate has the right to use the property as they wish and is limited only by general land-use laws.

An owner's promise to maintain the property only bars them from activities and use of the property which jeopardizes the *loan-to-value ratio (LTV)* of the mortgage holder's security interest in the property.[4]

For example, some trust deeds contain a clause in which the owner promises "not to commit, suffer or permit any act *upon said property* in violation of law." A violation of law provision of this nature is unenforceable since it addresses activities that are unrelated to the maintenance or value of the mortgaged property. Thus, they have no effect on the mortgage holder's efforts to protect their interest in the property from impairment.

Alternatively, provisions which promise to comply with laws affecting the property's value are enforceable. Thus, they are properly included in the nonwaste provision.

2.2 — Hazard insurance

Under the **hazard insurance provision**, the mortgage holder has the right to *call the loan* when the owner fails to provide hazard insurance which is acceptable to the mortgage holder.

If the owner then fails to satisfy the loan after the call, or provide the insurance coverage to reinstate the trust deed, the mortgage holder may:

- begin foreclosure immediately, subject to the owner's right to reinstate the loan by providing acceptable insurance; or
- acquire acceptable insurance and pay the premium.

When the mortgage holder purchases insurance and pays the premium on the owner's failure to provide it, they may either:

- add the amount paid to the debt as authorized by the **future advances clause** in the trust deed and continue to accept payments on the note; or
- make a demand for reimbursement, and if not paid in full, call the loan and commence foreclosure.

The mortgage holder may require the owner to carry hazard insurance up to the **replacement cost** of any improvements, even if replacement costs exceed the loan amount or the property's fair market value (FMV).[5]

However, the mortgage holder needs to allow the owner to rebuild damaged improvements using insurance proceeds unless the rebuilding effort impairs the mortgage holder's security.[6]

4 **Krone** v. **Goff** (1975) 53 CA3d 191

5 CC §2955.5

6 **Schoolcraft** v. **Ross** (1978) 81 CA3d 75

2.3 — Attorney fees

Attorney fees and costs incurred in litigation to protect the mortgage holder's security interest in the property are recoverable under the **attorney fees provision**. However, the fees and costs are only recoverable to the extent they are reasonable.[7]

Trust deeds give the mortgage holder remedies to *protect their security interest* in the real estate. *Remedial actions* are unrelated to the collection of the debt evidenced by the note or other document secured by the trust deed. Thus, an *attorney fees provision* is needed in the trust deed, even though the note contains an attorney fees provision.[8]

Attorney fees paid by the mortgage holder for professional services needed to enforce the trust deed are considered *future advances*, and thus are also secured by the trust deed.

If the mortgage holder records a Notice of Default (NOD), all amounts advanced are required to be paid in order to reinstate the trust deed. This includes reasonable attorney fees incurred to enforce provisions to protect the status of the trust deed.[9]

Conversely, recovery of attorney fees or trustee's fees incurred to judicially or nonjudicially foreclose on the property under the trust deed lien is capped by statute.

2.4 — Taxes and senior encumbrances

The **tax and senior encumbrance provisions** obligate the owner to keep all taxes and senior liens current. If the owner fails to do so, the mortgage holder may call the loan due and either:

- foreclose if the owner does not reinstate the delinquent taxes and senior liens; or
- pay the taxes under the future advances clause, add that amount to the loan balance, and foreclose if they so choose.[10]

If a mortgage holder with a senior trust deed commences foreclosure and their mortgage is not reinstated or paid off to redeem the property, the foreclosure of the senior mortgage wipes out any junior mortgage holder's security interest in the property.

Similarly, property tax liens attach annually to the property and are senior to all trust deed holders, as are improvement district bonds and liens imposed by the government. A delinquent tax lien may be foreclosed after five years. A property tax sale eliminates a mortgage holder's secured position on title.[11]

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7 **Buck** v. **Barb** (1983) 147 CA3d 920
8 **Hellier** v. **Russell** (1902) 136 C 143
9 **Bisno** v. **Sax** (1959) 175 CA2d 714; CC §2924c
10 CC §2876
11 Calif. Revenue and Taxation Code §2192.1

2.5 — Acts and advances to protect the security

The **future advances provision** obligates the owner to reimburse the mortgage holder on demand for any amounts advanced by the mortgage holder under any provision of the trust deed, for instance to:

- pay insurance premiums;
- defend the security; or
- bring taxes and senior liens current.

All advances made by the mortgage holder become part of the debt secured by the trust deed. If the owner fails to reimburse the mortgage holder, the mortgage holder may accelerate (call due) all amounts secured by the trust deed and foreclose on the property if the call is not fully paid, unless the debt is brought current as permitted by reinstatement rules.[12]

3.1 — Assignment of damages

eminent domain
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

Government agencies may **condemn** part or all of a mortgaged property in an *eminent domain action*. Alternatively, they may damage the value of the property by their activities. Here, the agency is to compensate the mortgage holder for the loss of all or part of their security.

Compensation is calculated based on the mortgaged property's value on the *date of the taking* and any loss of money additionally suffered by the owner.[13]

Accordingly, any condemnation award obtained by the owner of the mortgaged property is subject to the lien created by the trust deed. Equity law requires the money award to stand as *substitute security* for the property it replaces on the taking.[14]

However, the assignment of condemnation proceeds to the mortgage holder under the **condemnation provision** in the trust deed is not absolute. The mortgage holder is not allowed to apply the entire amount of the condemnation proceeds to the satisfaction of the mortgage if any portion of the mortgaged real estate remains after the taking.

Rather, the assignment provision is merely a **collateral assignment** of the funds for the purpose of securing the debt. Thus, the mortgage holder may keep only that portion of the condemnation proceeds necessary to *prevent impairment* of their security, called exercising control in *good faith*. The remaining funds are released to the owner.[15]

With a *partial taking*, the mortgage holder shares in the award only to the extent necessary to protect and maintain the LTV ratio of their security interest in the liened property. If the partial taking does not impair the mortgage holder's security, the mortgage holder is entitled to none of the proceeds.[16]

Impairment may occur even though the value of the property after a partial taking exceeds the balance outstanding on the debt. When the LTV existing

12 **Windt** v. **Covert** (1907) 152 C 350
13 Calif. Code of Civil Procedure §1260.220
14 **American Savings and Loan Association** v. **Leeds** (1968) 68 C2d 611
15 **Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482
16 CCP §1265.225

before the taking is altered substantially due to a reduction in value by the partial taking, the mortgage holder is entitled to a portion of the funds needed to bring their LTV ratio back in line with the pre-taking ratio.

Any dispute regarding the extent of the mortgage holder's impairment will be resolved by comparing the LTV ratios before and after the taking. Other risk factors influencing the impairment include:

- the owner's payment history;
- the economic effect of the taking on the remainder of the property; and
- whether the mortgage holder has recourse on the obligation.[17]

Injury to the property by third-parties

Coupled with the trust deed provision which collaterally assigns condemnation proceeds to the mortgage holder is a **third-party injury clause**. The *third-party injury clause* assigns the mortgage holder any award received by the owner for injuries to the property inflicted by private, non-governmental persons.

Thus, the mortgage holder may recover awards received by the owner for damage done to the property by others, subject to the same standards of good faith which apply to the provisions assigning condemnation awards and insurance proceeds.[18]

However, the mortgage holder may only participate in money judgments compensating the owner for **actual injury** to the physical property which reduces its value.

3.2 — Waiver

The **nonwaiver provision** establishes the mortgage holder's right to accept partial payments of amounts due under the note and trust deed without waiving the right to commence or continue foreclosure based on the owner's default in payments.[19]

The second part of the nonwaiver provision is a **general waiver** which allows the mortgage holder to forego enforcement of the trust deed provisions on a default without waiving their right to commence foreclosure on a later default.

For example, the mortgage holder's consent to a transfer of the real estate under the trust deed's *due-on clause* does not waive the right of the mortgage holder to interfere with further transfers, unless the mortgage holder agrees in writing to waive their right to call or recast the debt on future transfers.

alienation clause
A trust deed clause limiting the rights of the owner of the mortgaged property to freely transfer their interest in the property by sale, lease or further encumbrance.

3.3 — Due-on-sale

A mortgage holder may enforce their due-on clause, also called an **alienation clause**, by automatically calling the debt due on a voluntary or involuntary transfer of any legal or equitable interest in the property.[20] [See Chapter 11]

17 **People** v. **Redwood Baseline Ltd.** (1978) 84 CA3d 662
18 **Duarte** v. **Lake Gregory Land and Water Co.** (1974) 39 CA3d 101
19 **M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002
20 12 Code of Federal Regulations §591.2

3.4 — Assignment of rents

Two types of **assignment of rents provisions** exist:

- an *absolute assignment*; and
- a *conditional assignment*.

However, the distinction between the two types of assignment of rents clauses is not of concern to the holder of a trust deed recorded after 1996.

A trust deed recorded after 1996 creates a *present security interest* in existing and future leases, rents, issues or profits on the mortgaged real estate. This is the case of a trust deed containing either type of assignment of rents clause. This security interest is properly referred to as a **lien**.[21]

The assignment of rents clause is generally placed in the trust deed recorded against the real estate involved, but may be in a separate lien agreement.

Once the assignment (the trust deed containing the provision) is recorded, it:

- gives *constructive notice* to all persons of the mortgage holder's security interest in the rents; and
- is *fully perfected* even though the provision states the assignment is unenforceable until a default occurs on the note or trust deed.[22]

Perfection by recording establishes that the mortgage holder's security interest in the rents has priority over security interests in the rents later acquired by other subsequent mortgage holders or owners of the property.

3.5 — Acceleration

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

The **acceleration provision** allows the mortgage holder to call the full amount of all sums secured by the trust deed due and payable on **any default** under a provision in the trust deed.

Although not necessary, notes secured by trust deeds also contain *acceleration clauses*. However, trust deed provisions relate to the property and are not properly contained or referenced in the note secured by the trust deed.

Thus, an acceleration provision in the trust deed allows the mortgage holder to accelerate payment of all secured obligations (not just the debt evidenced by the note) when the owner breaches any provision of the trust deed, which includes a default on the note.

Also, the acceleration provision in the trust deed gives notice to future owners and encumbrancers of the property that the secured obligation can be accelerated on any default.

Any acceleration is subject to the owner's reinstatement rights, except for calls for incurable breaches requiring redemption of the property by payment in full. Incurable breaches include calls under:

- the due-on clause;
- waste provisions; and

21 CC §2938(a)
22 CC §2938(b)

- violations of law affecting the value of the real estate. [See Chapter 11]

3.6 — Trustee's sale

The **power of sale provision** grants to a named or an unnamed trustee the power to hold a private trustees' sale of the property on the owner's default.[23]

The completion of a trustee's foreclosure sale extinguishes the owner's interest in the property and terminates the owner's right to redeem the property by paying off the debt.[24]

3.7 — Trustor's offset statement

If the mortgage holder later sells or collaterally assigns the trust deed note to an investor, the **offset statement provision** requires the property owner to cooperate by completing and delivering a *trustor's offset statement*. Here, the owner is the trustor.

The offset statement is used by the trust deed investor when conducting due diligence investigations into a note to confirm the terms of the note and trust deed with the owner of the property encumbered by the trust deed. [See **RPI** Form 414]

The statement is requested by the mortgage holder through the trust deed sales escrow, and delivered to the trust deed investor.

In addition to confirming the terms of the note, the trustor's offset statement references the existence of any claims or offsets held by the owner against the note or the trust deed holder assigning the note. The offset information is necessary to establish the assignee's status as a **holder in due course** on their acquisition of a trust deed note.

The owner of the mortgaged real estate has no duty to respond to the request for an offset statement, unless they agreed to do so in the note or trust deed.

4 — Addenda

Special use agreements not covered by boilerplate provisions in the trust deed are attached as addenda to the trust deed, sometimes called **riders.**

Examples include:

- the all-inclusive trust deed (AITD) addendum [See **RPI** Form 442 and 443 in Chapter 15];
- agreements for impound accounts [See **RPI** Form 455];
- owner-occupancy riders; and
- agreements for mortgage indemnity insurance.

5 — Reconveyance

Within 30 days after payoff of the secured obligation, the mortgage holder is required to deliver instructions to the trustee to record a **deed of**

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23 CC §2924, et seq.

24 CC §2903

reconveyance. Alternatively, the mortgage holder may reconvey the trust deed themselves. Both the note and the trust deed are returned to the property owner when the debt is fully satisfied and paid in full.[25] [See **RPI** Form 472]

Failure by the mortgage holder or trustee to reconvey is a misdemeanor, punishable by a fine of up to $400 and up to six months in jail, or both. Also, the mortgage holder or trustee who fails to reconvey is liable for any losses sustained by the owner as a result, plus a civil penalty of $500.[26]

If the mortgage holder does not recovey the trust deed within 75 days of the owner's full satisfaction of the debt, a title insurance company may prepare and record a release of the trust deed. A title insurance company that fails to reconvey is subject to the same penalties as a mortgage holder who fails to reconvey.[27]

6 — Successors, assigns and pledgees

A **successor and assignee provision** extends the rights and obligations under the trust deed to all successors-in-interest of the owner of the mortgaged real estate or the mortgage holder.

Even without a successor provision, the owner's successor takes title to the mortgaged property subject to the mortgage holder's trust deed, regardless of whether they have in any manner assumed the owner's obligations on the mortgage. Thus, the successor needs to maintain the terms of the note, even though they are not a party to it, to prevent losing the property to foreclosure, called **privity of estate**.[28]

privity of estate
A mutual or successive relationship to the same rights in property; a connection between persons to the same estate in property.

Further, the owner may enforce provisions in the trust deed against the mortgage holder even though they did not assume the obligations of the note and trust deed. Here, the successor's ownership of the property is the interest which secures the mortgage holder's recovery on the note, the result of the *privity of estate* theory.[29]

7 — Trustee's foreclosure notices

A county recorder can only record trust deeds which contain an owner's request for an NOD.[30] [See Chapter 5]

The trustee commencing foreclosure proceedings needs to mail a copy of the NOD by certified or registered mail, and a second copy by first-class mail, to the owner's last known address of record.[31]

If the owner fails to specify their address in the trust deed or later changes their address, they may request any future NOD be mailed to them at a new address by recording a statutory **Request for NOD** form.[32] [See Form 412 in Chapter 5]

25 CC §2941
26 CC §§2941(d); 2941.5
27 CC §§2941(b)(3), (d); 2941.5
28 **Rodgers** v. **Peckham** (1898) 120 C 238
29 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309 (Disclaimer: the legal editor of this publication was the attorney of record in this case for the borrower.)
30 Calif. Government Code §27321.5
31 CC §2924b(b)
32 CC §2924b(a)

If no address is given for the property owner in the trust deed or *Request for NOD* form, the trustee needs to:

- *publish* a copy of the NOD in a newspaper of general circulation in the county where the property is located, once a week for four consecutive weeks commencing within ten days of recording the NOD;
- personally *deliver* a copy of the NOD to the property owner within ten days of recording or before publication is completed; or
- *post* a copy of the NOD in a conspicuous location on the property and send a copy of the notice by registered or certified mail to the owner's last known address.[33]

Junior lienholders also request NODs and Notices of Delinquency (NODq) to better protect their interests in the mortgaged property against foreclosure and extended delinquencies allowed by a senior lienholder. [See Chapter 5]

33 CC §2924b(d)

Chapter 10 Summary

A private lender or carryback seller uses the provisions of a trust deed to contractually restrict as many aspects of ownership and possession of the liened property as they are legally able to control.

Thus, trust deeds are recognized as adhesion contracts, offered by a person with superior bargaining power (the lender) to a weaker person (the borrower) on a "take it or leave it" basis.

A prospective borrower typically has no power to negotiate better terms than those provided in regular trust deeds. California courts developed special adhesion contract rules for interpreting rights and obligations under trust deeds due to this imbalance in bargaining power.

Enforceable provisions found in a standard trust deed used to secure the performance of a note include:

- condition of property;
- hazard insurance;
- attorney fees;
- taxes and senior encumbrances;
- acts and advances to protect the security;
- assignment of damages;
- waiver;
- due-on-sale;
- assignment of rents;
- acceleration;
- trustee's sale;
- trustor's offset statement;
- special use agreements;
- reconveyance;
- successors, assigns and pledgees; and
- trustee's foreclosure notices.

Chapter 10 Key Terms

Chapter 11

Due-on-sale regulation

Learning Objectives

After reading this chapter, you will be able to:

- understand the nature of a due-on clause in trust deeds as a restriction on the mobility of an owner's title and pricing in times of rising mortgage rates;
- explain ownership activities which trigger due-on enforcement by mortgage holders;
- apply the exemptions barring mortgage holders from due-on enforcement; and
- negotiate a limitation or waiver of a mortgage holder's due-on rights.

Key Terms

acceleration	**inter vivos trust**
due-on clause	**novation**
Garn-St. Germain Federal Depository Institutions Act of 1982	**waiver agreement**

Rising rates bring mortgage holder interference

During times of upward sales volume, increasing mortgage originations and rising absorption rates for space available to rent, the marketplace functions at full throttle. This is known economically as a **virtuous cycle**.

Responsibility to individuals in the market during this frenzy lies with the gatekeepers to real estate ownership — brokers, builders and lenders. To keep those responsible for the activity from harming the greater society, the government implements regulations to reduce adverse conduct in the real estate and mortgage markets.

During times of rising prosperity, buyers put up with the onerous threshold of entry procedures maintained by the gatekeepers. In the rush to close deals, all the numerous steps to ownership seem justified for the buyers. There is plenty of money for everyone, or so it seems.

However, when mortgage rates and short-term interest rates rise, lending standards suddenly tighten. At this point, buyers become unwilling to further cope with the regime of higher rates, increased credit standards, seller price expectations, and excessive documentation requirements. This recurring paradigm shift triggers a **vicious cycle** which begins quickly but takes years to unwind after it bottoms.

Enter **due-on-sale** restrictions.

When the boom turns to bust, and stagnation

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

A burden on the use and mobility of ownership is created by the existence of the **due-on clause** buried within all trust deeds serviced by mortgage holders.

During boom years and long-term cyclical episodes of declining interest rates, the *due-on clause* is not an issue. The clause lays dormant and is unused. The decades of the '80s, '90s and 2000s is an example of a period when buyers could easily qualify for a new mortgage at ever decreasing interest rates to cash out the seller. Further, sellers are relatively unconcerned about the size of any prepayment penalty on the payoff of their mortgages during these prosperous times.

However, as the boom turns to bust and buyers are induced to purchase property as prices fall, the most efficient arrangement for financing the purchase price is for the buyer to take over the seller's mortgage – if it has an interest rate lower than the current rates charged by lenders.

However, mortgage holders in the past have refused to consent to any type of mortgage takeover or assumption. The reason: they prefer to receive a prepayment penalty and re-lend the money at the higher current rate. Consumer mortgages greatly restrict the duration (three years) and amount (declines yearly) of these penalties for payoff of the debt.

Thus, though the due-on clause was not a burden during the Millennium Boom, it becomes a noose around the seller's neck during periods like the **secular stagnation** of the 2010s. The combination of generally rising interest rates (following the 2009-2016 zero lower bound interest rates) and due-on clauses in existing mortgages tends to tie the seller to their property. Thus, the sellers are too often fettered to their home without a financially suitable way out.

Editor's note – Prepayment penalties on consumer mortgages are restricted to only fixed- and step-rate qualified mortgages (QMs).[1]

1 12 Code of Federal Regulations §1026.43(g)

Attempts to circumvent the sales restraint

Consider a parcel of real estate listed for sale. The parcel is encumbered by a mortgage containing a due-on clause. The seller's agent locates a buyer for the property.

The purchase agreement negotiated by the seller's agent calls for closing to be contingent on the buyer entering into an **assumption agreement** with the existing mortgage holder allowing the buyer to take over the mortgage on the property. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

Editor's note – For mortgage holders under Regulation Z (Reg Z), when an assumption involves a consumer mortgage, mortgage holder acceptance and a written agreement, it is considered a new consumer mortgage subject to new disclosures, ability-to-repay (ATR) and QM rules.[2]

The buyer is advised the senior mortgage holder may:

- refuse to allow the mortgage to be assumed, forcing the buyer to arrange new financing; or
- require a modification of the note at a less favorable interest rate than the current note rate on the mortgage and demand a large assumption fee.

Before contacting the mortgage holder to process the assumption, the buyer suggests the sale of the property be structured as a *lease-option* in an attempt to avoid due-on enforcement by the mortgage holder. [See **RPI** Form 163]

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for an additional two years at an increased monthly payment. The buyer will be granted an option to purchase the property from the seller for the life of the lease.

The down payment will be restated as **option money**. The *option money* will apply to the purchase price of the property, as will a portion of each monthly rent payment.

Meanwhile, the seller will continue making payments on the underlying mortgage. When the buyer exercises their purchase option, the mortgage will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the mortgage holder?

No! Any lease agreement which contains an *option to purchase* triggers due-on enforcement by the mortgage holder on discovery.[3]

Interference by mortgage holders is federal policy

Generally, mortgage holders are allowed to enforce due-on sale clauses in mortgages on most transfers of any interest in any type of real estate.[4]

2 12 CFR §1026.20(b)
3 12 CFR §591.2(b)
4 12 United States Code §1701j-3; Garn-St. Germain Depository Institutions Act of 1982 (Garn)

Thus, federal mortgage law deprives Californians of their state law right to convey real estate subject to trust deed liens without the mortgage holder interfering with the transfer of ownership for additional profit.

To interfere with the sale of the secured property under state law, the mortgage holder needs to demonstrate the buyer:

- lacks creditworthiness; or
- is wasteful of property in their management.

Essentially, the mortgage holder needs to prove the buyer is an *insolvent arsonist*. However, the federal legislative process called **preemption** bars application of state law to the contrary.

acceleration
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

The occurrence of an event triggering due-on enforcement automatically allows the mortgage holder to:

- *call the mortgage*, demanding the full amount remaining due to be paid immediately, also known as **acceleration**; or
- *recast the mortgage*, requiring a modification of the note's terms as a condition for the mortgage holder's consent to a transfer, called a **waiver by consent**.

Garn-St. Germain Federal Depository Institutions Act of 1982
Federal legislation which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

The **Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn)** itself encourages mortgage holders to allow buyers to assume real estate mortgages at existing rates, but provides mortgage holders no incentives for doing so. The congressional intent in 1982 when passing *Garn* was to preempt state law restrictions of due-on enforcement solely to allow mortgage holders to increase their profits on an old mortgage whenever the owner:

- sells;
- leases with a term over three years; or
- further encumbers the secured property.

However, the enforcement of the due-on clause by mortgage holders was not intended to occur at the expense of permitting excessive interference by mortgage holders with real estate transactions.[5]

Yet, when the Federal Home Loan Bank Board (which later became the now defunct *Office of Thrift Supervision (OTS)*) issued due-on regulations to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights. The following 30 years saw mortgage rates drop, and buyers were no longer willing to take over existing mortgages at higher than current rates. Thus, the granting of leniency was never an issue during the period of constantly declining rates. However, leniency will certainly become an issue in the coming years, as occurred in the 1960s.

5 12 USC §1701j-3(b)(3)

No leniency when exercising due-on rights

The regulations under *Garn* allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence (SFR) exceptions.

No encouragement or guidelines were established in the regulations for consent by a mortgage holder to mortgage assumptions or to limit interference in commonplace transactions. However, regulatory encouragement will be needed to avoid the inevitable interference as buyers attempt to take over the seller's low-rate mortgages when the seller will not lower their price.

In the absence of any regulatory obligations, mortgage holders use their due-on clauses to maximize their financial advantage over owners by calling or recasting mortgages on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

Economic recessions and recoveries

In times of stable or falling interest rates, mortgage holders generally permit assumptions of mortgages at the existing note rate, unless a **prepayment penalty clause** exists. Mortgage holders have no financial incentive to recast mortgages, or call and re-lend the funds at a lower rate when interest rates are dropping.

However, in times of steadily rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. Here, mortgage holders employ title companies to advise them on recorded activity affecting title to the properties they hold mortgages on. Once the due-on clause is triggered, the mortgage holder requires the mortgage to be recast at current market rates as a condition for allowing:

- a loan assumption;
- a lease with a term over three years; or
- a further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on mortgages becomes increasingly difficult to transfer as interest rates rise. This imprisons owners in their home when they are unable to sell and relocate without accepting a lower price.

Adverse economic effects on sales

The **inhibiting effect** the due-on clause has on buyers during recessions has a similar adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing.

Ultimately, as rates and interference by mortgage holders rise, many buyers, equity lenders and long-term tenants are driven out of the market, further depressing property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, often leaving owners with *negative equity* in the property. It is a vicious cycle which

It has recently come to our attention

Mortgage called or recast at mortgage holder's option

Events triggering the due-on clause

Sale:

- *transfer of legal title (grant or quitclaim deed);*
- *land sales contract or holding escrow;*
- *court-ordered conveyance; or*
- *death.*

Lease:

- *lease for more than three years; or*
- *lease with an option to buy.*

Further encumbrance:

- *creation or refinance of a junior lien; or*
- *foreclosure by junior lienholder.*

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- *creation of junior lien where owner continues to occupy;*
- *transfers to spouse or child who occupies;*
- *transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);*
- *death of a joint tenant; or*
- *transfer on death to a relative who occupies.*

evolves into a dramatic increase in mortgage foreclosures, the antithesis of the profit motive for automatic enforcement of the due-on clause by mortgage holders.

Due-on interference was an obscure issue during the 30-year period (1982-2012) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 3.25% and mortgage money became more plentiful. All that downward rate movement was reversed in 2008 with zero lower bound interest rates and mortgages at historically low note rates in 2012.

Due-on-sale

Due-on clauses are most commonly known as **due-on-sale** clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the mortgage holder's due-on clause is a sale of property which is subject to the mortgage holder's trust deed lien.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not. [See **RPI** Form 404 and 405]

Examples include a:

- land sales contract;
- lease-option sale; or
- other wraparound carryback devices, such as an **all-inclusive trust deed (AITD) note**.

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed until the price is fully paid by the buyer. The seller retains title as security for the carryback debt owed by the buyer. However, the buyer under a land sales contract becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession transferred. This structuring of a carryback sale triggers the due-on clause in any existing trust deed.[6]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with an option to buy.[7]

For example, an owner with a short-term construction loan for nonresidential rental property obtains a conditional commitment from a lender for long-term financing to pay off the construction loan. Funding of the loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the mortgage which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the mortgage, the owner continues to lease out space in their property for five-year terms. Later, after interest rates rise, a representative of the lender visits the property and observes the new tenants. On inquiry, the lender learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the mortgage was originated.

The lender sends the owner a letter informing them it is calling the mortgage due since the owner entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the mortgage since long-term leases were initially required by the lender as a condition for funding the mortgage.

Can the lender call the mortgage due or demand a recast of its terms?

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6 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

7 12 CFR §591.2(b)

Yes! By requiring leases with terms over three years as a condition for funding the mortgage, the lender did not waive its right to call or recast the mortgage under its due-on clause if a lease with a term over three years is entered into after the mortgage was originated.

Due-on modification

An **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless:

- the lease is modified to extend the term beyond three years; or
- a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a mortgage containing a due-on clause. Later, the tenant assigns the lease with the owner's approval, as provided in the lease agreement which has priority to the mortgage.

Here, the due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the mortgage transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the mortgage.

novation
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

Now consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a **novation** of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the *novation* included a leasing period of over three years, the mortgage holder may call the mortgage.[8]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation.

Accordingly, a lease novation triggers the due-on clause if the lease has a remaining term of over three years or includes an option to purchase.

This interference addresses owners of nonresidential income property. Typically, the owners want long-term leases which run more than three years in their term. Here, the leasing periods have to be held to three years each, the initial term, and each extension of the periods of occupancy under a lease agreement. Otherwise, the mortgage holder may call the mortgage if the initial period is more than three years, or when exercised, the extension of the lease term is for more than three years.

Due-on-further encumbrance

Consider an owner-occupant of an SFR subject to a first mortgage. The owner applies for an *equity loan* to be secured by a second trust deed on their property. The first mortgage contains a due-on clause.

8 **Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424

The lender tells the owner they are concerned about due-on enforcement by the senior mortgage holder during times of rising rates. The lender is aware encumbering the property with a second mortgage triggers the existing mortgage holder's due on clause, unless the activity is exempt. On inquiry, the owner informs the lender they will continue to occupy the property as their residence.

The lender assures the owner that as long as they continue to occupy the property, the second mortgage will not trigger the senior mortgage's due-on clause. Due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted.[9]

However, on real estate other than an owner-occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing mortgage holder's consent and waiver of their due-on clause triggers the due-on clause.

Thus, junior financing in the form of an equity loan without a waiver of the senior mortgage's due-on clause becomes a risky enterprise for lenders in times of rising interest rates. Increasing market rates give mortgage holders an incentive to call mortgages on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

Due-on waiver

A lender who accepts a junior position on a property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior mortgage holder risks having the economic value of its position in title:

- **reduced** by an increase in the interest rate on the senior mortgage; or
- **wiped out** by the senior mortgage's foreclosure if its due-on rights were exercised based on the further encumbrance and it was not paid in full.[10]

Owners are driven to look elsewhere for funds when the existing mortgage holder does not grant a due-on waiver. Thus, an owner is forced to unnecessarily refinance existing mortgages in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second mortgage on the sale of property without the consent of the holder of the first mortgage which contains a due-on clause.

The holder of the first mortgage learns of the sale and calls the mortgage. To avoid the call, the buyer assumes the first mortgage and modifies the note by shortening the due date.

9 12 CFR §591.5(b)(1)(i)

10 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

The carryback seller claims their second mortgage now has priority over the first mortgage since the modification of the first mortgage substantially impairs their security by increasing the potential for default on the carryback mortgage.

Here, the modification of the first mortgage without the consent of the junior carryback seller does not result in a change in mortgage priorities since the existence of the second mortgage is in violation of the due-on clause in the first mortgage.

When the secured property is sold and the seller accepts a second mortgage without receiving the mortgage holder's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the holder of the first mortgage to avoid further subordinating the interest of the holder of the unconsented-to junior mortgage by recasting the first mortgage.[11]

Due-on-foreclosure

Consider a parcel of real estate subject to a first and a second mortgage which the holder of the first mortgage previously consented to.

The property owner defaults on the first mortgage. The junior mortgage holder reinstates the first mortgage and forecloses on the second, acquiring the property at the trustee's sale. At all times, the second mortgage holder keeps the first mortgage current and advised of the foreclosure proceedings.

On acquiring title at foreclosure, the junior mortgage holder advises the senior mortgage holder they are now the **owner-by-foreclosure**. The senior mortgage holder informs the junior mortgage holder, now the owner of the property, that they are calling their mortgage due based on the transfer of the property by trustee's deed – unless they are to receive points for an assumption of the mortgage and a modification of the note's interest rate and payments to current market rates.

May the senior mortgage holder call their mortgage due based on the completion of foreclosure by the second mortgage holder?

Yes! A senior mortgage holder may call a mortgage due on completion of the **foreclosure sale** by a junior mortgage holder on any type of real estate. A **trustee's deed** on foreclosure is considered a voluntary transfer by the owner, since the power-of-sale authority in the junior mortgage was agreed to by the owner of the real estate.

The due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, it is also triggered by any involuntary foreclosure, such as a tax lien sale.[12]

Federal regulations allow due-on enforcement on *any transfer* of real estate which secures the lien, whether the transfer is voluntary or involuntary.[13]

11 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869

12 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 [Disclosure: the legal editor of this publication was the owner's attorney in this case]

13 12 CFR §591.2(b)

The risk of a senior mortgage holder enforcing their due-on clause on a trustee's sale by the junior mortgage holder has a **debilitating effect** on the availability of junior mortgages and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt if they are forced to foreclose on the real estate.[14]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause. However, this is conditioned on the relative becoming an occupant of the property.[15]

Also, where two or more people hold title to one-to-four unit residential property as **joint tenants**, the death of one *joint tenant* does not trigger due-on enforcement.

However, at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, needs to have occupied the property when the mortgage was originated. Conversely, occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception.[16]

On all other transfers, the death of a vested owner, joint tenant or other co-owner triggers the mortgage holder's due-on clause.

Thus, due-on enforcement is triggered on death by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

Consider a married couple who occupies a residence vested in the name of the husband and owned as his separate property. The residence is encumbered by a mortgage containing a due-on clause.

14 **Pas** v. **Hill** (1978) 87 CA3d 521

15 12 CFR §591.5(b)(1)(v)(A)

16 12 CFR §591.5(b)(1)(iii)

The couple separates and the residence is transferred to the wife as part of the property settlement to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the mortgage holder?

No! Federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property.[17]

However, if the acquiring spouse chooses to lease the residential property for any period of time rather than occupy it, the mortgage holder may call or recast the mortgage.

Inter-family exception

The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a **spouse or child** who occupies the property.[18]

This *inter-family transfer exception* applies only to transfers from an owner to a spouse or child. Any transfer from a child to a parent triggers due-on enforcement.

inter vivos trust
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. [See **RPI** Form 463]

Consider an owner-occupant of one-to-four unit residential property who transfers the property into an **inter vivos trust**, naming themselves as beneficiary. The owner continues to occupy the property after transferring title into the living trust.

The owner notifies the mortgage holder prior to transfer. The owner agrees to give the mortgage holder notice of any later transfer of their beneficial interest in the trust or change in occupancy of the property as requested by the mortgage holder.

Does this transfer into the *inter vivos trust* trigger the due-on clause in a mortgage encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust.[19]

To meet regulations, the owner needs to provide means acceptable to the mortgage holder by which the mortgage holder is given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the mortgage holder's approval, the mortgage holder may call the mortgage due.

Thus, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the mortgage holder may call or recast the mortgage.

17 12 CFR §591.5(b)(1)(v)(C)
18 12 CFR §591.5(b)(1)(v)(B)
19 12 CFR §591.5(b)(1)(vi)

Lender waiver by negotiations and by conduct

An owner intending to enter into a transaction to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a *limitation* or *waiver* of the mortgage holder's due-on rights.

waiver agreement
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **RPI** Form 431 and 432]

Waiver agreements are trade-offs. In return for waiving or agreeing to limit the exercise of its due-on rights in the future, the mortgage holder demands consideration such as:

- additional points in the instance of an origination;
- additional security;
- the borrower's pay-down of principal balance;
- increased interest;
- a shorter due date; or
- an assumption fee.

Consider a buyer who applies for a mortgage to purchase a residence they intend to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult to resell their property.

The buyer and lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the buyer's mortgage without a call by the mortgage holder. In exchange, the buyer agrees to pay increased points or a higher interest rate, subject to applicable Reg Z fee caps.

The mortgage holder's waiver of their due-on rights under an *assumption agreement* applies only to the present transfer to the buyer. Unless additionally agreed to, any *later transfer* of an interest in the property will trigger the due-on clause, allowing the mortgage holder to call or recast the mortgage again.

In addition to a *waiver agreement*, waiver of the mortgage holder's due-on rights may occur *by conduct* when the mortgage holder fails to promptly enforce its due-on rights.

For example, a buyer purchases real estate subject to a mortgage containing a due-on clause. The mortgage holder is informed or discovers the transfer and immediately calls the mortgage. However, the mortgage holder then accepts payments from the buyer for over 12 months. After interest rates increase, the mortgage holder later seeks to enforce their prior call by refusing further payments.

Here, the mortgage holder waived the right to enforce their due-on clause by their conduct.[20]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior mortgage holder's due-on clause is triggered regardless of the form used to document the sales transaction.

20 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

Regardless, the mortgage holder can only call the mortgage when they actually discover a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term of three years or less, the mortgage holder may not discover any transfer of an interest in the real estate which triggered their due-on clause has taken place.

If the mortgage holder later discovers a change of ownership has taken place, their only remedy against the buyer and seller is to call the mortgage due, or arrange to recast the mortgage as a condition for waiving their right to call and allowing an assumption by the buyer. Additionally, the mortgage holder may not recover the *retroactive interest differential* (RID) for the period before they discovered the transfer and called the mortgage.[21]

However, an **adviser**, such as a broker or attorney, assisting the buyer or seller to *mask the change of ownership* from the mortgage holder with the primary purpose of avoiding due-on enforcement may be held liable for wrongfully interfering with the mortgage holder's right to call or recast the mortgage, an offense called **tortious interference with prospective economic advantage**.

The *adviser's* liability arises based on the extent to which their actions were *specifically intended* to conceal the transfer and prevent a call by the mortgage holder, and on the foreseeability the mortgage holder will incur losses due to the concealment.[22]

The mortgage holder's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the mortgage holder to the date of the transfer.

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21 **Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49 [Disclosure: the legal editor of this publication was the attorney of record for the borrower in this case.]

22 **J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799

Chapter 11 Summary

Lenders and carryback sellers are allowed to enforce due-on sale clauses in trust deeds on most transfers of any interest in any type of real estate. The occurrence of an event which triggers due-on enforcement automatically allows the mortgage holder to call or recast the mortgage. In times of rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio.

The due-on clause is triggered by any conveyance of legal or equitable ownership of real estate, such as a sale. A due-on clause is also triggered by:

- a lease with a term over three years;
- a lease for any term when coupled with an option to purchase;
- further encumbrance of a non-owner-occupied, one-to-four unit residential property; and
- on completion of the foreclosure sale by a junior mortgage holder on any type of real estate.

Further, transfers of real estate resulting from the death of a vested owner also trigger due-on enforcement, with narrow exceptions based on occupancy of residential property.

Exceptions to due-on enforcement exist. Due-on enforcement based on the further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted. Similarly, the due-on clause is not triggered by an owner's transfer of property to a spouse or child who then occupies the property, or on the transfer of one-to-four unit residential property to a spouse after a divorce if the spouse occupies the property.

An owner wishing to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a limitation or waiver of the mortgage holder's due-on rights. Waiver of the mortgage holder's due-on rights may also occur by conduct when the mortgage holder fails to promptly enforce them.

An adviser assisting the buyer or seller to mask the change of ownership for the purpose of avoiding the mortgage holder's due-on enforcement may be held liable for interfering with the mortgage holder's right to call or recast the mortgage.

Chapter 11 Key Terms

acceleration .... pg. 120
due-on clause .... pg. 118
Garn-St. Germain Federal Depository Institutions Act of 1982 .... pg. 120
inter vivos trust .... pg. 128
novation .... pg. 124
waiver agreement .... pg. 129

Chapter
12

Due-on waiver and junior financing

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between a buyer's assumption and a due-on waiver negotiated in an all-inclusive trust deed situation when an existing mortgage will remain of record;
- negotiate a waiver of the senior mortgage holder's due-on clause on a sale subject to the existing mortgage; and
- understand the need to disclose the presence of a due-on clause in existing mortgages and advise clients in carryback transactions on their consequences.

Key Terms

all-inclusive trust deed (AITD) note

call

due-on clause

recast

waiver agreement

Prior planning prevents a mortgage holder's interference

Consider a seller of real estate encumbered with a mortgage who lists the property for sale with their broker. The mortgage contains a **due-on clause**.

Later, the seller's broker submits a purchase offer from a buyer on terms which include:

- a cash down payment;
- an assumption of the existing mortgage by the buyer; and
- a seller carryback note entered into by the buyer for the balance of the purchase price, secured by a second trust deed on the property.

Following negotiations and agreement, sales escrow is opened. As called for in the escrow instructions, escrow requests a **loan assumption package** from the existing mortgage holder.

Before the close of escrow, the mortgage holder approves the sale conditioned upon the buyer:

- *assuming* the mortgage debt; and
- agreeing to a *modification* of the interest rate and payment schedule in the note.

The buyer agrees to the mortgage holder's demands and signs the loan assumption and note modification agreement. The mortgage holder does not enter into a written consent agreement with the seller regarding the carryback second trust deed. However, the mortgage holder did receive a copy of the purchase agreement and escrow instructions during the loan assumption process which disclosed the carryback second trust deed as part of the sales transaction.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

Here, the mortgage holder consented to the conveyance of the mortgaged property to the buyer on the terms of the sale as set out in the purchase agreement and sale escrow instructions they received. Thus, by their conduct, the mortgage holder has *waived* their rights under the *due-on clause* regarding the further encumbrance (second trust deed) carried back by the seller. The carryback trust deed is a separate transfer from the grant deed conveyance to the buyer, which itself triggers the due-on clause.[1]

Call or recast the mortgage

However, the mortgage holder was not asked to and did not enter into a written agreement to further waive their due-on right to **call or recast** the mortgage in the future if:

- the buyer *transfers an interest* in the property while the carryback seller still holds their second mortgage; or
- the seller *forecloses* and becomes the owner of the property again.

call
A lender's demand for the balance of the loan to be immediately paid in full. [See **RPI** From 418-3]

After the buyer takes title to the property, a transfer by the buyer of their interest in the mortgaged real estate will require the mortgage holder's prior consent to avoid the risk of the mortgage holder calling the mortgage under the due-on clause, with limited exceptions. [See Chapter 11]

Exceptions include:

- a lease with a term under three years containing no option to purchase the property; and
- most *non-sale intra-family* principal residence transfers.

1 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

The mortgage holder may *call* the mortgage or demand the mortgage be *recast*, with exceptions for most conveyances of the principal residence to family members or for an equity loan encumbrance on that residence, if, after escrow closes, the buyer:

- dies;
- conveys or further encumbers the property;
- enters into a long-term lease (over a three-year term) or a lease with a purchase option; or
- defaults on the carryback mortgage and the seller forecloses. [See Chapter 11]

recast
A mortgage holder's demand to modify the note terms and receive payment of additional fees in exchange for waiving the due-on clause in their mortgage.

The written waiver

A typical carryback sales transaction involving an existing mortgage is structured as either:

- a **regular** second mortgage carried back by the seller with the existing mortgage holder consenting to the conveyance of the property and the carryback mortgage by waiving their due-on clause in exchange for an assumption fee and modification of the note by the buyer; or
- an **all-inclusive trust deed** (AITD) and note, or another wraparound security device, with the underlying mortgage holder consenting to the conveyance to the buyer and the carryback *AITD* by waiving their due-on clause in exchange for a modification of the note and payment of fees by the seller — all in lieu of the buyer's assumption of the mortgage, an activity labeled a **reverse assumption**. [See Chapter 13]

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

After the mortgage holder consents to the carryback sale and escrow closes, future events beyond the seller's control can again trigger the due-on clause.

Without the mortgage holder's **prior written waiver** of their due-on enforcement rights triggered by future transfers, the mortgage holder can call the mortgage due on a later transfer of the buyer's interest in the property. With some exceptions for a principal residence, a transfer subject to due-on enforcement rights may include a:

- resale;
- further encumbrance;
- lease for over three years;
- court ordered transfer;
- foreclosure; or
- death.

A written waiver of the mortgage holder's **future enforcement** of the due-on clause bars the mortgage holder from calling the mortgage due. Further, it protects the carryback seller as long as the seller has an interest in the property. The **waiver agreement** assures the carryback seller they can protect their security interest in the property without interference from the underlying mortgage holder. [See Form 410 accompanying this chapter]

waiver agreement
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **RPI** Form 431 and 432]

Form 410

Further Encumrance Consent

FURTHER ENCUMBRANCE CONSENT

NOTE: This form is used by a prospective junior lender or carryback seller when the real estate is encumbered by an existing first mortgage containing a due-on clause, to obtain consent from the lender holding the mortgage to further encumber the property with a second mortgage.

DATE: ______________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This consent agreement is entered into between

1.1 ____, as the Existing First Lender,

1.2 and ____, as the New Junior Lender,

1.3 regarding the Existing First Lender's trust deed recorded on ____, as Instrument No. _______________________, in ___________________________ County Records, California,

1.4 executed by ____, as the Trustor,

1.5 in which ____ is named as the Beneficiary,

1.6 encumbering property referred to as ____.

2. A trust deed, junior and subordinate to the Existing First Lender's trust deed, will be executed in favor of the New Junior Lender in reliance on this consent agreement.

AGREEMENT:

3. The Existing First Lender hereby:

3.1 Consents to the further encumbrance of the property in favor of the New Junior Lender.

3.2 Waives its due-on rights until the New Junior Lender's trust deed encumbrance is reconveyed or foreclosed and no longer is a lien on the property.

3.3 Waives its due-on rights if the New Junior Lender later acquires title to the property by foreclosure or deed-in-lieu of foreclosure under its trust deed, subject to the following checked conditions at the time of transfer:

a. ☐ Payment of an assumption/transfer fee of $_______________.

b. ☐ Modification of the Existing First Lender's note to reflect interest at the fixed rate of ______% per annum, amortized over the loan's remaining term, with the principal balance due ___________________, 20________.

c. ☐ ____.

4. GENERAL PROVISIONS:

4.1 All other provisions of the Existing First Lender's trust deed remain unaffected by this consent.

4.2 This consent is for only one further encumbrance by the New Junior Lender.

4.3 This consent inures to the benefit of the successors and assigns of the parties.

NOTE: The following agreements are used when an existing second trust deed will remain of record after further encumbering the property.

5. SUBORDINATION AGREEMENT to any modification agreed to in Section 3.3 above.

5.1 _________________ is the Beneficiary under a second trust deed lien on the property recorded as Instrument No. _______________, in _______________________________________ County Records, California.

5.2 The Existing Second Trust Deed Beneficiary consents to this modification and agrees to subordinate their trust deed to these modifications on demand.

5.3 The Existing Second Trust Deed Beneficiary consents to this further encumbrance and waives enforcement of any due-on clause in its trust deed.

5.4 The Existing Second Lender is____.

Date: _______________, 20______. Signature of Existing Second Lender: ______________________________

EXISTING FIRST LENDER:	NEW JUNIOR LENDER:
I agree to the terms stated above.	**I agree to the terms stated above.**
Lender: ______________________	Lender: ______________________
By: ______________________	By: ______________________
Signature: ______________________	Signature: ______________________
Title: ______________________	Title: ______________________

FORM 410 03-11

To best protect the seller's trust deed, the seller needs to have the mortgage holder waive their right to call the mortgage:

- on the conveyance and further encumbrance of the property on the close of the carryback sale;
- for as long a period as the carryback mortgage remains of record; and
- on the carryback seller's reacquisition of title to the property if the seller completes a foreclosure on the property or accepts a **deed-in-lieu** of foreclosure.

To be enforceable against the mortgage holder, the waiver needs to be in writing as do any other commitments made by a lender.[2]

The AITD and a due-on waiver

The AITD carryback is a variation on the standard carryback second mortgage. An AITD is always a junior mortgage, typically a second. [See Chapter 13]

However, in contrast to the standard trust deed, the AITD:

- secures a note for a principal amount which totals the unpaid balances on the underlying liens and the balance of the seller's equity remaining unpaid after a down payment;
- obligates the carryback seller to remain responsible for making payments on the underlying liens; and
- does not involve the buyer with the existing mortgage holder in an **assumption** of the underlying (wrapped) mortgage. [See Chapter 13, 14 and 15]

The creation of the AITD triggers the due-on clause, as does a grant deed, since it is a further encumbrance and thus a transfer of an interest in the real estate. The due-on clause is triggered whether or not the AITD is recorded.

Prior to closing an AITD sale, it is the *seller*, not the buyer, who negotiates any modification of the note and arranges for the payment of any fees required by the mortgage holder to waive due-on clause enforcement. The note modification entered into by the seller here again is an additional benefit received by the mortgage holder.

The modification enlarges the mortgage holder's portfolio yield through an increase in the note's interest rate and the monthly payments. This is no different than if the buyer assumed the mortgage. Thus, the mortgage holder of record receives the same economic benefits of fees and market rates on the seller's modification of the note as though the buyer had assumed and modified the mortgage.

In exchange for the fees and modification, the mortgage holder consents to the seller's AITD financing. As part of the negotiations, the mortgage holder agrees in writing to waive their rights under the due-on clause for as long as the carryback seller holds an interest in the property.

Seller remains responsible

The seller carrying back an AITD retains the responsibility for paying the principal and interest installments and any impounds due to the mortgage holder on the underlying mortgage. Thus, the **credit review** of the buyer by the mortgage holder is avoided since the seller remains the sole party responsible for payment.

After closing, instead of the buyer making payments on the underlying mortgage, the buyer makes installment payments on the AITD note directly

2 12 Code of Federal Regulations §591.5(b)(4)

to the carryback seller. On receiving installment payments on the AITD note from the buyer, the carryback seller pays the installment due on the underlying mortgage and keeps any remaining amount as their funds.

Broker's duty to disclose AITD risks

All brokers in a sale in which an existing trust deed is to remain of record have a duty to disclose the **existence** of a due-on clause in the trust deed. [See Chapter 11]

Beyond disclosing the existence of a due-on clause, both the seller's and buyer's brokers have a **duty** to advise their clients in the carryback transaction on the *legal and financial consequences* of the due-on clause.

For example, the seller's broker negotiating the carryback of a junior trust deed on behalf of a seller is to inform the seller of the risks posed by the due-on clause in the existing trust deed. As for the buyer, it is the buyer's broker who is obligated to review the due-on risks and advise the buyer on the consequences of structuring the transaction to either:

- negotiate a *waiver* of the senior mortgage holder's exercise of their due-on rights; or
- take title *subject to* the existing mortgage. [See **RPI** Form 150 §4]

Also, the carryback seller needs to be informed and understand that a default by the buyer on installments on the AITD note will force the seller to advance payments on the underlying mortgage holder. If the installment is not advanced, the seller risks having their AITD wiped out by the existing mortgage holder's foreclosure, a result no different than when a seller carries back a regular second mortgage. This critical discussion is the task of the seller's broker, not the buyer's broker.

General duty to both parties

Now consider a buyer who is not represented by a buyer's broker and submits an offer to purchase a property through the seller's broker. The buyer is fully qualified to make payments on both the existing mortgage and a carryback mortgage.

The terms of purchase include:

- the buyer paying a small cash down payment;
- the buyer taking title subject to the existing mortgage; and
- the seller carrying back a note for the balance of the purchase price.

The seller accepts the offer. However, the buyer is not informed by the seller's broker of the existence of the due-on clause in the existing mortgage. Since an assumption of the mortgage by the buyer will not occur, a **beneficiary statement** is not requested from the mortgage holder. A *beneficiary statement*, if received, discloses the existence of the due-on clause and the mortgage holder's intentions to the buyer prior to closing, as does a copy of the recorded trust deed.[3] [See **RPI** Form 415; see Chapter 11]

3 Calif. Civil Code §2943

After escrow closes, the first-lien mortgage holder discovers the sale and calls the mortgage due. The buyer, unable to pay the balance due on the mortgage, ultimately loses the property through foreclosure.

The buyer seeks to recover their lost value from the seller's broker, claiming the broker had a duty to investigate and disclose the existence of a due-on clause on a sale of property subject to an existing mortgage.

The broker claims they owed no duty to the buyer to investigate or disclose title conditions contained in the recorded trust deed since these are public records and the buyer was not their client.

Can the buyer collect the dollar amount of their lost equity in the property from the seller's broker?

Yes! Any broker negotiating a transaction as an agent for either party has a **general duty** to disclose title conditions affecting ownership or use of the property to *both parties*, not just their client.

Waiver negotiations

The broker negotiating the carryback sale structured as an AITD or other wraparound financing agreement needs to anticipate the parameters of the mortgage holder's demand for increased interest and payments in exchange for a waiver of their due-on clause.

In turn, the interest rate and payment schedule negotiated for the AITD note needs to **equal or exceed** the interest rate and payment schedule the existing mortgage holder will demand as a modification of their note to consent to the sale.

If the AITD carryback sale is negotiated when market interest rates are the same or lower than the interest rate on the existing mortgage, the mortgage holder will be inclined to retain the original rate and demand only an assumption fee, often expressed in terms of points, for consenting to the seller's AITD sales transaction.

Conversely, in a market of rising interest rates, when the existing mortgage's interest rate is below market rates, the mortgage holder will use the due-on clause to take advantage of the higher current rates and increase the note rate, and their yield, on:

- the buyer's assumption; or
- the seller's modification in the case of an AITD transaction. [See Chapter 13]

The AITD purchase agreement needs to specify the terms for modification of the existing mortgage which are acceptable to both the buyer and the seller. Thus, terms need to be negotiated by the seller with the mortgage holder placing limitations on the:

- interest rate;
- monthly payments;

- due date; and
- assumption fee.

Alternatively, the purchase agreement may include a contingency for the seller's further approval of the modification demands by the mortgage holder to avoid impairing their AITD.

The carryback seller or their broker will need to negotiate the assumption or modification agreement with the mortgage holder, as well as any waiver of the mortgage holder's exercise of their due-on rights for as long a period as the seller retains an interest in the property.

Chapter 12 Summary

When a buyer agrees to obtain a carryback note in favor of the seller and assume an existing mortgage, escrow requests a loan assumption package and provides a copy of the purchase agreement and escrow instructions to the existing mortgage holder. When the mortgage holder approves and consents to the sale, their conduct waives their rights under the due-on clause regarding the further encumbrance carried back by the seller, whether or not the mortgage holder enters into a written consent agreement.

After the buyer takes title to the property, a transfer by the buyer of their interest in the mortgaged real estate will require the mortgage holder's prior consent to avoid the risk of the mortgage holder calling the mortgage under the due-on clause, with limited exceptions.

Exceptions include:

- a lease with a term under three years containing no option to purchase the property; and
- most non-sale intra-family principal residence transfers.

A typical carryback sales transaction involving an existing mortgage is structured as either:

- a regular second mortgage carried back by the seller with the existing mortgage holder consenting to the conveyance of the property and the carryback mortgage by waiving their due-on clause in exchange for an assumption fee and modification of the note by the buyer; or
- an all-inclusive trust deed (AITD) and note, or another wraparound security device, with the underlying mortgage holder consenting to the conveyance to the buyer and the carryback AITD by waiving their due-on clause in exchange for a modification of the note and payment of fees by the seller.

After the mortgage holder consents to the carryback sale and escrow closes, future events beyond the seller's control can again trigger the due-on clause.

A written waiver of the mortgage holder's future enforcement of the due-on clause bars the mortgage holder from calling the mortgage due. Further, it protects the carryback seller as long as the seller has an interest in the property.

All brokers in a sale in which an existing trust deed is to remain of record have a duty to disclose the existence of a due-on clause in the trust deed.

Beyond disclosing the existence of a due-on clause, both the seller's and buyer's brokers have a duty to advise their clients in the carryback transaction on the legal and financial consequences of the due-on clause.

Any broker negotiating a transaction as an agent for either party has a general duty to disclose title conditions affecting ownership or use of the property to both parties, not just their client.

The broker negotiating the carryback sale structured as an AITD or other wraparound financing agreement needs to anticipate the parameters of the mortgage holder's demand for increased interest and payments in exchange for a waiver of their due-on clause. Thus, an AITD purchase agreement needs to specify the terms for modification of the existing mortgage which are acceptable to both the buyer and the seller.

Chapter 12 Key Terms

Notes:

Chapter 13

Working the AITD

Learning Objectives

After reading this chapter, you will be able to:

- recognize the advantages of an all-inclusive trust deed (AITD);
- understand the terms to be negotiated for an all-inclusive note; and
- identify the forms used to document a carryback AITD.

Key Terms

all-inclusive trust deed (AITD) note

beneficiary statement

blanket mortgage

due-on clause

negative amortization

pass-through provisions

Flexible financing via the seller

As a *debt instrument* and *security device* for the carryback sale of mortgaged real estate, the **all-inclusive trust deed (AITD)** and note provides agents, sellers and buyers with the flexibility needed to finance the **balance of a sales price** remaining to be paid after a down payment. AITDs become more common during periods of tightened availability of mortgage funds.

For a buyer with a down payment, the *AITD* carried back by a seller is all the financing needed to acquire mortgaged real estate.

The principal amount of the AITD includes:

- the **unpaid balance** on the existing mortgage which will remain of record, called the *wrapped mortgage* or *underlying mortgage*; and
- the **seller's equity** in the property remaining to be paid after the buyer's down payment.

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

Through the use of an *AITD*, the buyer makes monthly payments to the seller as negotiated in the all-inclusive note. In turn, the seller continues to make monthly payments to the mortgage holder on the underlying mortgage.

The advantages of an AITD over a regular second mortgage are experienced primarily by the seller. However, the buyer and underlying mortgage holder benefit as well since the arrangement allows the underlying mortgage holder and the buyer to avoid the assumption process.

For the benefit of the seller, the AITD:

- **allows a greater yield** than ordinarily can be negotiated for the note rate on a regular second mortgage, a financial advantage generated by the **overriding interest rate** feature available by use of an all-inclusive note;
- **eliminates the risk of loss** due to a default on the underlying mortgage since the seller remains responsible for its payment;
- **defers profit tax liability** for a greater percentage of the transaction's profit since an all-inclusive note increases the percentage of profit allocated to the principal in the carryback mortgage;
- **supports the price** sought by the seller by providing non-institutional financing; and
- **provides for a trustee's foreclosure** on the buyer's default, unlike other wraparound security devices, such as land sales contracts and purchase/lease-option agreements which require a judicial foreclosure (unless they contain a power-of-sale provision).

Buyer benefits of the AITD

As a benefit to the buyer, the AITD provides more simplicity and flexibility than conventional or government insured mortgages, since:

- the interest rate and payment schedules are **fully negotiable** and not tied to rigid secondary money market standards;
- the carryback seller is less concerned with **creditworthiness** and income ratios than standardized institutional lenders due to the seller's knowledge of the property and a more personal relationship with the buyer;
- the buyer makes payments on only one debt obligation, the all-inclusive note; and
- no third-party lender fees are required, such as points, garbage fees, private mortgage insurance (PMI), assumption fees or a separate (and expensive for value received) lender's American Land Title Association (ALTA) title insurance policy.

Editor's note – Although a carryback seller may be less concerned with the buyer's creditworthiness than an institutional lender, a prudent agent will gather the buyer's financial statements and credit report for the seller's review before negotiations commence.

AITD concepts

An AITD is always a **junior mortgage**, usually a second, subordinate to a pre-existing, underlying first mortgage. Legally, the AITD has the same function as a regular trust deed.

The AITD form used is a regular trust deed form with the addition of an AITD addendum. The AITD addendum covers the disclosures and accounting for the financial aspects unique to an AITD. [See Form 442 and 443 in Chapter 15; see **RPI** Form 450]

Like the AITD, land sales contracts and lease-option sales are also all-inclusive security devices which exhibit the same wraparound debtor/creditor features. Under all three, the seller has sold the property yet remains responsible for payments on the underlying mortgage while receiving installments from the buyer. Additionally, income and property tax results for each device are treated the same by all government agencies.

AITD terms

The terms negotiated for payment of the sales price when the seller carries back an AITD include five variables:

- the down payment;
- the principal amount of the AITD;
- the interest rate;
- the periodic (monthly) payments; and
- the due date.

Down payment

The down payment in an AITD transaction is handled no differently than on any other method of carryback or conventional financing, such as a:

- regular first or second trust deed;
- land sales contract; or
- lease-option sale.

The amount of the down payment is fully negotiable between a buyer and seller. It may range from zero to the seller's entire equity in the mortgaged property.

The prudent carryback seller will require a down payment of no less than 10% to 20% of the sales price, depending on whether the property sold is intended as:

- a buyer-occupied residence; or
- an income-producing property.

The smaller the down payment, the greater the risk of loss for the seller if the buyer defaults on the mortgage and the property is foreclosed on. The risk of loss created by a low down payment is covered financially by:

- an increase in the price or interest rate, or both;
- guarantee by a person other than a signer of the note;

- cross-collateralization by a lien on other property owned by the buyer; or
- the bifurcation of the carryback debt into separate secured and unsecured debts.

The amount of the AITD

The distinguishing characteristic of the all-inclusive note is its **face amount**. The *face amount* of the all-inclusive note is the entire balance of the sales price remaining after the down payment. [See Form 421 in Chapter 15]

At first glance, the total dollar amount of the debts secured by the underlying mortgage and the AITD appear to over-encumber the property.

However, the amount of the AITD **wraps around** and is **inclusive** of the underlying mortgage balance. Thus, the separate trust deed balances cannot be added together to determine the total dollar amount of encumbrances on the property. The amount of the AITD is often the total of the amounts owed on *all* encumbrances.

For example, property encumbered by a $600,000 first mortgage is sold for $1,000,000 with a $300,000 down payment. An AITD is carried back for $700,000, the amount remaining unpaid on the purchase price. The buyer does not assume or otherwise agree to pay the first mortgage. Collectively, the amounts secured by the two trust deeds total $1,300,000, yet the amount required to clear title of both trust deeds is controlled by provisions in the AITD addendum and is only $700,000, the amount of the AITD. [See Form 442 and 443]

Conversely, a **regular** trust deed carried back as a second mortgage for the balance of the seller's equity (after the down payment) is in this case $100,000 with the buyer assuming the $600,000 first mortgage for an aggregate debt of $700,000.

AITD with multiple liens

The minimum dollar amount the seller is able to carry back on an AITD is the total amount of the underlying mortgages and liens encumbering the property for which the seller remains responsible. The AITD needs to be mathematically structured so that it has a remaining **principal balance** at all times equal to or greater than the remaining balances on the wrapped liens.

However, an AITD does not need to include all pre-existing mortgages and liens recorded against the property sold. The AITD may be a third mortgage which wraps only the second and not the first, or vice versa.

For example, consider a buyer who takes over payments on an existing mortgage which is not included in the AITD face amount with the seller remaining responsible for the wrapped lien. The wrapped lien may be a:

- tax lien;
- judgment lien; or

- mortgage with an interest rate unacceptable to the buyer.

When only one of two existing mortgages or liens is wrapped, the dollar amount of the AITD is for the remaining balance of the purchase price after deducting both:

- the down payment; and
- the remaining balance on the one mortgage assumed by the buyer.

The interest in an override

The seller's offering and use of an AITD makes financing for buyers during periods of high interest rates more attractive by offering a **below-market rate**, whether or not the rate on the underlying mortgage is below market.

For the seller, the interest rate on the AITD will ideally be equal to or exceed the rate on the underlying mortgage, although this is not always the case.

In this respect, the AITD's rate is said to **override** the rate on the underlying mortgage. The *override* is the difference between the interest rate on the underlying mortgage and the higher rate negotiated on the AITD.

For example, an AITD with an 8% interest rate which wraps a first mortgage at 5% gives the seller a 3% interest override on the underlying mortgage balance in excess of the interest on the first mortgage.

The override is the financial advantage available to the carryback seller when using an AITD. Use of the AITD greatly increases the yield on their equity in the AITD. [See Chapter 14 and 15]

Equity burn-off dilemma

Alternatively, if the interest rate on the underlying mortgage exceeds the interest rate on the AITD, the seller's equity in the AITD is said to **burn-off** bit by bit. Here, the seller's equity shrinks daily as interest accrues in dissimilar amounts on both the underlying and the carryback mortgages.

In addition to reducing the seller's equity in the AITD, this principal *burn-off* reduces the AITD balance faster than the balance on the underlying mortgage. In turn, this converts the cash received as principal payments on the AITD into interest paid on the wrapped mortgage.

To avoid having the balance on the AITD drop below the balance on the underlying mortgage, a due date on the AITD is set for payoff before the balance on the AITD sinks below the balance on the wrapped mortgage, a moment in time called a **crossover**.

Wrapping an adjustable rate mortgage

The seller wrapping an **adjustable rate mortgage (ARM)** with an AITD needs to conform the interest rate provisions in the AITD to the rate adjustment provisions in the underlying *ARM*. The same index, adjustment periods, floor and ceiling rates, and payment schedules need to be included in the AITD, making the AITD an ARM.

For example, consider an owner who decides to sell real estate encumbered with an ARM. The ARM has an interest rate which periodically resets in accordance with the **11th District cost-of-funds index (COFI)**, plus a **margin** of 2.5%. By using the same *index* with a *margin* equal to or greater than on the underlying ARM, the seller will receive sufficient interest to service the first mortgage without reducing the seller's return on the AITD ARM. This will result in no burn-off of the equity in the seller's AITD.

When the seller uses the same index for the AITD as the index used on the underlying ARM and negotiates a greater margin than exists on the wrapped ARM, the seller receives additional **overriding interest** on the portion of the AITD amount representing the balance on the underlying mortgage.

When a different index is used, the index for the carryback mortgage may fall while the index on the underlying mortgage rises, leaving the seller paying the difference for lack of a *pass-through arrangement* for the adjustments on the underlying mortgage.

Also, a seller can wrap a **fixed rate mortgage (FRM)** by carrying back an AITD ARM. The adjustable rate provision included in the all-inclusive note needs to set the life-of-mortgage *floor rate* at no less than the fixed rate on the underlying *FRM*. Thus, the seller prevents the interest rate on the AITD ARM from falling below the rate on the underlying FRM. [See Chapter 16]

Payments and contract collection

In a typical AITD transaction, the buyer makes installment payments on the AITD directly to a seller while the seller makes the scheduled payments owed to the underlying senior mortgage holder. The seller retains the difference as their net cash flow on the AITD.

The seller may enter into **contract collection** with a servicing agent to receive payments and make disbursements to the underlying mortgage holder. Collection and disbursement of the monthly payments called for in the AITD may be made under *contract collection* by:

- a bank;
- a credit union;
- an escrow company; or
- a broker. [See **RPI** Form 237]

Contract collection is convenient for the seller. However, if the seller and the buyer *mutually agree* that the seller will place the AITD on contract collection, the agreement will severely reduce the deferral of profit tax on the installment sale. The collection agent is deemed to be the agent of the buyer when agreed to by the buyer and the seller. When payments are made by the buyer's agent, the responsibility for payments on the underlying mortgage is attributed to the buyer.

Due to the shift in responsibility created by a mutually agreed to contract collection account, the seller has **debt relief**, increasing the profit-to-equity ratio on the installment sale and increasing the percentage of down payment and principal payments reported annually as profit.[1]

The buyer's monthly payments on the AITD may be in any negotiated amount. However, prudence suggests the payments will be no less than the amount the seller pays on the underlying mortgage, even if good reason exists for a lesser payment.

Also, the flexibility available with the AITD allows for payment schedules to be negotiated which are attractive to buyers.

Graduated monthly payments

Consider a business owner who is purchasing a commercial property to relocate their expanding business. The business owner anticipates reduced cash flow over the first two years at the new location due to:

- moving expenses,
- relocation costs, including permits and licensing;
- building improvement costs; and
- the need to reestablish goodwill.

The business owner anticipates that by the third year of operating at the new location, they will have recovered the costs of relocating their business and reestablished the goodwill necessary to regain their previous level of profitability.

Knowing the property is encumbered by a mortgage with a lower than market interest rate, the business owner offers to purchase the property subject to a seller carryback AITD with **graduated monthly payments**. As the business grows, the increased cash flow will allow the business owner to make larger payments in the future. Thus, lower initial payments make the purchase of the property affordable.

Graduated monthly payments allow buyers to make monthly payments which start out low, but gradually increase from year to year. For instance, a buyer who is unable to currently afford a fully amortized monthly AITD payment of $2,000 may offer to pay $1,400 monthly for the first year. With the mutual agreement of the buyer and seller, the monthly payments will increase $300 annually, until the full $2,000 amount needed to amortize the AITD is reached.

However, the low monthly payments may be insufficient to cover the accrual of a fixed rate of interest on the AITD. In this case, a provision may be included in the all-inclusive note calling for any accrued and unpaid interest to be added to the principal, called **compounding**.

1 **Goodman** v. **Commissioner of Internal Revenue** (1980) 74 TC 684

negative amortization
Occurs when monthly installment payments are insufficent to pay theinterest accruing on the principal balance, requiring the unpaid interest to be added to the principal.

Thus, until the buyer's monthly payments increase enough to cover the accruing interest, the principal amount of the all-inclusive note will increase, an accounting situation called **negative amortization**.

Rather than adding interest to the principal, a provision for an additional installment may be negotiated and added into the all-inclusive note calling for an additional payment on a future date of all accrued interest which remains unpaid. For an alternative to *negative amortization* under the fixed rate, a *graduated rate* of interest may be charged which is consistent with the graduated payment schedule.

Allowable prepayment penalties

Another tax consideration for carryback sellers is the use of a **prepayment penalty** provision to induce the buyer to pay no more than the amount of the scheduled monthly payments for an agreed-to period of years. Any early payoff of additional principal during the enforcement period will include a *prepayment penalty*.

A prepayment penalty, needs to be a sufficient amount to provide funds for the seller to cover the tax liability incurred on the premature termination of the installment sale due to an early payoff.

Payoff amounts vary from AITD to AITD

Two types of AITDs exist:

- an **equity payoff** AITD [See Form 442]; and
- a **full payoff** AITD. [See Form 443]

With an *equity payoff* AITD, reconveyance occurs when a seller's equity in the AITD — the principal amount of the AITD remaining after deducting the underlying mortgage balance — is fully paid.

Once the seller receives the payoff for the equity amount in their AITD and reconveys it, the buyer is left with the primarily responsibility for installment payments on the remaining mortgage. With the equity payoff AITD, the underlying mortgage is not paid off and remains of record with the reconveyed AITD no longer of record. In this situation, the buyer originally took title subject to the underlying mortgage.

However, when an equity payoff AITD is fully paid and reconveyed, a prudent seller will require the buyer to formally assume the underlying mortgage with the mortgage holder since the buyer becomes responsible for making its installment payments.

Full payoff AITDs require payment of the entire balance on the AITD — which includes amounts owed on the underlying mortgage — before reconveyance can occur. Thus, both the AITD and the underlying mortgage are fully satisfied and reconveyed on payoff of the AITD. The full payoff AITD is less financially flexible for the buyer when arranging for a payoff.

Tax-wise, the full payoff AITD is preferable for the seller. The full payoff AITD, without a contract collection provision, provides for no debt relief at any time during the life of the AITD. The buyer may never take over the responsibility for the underlying mortgage, even on final payoff and reconveyance of the AITD. Thus, the full payoff AITD allows the seller to use the installment sales method of income tax reporting without the issue of debt relief ever arising. [See Chapter 26]

Due dates and final/ balloon payments

The due date for an AITD can be set at any length of time, ranging from the first of the next calendar year to 15 years or more.

However, the due date of the AITD needs to fall on or before:

- the due date of the underlying mortgage; or
- a crossover in principal balances occurs due to differing interest rates and amortization schedules.

For example, if an underlying mortgage is due in three years and the AITD is due in five, the seller will be required to pay off the underlying mortgage holder before they are due to be paid off on the AITD.

In this scenario, the seller may negotiation to pass the payoff burden to the buyer by including a special additional installment on the AITD. The payment needs to be sufficient in time and amount to meet the final/balloon payment on the underlying mortgage. The alternative is to set the due date on the AITD to no later than the date of the final/balloon payment on the underlying mortgage.

When an amortization schedule reduces the AITD balance to an amount equal to the wrapped mortgage, it requires a due date on or before the date by which both notes will have the same remaining principal balance, before the crossover. Thus, the seller avoids liability for a reduction in the AITD balance below the amount of the wrapped mortgage.

pass-through provisions
An all-inclusive trust deed (AITD) provision used by a carryback seller which provides for the payment of any demands made by the underlying mortgage holder, other than regular principal and interest payments, to be passed through to the buyer when triggered by the buyer's conduct. [See **RPI** Form 442 and 443]

Pass-through provision protection

An AITD also contains **pass-through provisions** to cover charges demanded by the underlying mortgage holder. [See Form 442 §5 and 443 §6]

For instance, the buyer may wish to refinance and pay off the AITD and the underlying mortgage before they become due. With a *pass-through provision* in the AITD addendum, the buyer, not the seller, will fund any prepayment penalty the underlying mortgage holder is entitled to for an early payoff, even though the seller is primarily responsible for paying principal and interest on the underlying debt.

Also, the payment of the any demands made by the underlying mortgage holder is passed through to the buyer when brought about by the buyer's conduct.

Demands may include payment of:

- any late charges;
- future advances; or
- the entire mortgage balance.

Due-on interference hazards

When a mortgage contains a due-on clause, the mortgage holder may call the mortgage due on the transfer of almost any interest in the property. The call that results in the note being fully due and payable is referred to as an acceleration of the note balance. [See Chapter 11]

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

The **due-on clause,** also called an **alienation clause**, in a mortgage is triggered by:

- any conveyance of ownership, including land sales contracts;
- origination (except *home equity lines of credit (HELOCs)*) or foreclosure of junior mortgages on the property; or
- the creation of a lease for more than three years; or
- a lease of any period coupled with an option to purchase the property.[2] [See Chapter 11]

The carryback AITD transaction involves both a sale (the grant deed) and a further encumbrance (the trust deed).

Thus, an AITD transaction triggers the due-on clause in any mortgage encumbering the property sold. Once triggered, the mortgage holder may:

- call or recast the mortgage, unless they have given written consent to the sale, called **waiver by consent**; or
- waive their right to call the mortgage by failing to timely act after notice of the transaction, called **waiver by conduct**.

When current market interest rates are high or rising, a time when the AITD is most beneficial to both the buyer and seller, the senior mortgage holder is likely to call the underlying mortgage due upon a sale. Alternatively, the mortgage holder may demand the mortgage be recast at current market rates (including modified payments to retain the same amortization period and fees for doing so), or they may do nothing at all.

Buyer is held harmless

Consider an AITD buyer who takes title to the property **subject to** the underlying mortgage. The buyer does not assume the seller's obligation to pay the mortgage at the time of the sale, nor is mortgage holder consent to the carryback sale sought or obtained by the seller.

Under the terms of the AITD, the seller agrees to hold the buyer harmless from all obligations which exist on the underlying mortgage. [See Form 442 §1 and Form 443 §1]

2 12 Code of Federal Regulations §591.2(b)

Thus, the buyer is **held harmless** (by the seller) against any activities of the underlying mortgage holder, unless:

- the buyer interferes by triggering the due-on clause through further encumbrance (long-term lease, resale, waste, etc.); or
- a pass-through provision in the AITD shifts the due-on-sale burden to the buyer, as it does to late charges, prepayment penalties or future advances.

Payments made as payments received

The primary duty of a seller carrying back an AITD is to make the payments on the underlying mortgage as they become due, as long as the AITD remains of record and the buyer is not in default.

If a buyer fails to make payments on the AITD, the seller is under no legal obligation to:

- forward their own funds to the underlying mortgage holder; or
- protect the property from a foreclosure under the senior mortgage.

Even without the obligation to keep the senior mortgage current when the buyer defaults, the seller may feel compelled to advance funds to keep the underlying mortgage current. If they do not, the seller risks allowing their AITD to be wiped out by the underlying mortgage holder's foreclosure.

If the underlying mortgage holder calls the mortgage based on the AITD transaction, the seller may be forced to use their own funds or borrow against other assets (or collateralize the AITD) to pay off the senior mortgage holder. Thus, the AITD seller needs to have an agreement with the buyer to cooperate with the seller if the senior mortgage is called due and it becomes necessary for the buyer to sign documents to refinance the property to fund the payoff.

If possible, prior arrangements need to be made by the seller, not the buyer, with senior mortgage holders to prevent due-on enforcement during the term of the AITD, known as a **reverse assumption**.

AITD documentation

The AITD transaction is best documented:

- between a buyer and seller in a purchase agreement, escrow instructions, grant deed, trust deed with all-inclusive addendum, and all-inclusive note;
- between a seller and the underlying mortgage holder in a written due-on waiver with any modification of the underlying note agreed-to with the mortgage holder for consent; and
- through escrow, by the buyer depositing the down payment funds and the AITD, and the seller depositing their grant deed.

Agents involved in any carryback transaction need to make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum.

Further, a **carryback disclosure statement** with statutorily mandated content is to be used on carryback sales of one-to-four unit residential property and, as good practice, on the carryback sale of all other types of property. [See Form 300 in Chapter 3]

Buyer NODq protection

A buyer and the buyer's agent need to confirm the terms of the AITD are consistent with the underlying senior mortgage it wraps. However, if the AITD is a consumer mortgage, the terms of the AITD need to comply with federal mortgage law, regardless of the underlying mortgage's terms.

beneficiary statement
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage assumed by a buyer. [See **RPI** Form 415]

To assure consistency, escrow needs to be instructed to order a **beneficiary statement** from the existing mortgage holder. A mortgage holder's *beneficiary statement* confirms the terms of the underlying mortgage are as represented by the seller. The statement enables the buyer to confirm the consistency of the terms in the underlying mortgage and the AITD. [See **RPI** Form 415]

The buyer also needs to request that the seller record and serve the underlying mortgage holders with a **Request for Notice of Default (NOD) and Notice of Delinquency (NODq)** on any underlying mortgages. [See Form 412 in Chapter 5]

The request for an *NODq* assures the buyer they will promptly learn of any failure by the carryback seller to make payments to senior mortgage holders.[3]

The risks in a blanket encumbrance

Finally, a buyer and their agent need to review the **preliminary title report** to determine if the underlying mortgage is a **blanket mortgage** which also affects property other than the property in question.

AITDs are sometimes used by undercapitalized developers and land sales promoters to finance the sale of undeveloped land which has been cut out of larger parcels. The larger subdivided parcel may be encumbered by a blanket trust deed which lacks a partial release clause.

For their purpose, developers and promoters use AITDs which only disclose that "underlying mortgages may or may not exist."

blanket mortgage
A mortgage which is secured by two or more parcels of real property. [See **RPI** Form 450]

Typically, in these cases of *blanket mortgage*, no disclosure is made of the amount or terms of the underlying mortgage, nor of the existence of the blanket mortgage on the **parcel in question with other parcels**.

If the seller defaults on a blanket mortgage which lacks a partial release clause, the buyer of a parcel of real estate on an AITD will have to pay off or refinance the entire blanket mortgage to protect themselves. Paying off or refinancing the entire blanket mortgage is economically unlikely when, as in most cases, the underlying mortgage balance exceeds the AITD balance, and the price paid for the individual lot.[4]

3 Calif. Civil Code §§2924b, 2924e

4 **Drake** v. **Martin** (1994) 30 CA4th 984

Chapter 13 Summary

The all-inclusive trust deed (AITD) and note provides agents, sellers and buyers with the flexibility needed to finance the balance of a sales price remaining to be paid after a down payment during periods of tightened availability of mortgage funds.

The advantages of an AITD over a regular second mortgage are primarily in favor of the seller. However, the AITD provides more simplicity and flexibility than conventional or government insured mortgages as a benefit to the buyer.

The down payment in an AITD transaction is handled no differently than on any other method of carryback or conventional financing. The smaller the down payment, the greater the risk of loss for the seller if the buyer defaults on the mortgage and the property is foreclosed on.

The distinguishing characteristic of the all-inclusive note is its face amount. The amount of the all-inclusive note wraps around and is inclusive of the underlying mortgage balance. In a typical AITD transaction, the buyer makes installment payments on the AITD directly to a seller while the seller makes the scheduled payments owed to the underlying senior mortgage holder.

The seller may enter into contract collection with a servicing agent to receive payments and make disbursements to the underlying mortgage holder.

Two types of AITDs exist. An equity payoff AITD is reconveyed when a seller's equity in the AITD is fully paid. Full payoff AITDs require payment of the entire balance on the AITD, which includes amounts owed on the underlying mortgage, before reconveyance can occur. Tax-wise, the full payoff AITD is preferable for the seller.

An AITD also contains pass-through provisions to cover charges demanded by the underlying mortgage holder which are passed through to the buyer when brought about by the buyer's conduct.

Agents involved in any carryback transaction need to make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum, and a carryback disclosure statement with statutorily mandated content.

The buyer also needs to request that the seller record and serve the underlying mortgage holders with a Request for Notice of Default (NOD) and Notice of Delinquency (NODq) on any underlying mortgages. The request for an NODq assures the buyer they will promptly learn of any failure by the carryback seller to make payments to senior mortgage holders.

Chapter 13 Key Terms

Chapter 14

The AITD's leverage yield

Learning Objectives

After reading this chapter, you will be able to:

- evaluate the annual yield a seller receives on their equity in an all-inclusive trust deed (AITD);
- address due date aspects of a reverse AITD; and
- compare alternative AITD financing to better attract buyers.

Key Terms

all-inclusive trust deed (AITD) note

balloon payment

compounding

effective yield

graduated payment mortgage

leveraging

negative amortization

Modifying provisions in a note

Consider a property encumbered by an existing mortgage which has:

- a balance of $600,000;
- a 7% fixed interest rate; and
- a monthly payment schedule which will fully amortized in 26 years.

The property owner wants to sell their property and cash out their equity without reducing their sales price below $1,000,000.

However, a recent inflationary economy and over-active, speculative asset markets have brought on a Federal Reserve (Fed)-induced corrective *credit crunch*, restricting the availability of money in the markets. Thus, monetary policy has made it difficult for buyers with modest down payments and less than perfect credit to obtain financing from conventional lenders.

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

Facing a decline in sales volume, the owner lists the property for sale for $1,000,000. To support their asking price, the seller offers to carry back a mortgage from a buyer with a 20% down payment for the **balance of the purchase price**, called an **all-inclusive trust deed (AITD)**.

Here, the *AITD* will "wrap" the existing $600,000 **underlying mortgage** encumbering the seller's property. Specifically, the principal amount of the all-inclusive note will include the $600,000 principal balance on the *underlying mortgage*.

The seller, after deducting the 20% down payment from the price of $1,000,000, carries back an AITD for $800,000 bearing an 8% interest rate with monthly payments amortized over 30 years, all due in seven years. The **seller's equity** in the AITD is the difference between the $800,000 all-inclusive note and the $600,000 balance on the underlying mortgage — a $200,000 equity in the AITD at the time of closing.

Observe that the seller receives 8% interest on the entire amount of the $800,000 AITD. In turn, the seller continues to pay the underlying mortgage holder 7% interest on the $600,000 wrapped mortgage.

The AITD interest override

At a time when interest rates for mortgages are higher than prevailing rates charged during the prior 18 to 24 months, a carryback seller may offer a below-market rate on an AITD and yield a greater return on their equity in the AITD than rates currently charged by lenders.

The spread between the interest rate on the underlying mortgage and the interest rate on the AITD is called an **overriding interest rate**. The seller's all-inclusive note in the example above has an interest rate *override* on the underlying mortgage of 1% (8% AITD rate minus 7% underlying mortgage rate).

effective yield
The actual rate of interest received by the mortgage holder as a result of leveraging, discounts and bonuses, distinct from the interest rate charged on the mortgage, also known as the effective rate of return.

The spread in the override accrues to the benefit of the seller. The interest rate override raises the **effective yield**, also known as **the effective rate of return**, on the seller's equity in the AITD above the all-inclusive note rate. This feature is the result of **leveraging** (the ratio of the underlying mortgage balance to the AITD equity; three to one).

leveraging
A double-edged sword of possible greater returns or potential total loss. In real estate, leveraging is the concept that a lien either increases the owner's risk they will lose the property (and their investment) to foreclose or increases the return on their investment.

However, this *leveraging* ability is often hindered by the seller's need for the underlying mortgage holder's consent under any due-on clause in the wrapped mortgage.

For the carryback seller, the AITD with its interest override may be compared to a private lender borrowing money from a bank at one rate (the rate on the underlying mortgage) and lending the funds to buyers of real estate at a higher rate (the rate on the AITD), as institutional lenders do.

In our example above, the seller receives annual interest on their AITD of about $64,000 (8% of $800,000). In turn, the seller pays the underlying mortgage holder about $42,000 in interest (7% of $600,000). Thus, the seller's net annual interest income equals $22,000 during the first 12 months.

The $22,000 net interest income is the seller's annual interest income earned on their $200,000 AITD equity, resulting in an 11% **effective yield.**

The AITD equity allows the seller to receive a greater return than the actual all-inclusive note rate – the *effective yield.*

Editor's note — The equity leverage on the 1% override on the existing debt is 600,000:200,000, or 3:1. Hence, the 1% override becomes an additional 3% yield on the equity in the AITD — a yield added to the 8% AITD rate on the $200,000 equity in the AITD. Thus, the effective yield on the $200,000 equity in the AITD is 11% (3% plus 8%).

The effective yield

The effective yield on a seller's equity in an AITD is calculated using:

- the *principal amount* of the underlying mortgage;
- the *equity amount* in the AITD; and
- the *interest rate spread* between the two mortgages.

To determine the effective yield, the following mathematical formula is used.

First, start with the amount of the underlying mortgage balance.

1. underlying mortgage balance = $600,000

Next, divide (÷) the amount of the underlying mortgage balance by the equity in the AITD.

2. $600,000 ÷ $200,000 = 3

Next, multiply (x) the result by the interest rate override between the underlying mortgage and the AITD.

3. 3 x 1% = 3%

Last, add (+) the AITD interest rate to this amount.

4. 3% + 8% = **11%**

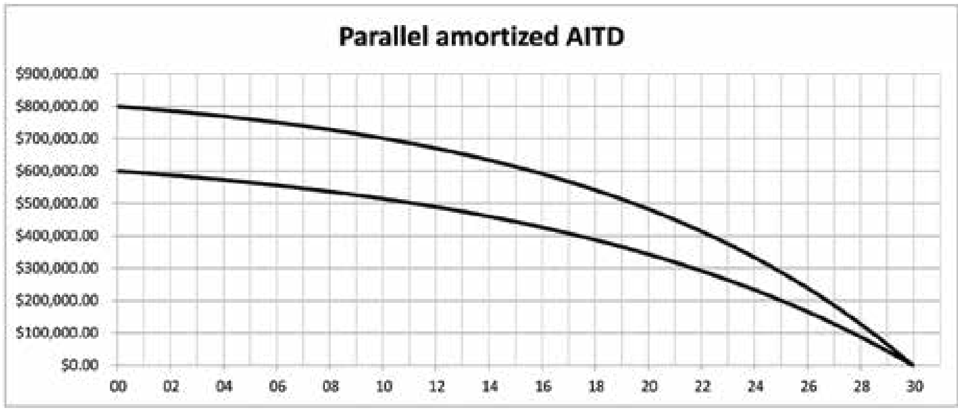
This equals the effective yield on the seller's AITD equity.

The $800,000 AITD carried back at an interest rate of 8% gives the seller the same effective yield as though the buyer had assumed the underlying mortgage and executed a separate seller carryback mortgage for $200,000 at 11%.

However, the AITD gives the seller a great *psychological advantage* over the typical buyer. With an AITD, the buyer may boast about the lucrative financing they negotiated with the seller. Under this arrangement, the buyer has obtained maximum financing and pays 8% interest, with no points or garbage fees.

Figure 1

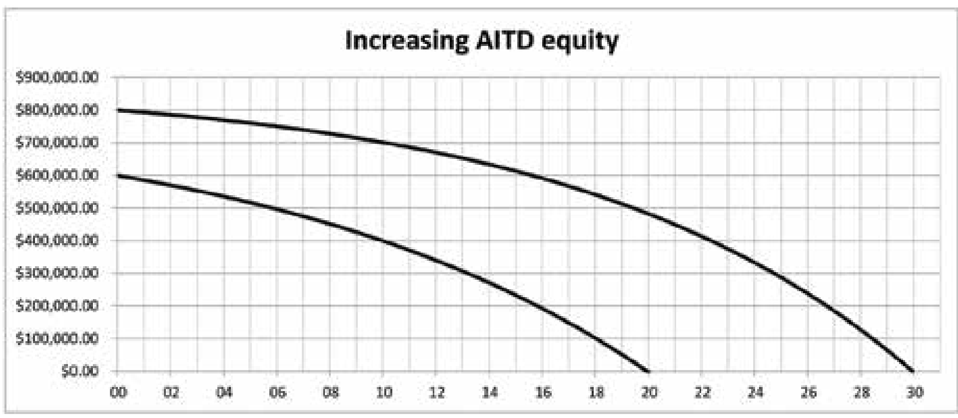
Parallel amortized AITD



An $800,000 AITD and a $600,000 underlying mortgage are both amortized over 30 years. The result is an AITD equity which gradually increases as a percentage of the total AITD throughout the term of the AITD. For example, by year 23, the AITD principal balance is $376,600 and the underlying mortgage balance is $264,500. Thus, the AITD equity has increased from 25% to 30% ($112,100 ÷ $376,600) of the remaining AITD balance. However, the equity leverage has declined to 2.4% ($264,500 ÷ $112,100) reducing the effective yield to 10.4% (8% + 2.4%).

Figure 2

Increasing AITD equity

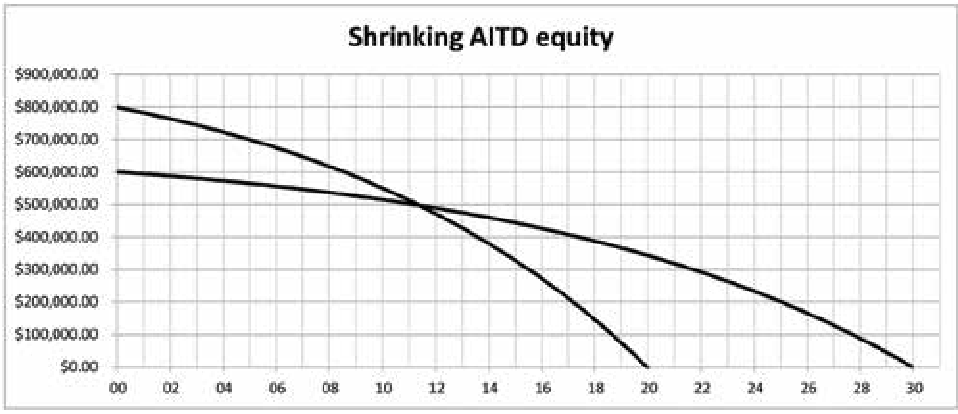


An $800,000 AITD amortized over 30 years wraps a $600,000 underlying mortgage amortized over 20 years. As a result, the AITD equity increased from 25% to 80% of the AITD principal balance by year 18. Thus, by year 20, the underlying mortgage is paid off, reducing the seller's effective yield on the AITD equity from the original 11% to 8%.

Conversely, if the buyer executed a separate carryback mortgage for $200,000 at 11% interest, they have nothing to brag about, even though they have taken over the first mortgage at 7% and will be paying the same overall amount of annual interest on the two encumbrances as on the AITD at 8% interest.

Conflicting amortization periods

The calculation for the effective yield on an overriding AITD sets the yield at the time of sale. However, the effective yield on the AITD will vary following each payment throughout the life of the AITD.



An $800,000 AITD amortized over 20 years wraps a $600,000 underlying mortgage amortized over 30 years. Since the AITD equity is shrinking, the seller needs to require a payoff of the AITD before year 12. By then, the AITD and the underlying mortgage balances will have crossed over causing the AITD to have a negative equity which is to be avoided.

Figure 3

Shrinking AITD equity

When the amortization periods for both the AITD and the underlying mortgage are the same, the amount of equity in the AITD *decreases gradually* until the principal on the AITD and the underlying mortgage is fully paid at the same time. However, the AITD equity as a percentage of the total AITD balance *actually increases slightly* throughout the term of the AITD.

With the amortization periods being the same on both mortgages, the effective yield also *decreases gradually* over the life of the AITD since the ratio of the AITD equity to the balance remaining on the underlying mortgage decreases. [See Figure 1]

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

When the underlying mortgage amortizes over a *shorter period of time* than the AITD, the AITD equity *increases more dramatically* from month to month while its effective yield *decreases*. Earlier principal payoff on the underlying mortgage decreases the AITD leverage. This causes the seller's equity in the remaining balance on the AITD to increase while the effective yield decreases until the underlying mortgage is fully paid. [See Figure 2]

Shrinking equity in the AITD

When the underlying mortgage is amortized over a *longer period of time* than the amortization period for the AITD, the equity in the AITD decreases while the effective yield increases. Thus, the seller's equity in the AITD decreases from month to month, until *no equity remains* in the AITD. Consequently, the increasing leverage causes the effective yield on the seller's equity in the AITD to increase from month to month, until there is a **cross-over** in the mortgage balances. [See Figure 3]

Accordingly, the all-inclusive note which produces a **shrinking AITD equity** needs to include a due date for a **final/balloon payment** when the AITD will be fully satisfied and reconveyed. The *final/balloon payment* needs to occur prior to the cross-over of mortgage balances. If not, the seller is **contractually liable** for the amount of the underlying mortgage which exceeds the balance of the AITD when the AITD is eventually satisfied. [See Figure 3]

Yield when wrapping two debts

Occasionally, a seller's property is encumbered by more than one mortgage. Two or more mortgages may be wrapped by an AITD, with their principal balances included in the amount of the AITD. Thus, a buyer only makes one payment each month, which is paid to the seller. In turn, the seller makes two payments, one to the holder of each of the wrapped mortgages.

When wrapping two or more mortgages, the effective yield on the AITD equity is calculated by dividing the dollar amount of the AITD equity into the seller's **net annual interest income**. The seller's *net annual interest income* is the total of the interest earned on the AITD minus all interest expenses incurred on the wrapped mortgages.

For example, a seller carries back an AITD which wraps two mortgages totaling $750,000:

- a first mortgage for $600,000 at 9% interest; and
- a second mortgage for $150,000 at 10.5% interest.

The seller carries a $1,000,000 AITD at 12%.

The equity in the AITD is $250,000 ($1,000,000 AITD minus the $750,000 due on the two wrapped mortgages).

The net interest income the seller receives is the difference between the $120,000 interest received on the AITD ($1,000,000 x 12%), and the $69,750 interest expense paid on the underlying first and second mortgages ($600,000 x 9% plus $150,000 x 10.5 %).

Thus, the seller's net annual interest income at the time of the AITD's creation is $50,250. The effective yield on the seller's equity in the AITD is calculated as the net interest income divided by the dollar amount of the equity in the AITD.

Thus, the effective yield on the AITD is: $50,250 ÷ $250,000 = **20%.**

The reverse AITD when interest rates are too high

The interest rate on an AITD is usually negotiated at a rate higher than the rate on the underlying mortgage, called an **override rate** or **spread.**

However, sellers occasionally have the incentive to carry back an AITD with a lower interest rate than the rate on the underlying mortgage, called a **reverse rate of return** or **negative spread**.

To motivate buyers to pay the price sought by the seller for a mortgaged property during a depressed seller's market with limited availably to mortgage financing, the seller may offer financing at a **lower-than-market interest rate** through the use of an AITD.

For example, consider a property offered for sale which is encumbered with an $800,000 mortgage bearing interest at the current market rate of 9%. The mortgage is payable monthly, amortized over the next 26 years.

To attract buyers and cash out their $200,000 equity in the property, the seller will carryback an AITD at an interest rate of 6%, a sort of **teaser rate** used to attract prospective buyers. The AITD rate, being lower than the rate on the underlying mortgage – a *negative spread* – has the opposite mathematical effect from an overriding rate. Thus, dollar for dollar, the seller incurs monthly interest expenses in excess of the interest income on the principal in the AITD, a negative annual rate of 3%.

To accommodate the 3% negative spread, the price for the property is increased to $1,150,000, approximately 15% above its current cash market value (determined as five years x 3% reverse spread). The down payment will remain the same at $200,000. The 15% increase in the purchase price will be reflected in the AITD amount at $950,000. Thus, the AITD equity at origination will be $150,000, equivalent to five years interest on the existing mortgage.

This add-on amount will cover the 3% reverse interest rate charged by the seller until the AITD is due – in five years. The all-inclusive note will contain a five-year due date so the seller avoids incurring a *negative equity* in the AITD.

Lower-than-market interest rate

To continue our previous example, the price paid by a buyer is adjusted upward to offset the seller's cost of financing the sale by extending credit at a *lower-than-market interest rate*. Financially, what occurs is a one-time "buy down" of the interest rate for the five-year life of the AITD, paid for by the increased price.

Of course, the buyer will pay the exact same amount of dollars for financing and acquisition costs by the end of their first five years of ownership, including payoff amounts, as they would have paid had they assumed the underlying 9% mortgage and paid $1,000,000 for the property with a $200,000 down payment.

At the end of five years, the final/balloon payment on the AITD will be the same amount as the balance on the wrapped mortgage.

Here, the entire AITD equity *burns off* gradually, decreasing monthly to zero by the end of the five-year period.

Since a default on the final/balloon payment due in five years is foreseeable, the AITD with a negative interest rate spread needs to include a **default interest rate** of at least the rate on the underlying mortgage (9% in our example). [See **RPI** Form 418-1]

During periods of economic recession or stagnant market conditions, new conventional financing is not available at interest rates which support past property values and seller *sticky price* expectations. Without lender help to finance the purchase of real estate, a seller seeking to successfully entice buyers to purchase their property needs to either accept a reduced purchase price or carry back financing at a lower-than-market interest rate.

Carryback financing facilitates a sale by supporting the seller's elevated price with a lower interest rate and an accommodating payment schedule which are readily acceptable by buyers.

The graduated payment AITD

To attract more creditworthy buyers, the seller may agree to a **graduated payment** schedule over a two- or three-year period to reduce the carrying costs of ownership and better qualify the property for acquisition by a buyer.

For example, consider a seller whose monthly payment on their existing mortgage is $6,500. To reduce a perspective buyer's initial costs of ownership, the seller carries back an AITD calling for the same ($6,500) monthly payment for the first year, sufficient in amount to cover the seller's payments due on the underlying mortgage.

The payments will rise on the AITD each year until a payment schedule is reached which will amortize the balance over the desired remaining number of years.

negative amortization
Occurs when monthly installment payments are insuffcient to pay the interest accruing on the principal balance, requiring the unpaid interest to be added to the principal.

The seller does not need to periodically adjust the rate of interest on the AITD. However, during the first year(s) of payments, they will be accepting a payment in an amount which will not cover the interest accruing each month, a situation called **negative amortization**.

compounding
The adding of accrued and unpaid interest to principal which thereafter accrues interest as principal at the note rate.

Here, the accrued and unpaid monthly interest on the AITD may be added by agreement to the AITD's principal balance each month. The unpaid interest will then earn interest as principal, called **compounding**.

A seller may consider offering an AITD with an annually escalating rate of interest and payment schedule to attract buyers instead of a fixed rate of interest coupled with *negative amortization*.

Being comparable to the 2-1 buy-down programs used by builders and other informed sellers, the terms of a graduated AITD for the first three years reduces the present cash value of the AITD by about 5% of its principal balance, a cost which is passed on to the buyer through a higher-than-market sales price.

Again, the seller carryback financing facilitates the sale and supports the price sought by the seller. Without carryback financing during periods of restricted access to purchase-assist financing and reduced buyer purchasing power, either the price for the property is reduced or the property will not sell.

Start low, then adjust upward

A seller may agree to a reduced interest rate on the AITD during the first few years after the sale. For example, the AITD interest may start at a low initial (teaser) rate and be adjusted upward periodically, annually or semiannually, by one-half or one percent until a fixed rate for the remainder of the AITD term is reached.

Payments start low and adjust upward to maintain the original amortization period, called a **graduated payment mortgage**.

graduated payment mortgage
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

The *graduated AITD* allows property to be sold without the seller lowering the asking price. For example, a seller wants an interest rate of 6% on their carryback AITD due in seven years.

For the seller to maintain their sales price and accommodate the buyer, they agree to a 4% interest rate during the first year after the sale with monthly payments amortized over 30 years.

Further, on each anniversary of the AITD, the interest rate is increased by 0.5% until the AITD interest rate is 6%. Thus, the interest rate on the AITD is:

- 4% in the first year;
- 4.5% in the second year;
- 5% in the third year;
- 5.5% in the fourth year; and
- 6% in the fifth year, fixed for the remaining life of the AITD.

The amount of the AITD payments graduate annually, re-amortized over the remaining life of the AITD on each interest rate adjustment. Thus, negative amortization, with its build up of principal, is avoided by all.

Chapter 14 Summary

At a time of rising interest rates for mortgages, a carryback seller may offer a below-market rate on an all-inclusive trust deed (AITD) and yield a greater return on their equity in the AITD than rates currently charged by lenders.

The spread between the interest rate on the underlying mortgage and the AITD is called an overriding interest rate. The interest rate override raises the effective yield on the seller's equity in the AITD above the all-inclusive note rate.

The AITD equity allows the seller to receive a greater return than the actual all-inclusive note rate, known as the effective yield. The calculation for the effective yield on an overriding AITD sets the yield at the time of sale.

When a seller's property is encumbered by more than one mortgage, two or more mortgages may be wrapped by an AITD, with their principal balances included in the amount of the AITD.

The interest rate on an AITD is usually negotiated at a rate higher than the rate on the underlying mortgage. However, sellers occasionally have the incentive to carry back an AITD with a lower interest rate than the rate on the underlying mortgage, called a reverse rate of return or negative spread.

To motivate buyers to pay the price sought by the seller for a mortgaged property during a depressed seller's market, the seller may offer financing at a lower-than-market interest rate through the use of an AITD. The price paid by a buyer is adjusted upward to offset the seller's cost of financing the sale at a lower-than-market interest rate.

To attract more creditworthy buyers, the seller may agree to a graduated payment schedule over a two- or three-year period to reduce the carrying costs of ownership. Here, the accrued and unpaid monthly interest on the AITD may be added by agreement to the AITD's principal balance each month, called compounding. However, during the first year(s) of payments, they will be accepting a payment in an amount which will not cover the interest accruing each month, called negative amortization.

Chapter 14 Key Terms

Chapter 15

The all-inclusive note and trust deed rider

Learning Objectives

After reading this chapter, you will be able to:

- prepare an all-inclusive note;
- anticipate the existing mortgage holder's demand to recast their note; and
- understand the relationship between the all-inclusive note and the two addenda which convert a regular trust deed to an all-inclusive trust deed (AITD).

Key Terms

all-inclusive trust deed (AITD) note	**call**
	due-on clause

Negotiating interest rates and payments

A **note** in an **all-inclusive trust deed (AITD)** transaction, also called an **all-inclusive note** or **wraparound note**, is evidence of an **installment debt** extended by the seller to the buyer for the balance due on the purchase price after the buyer makes a down payment. In turn, the seller remains responsible for payment to the holder of the underlying mortgage encumbering the property sold.

The interest rate charged by the seller carrying back an *AITD* with a five- to ten-year due date is usually comparable to rates available on new mortgage financing.

Conversely, the interest rate charged on carryback notes with due dates exceeding five to ten years usually exceeds market rates for new mortgages. However, rates charged by carryback sellers vary greatly with the needs and expectations of the seller and the buyer.

Also, sellers rarely seek points or origination fees as compensation for providing the buyer with AITD financing. Instead, the seller is generally motivated by the interest rate override on the wrapped mortgage.

Waiver of due-on clause

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

The AITD carryback seller agreeing to wrap a first mortgage containing a **due-on clause** needs to, during negotiations, anticipate the mortgage holder's demand to recast their note by increasing the interest rate, payment amounts or due date.

Prior to closing the carryback sale, the seller needs to request the existing mortgage holder waive their right to **call** the mortgage on the sale and carryback of the AITD, called a **reverse assumption**.

In exchange for the mortgage holder's written waiver of the *due-on clause*, the seller agrees to:

- a modification of the note; and
- the payment of a fee. [See Form 410 in Chapter 12]

Thus, instead of the buyer assuming the first mortgage, the carryback seller remains responsible for payment of the underlying mortgage.

Provisions of the all-inclusive note

The *all-inclusive note* is used with either the **equity payoff** or **full payoff** varieties of AITD addenda attached to a regular trust deed.

*Editor's note — The **All-Inclusive Promissory Note**, published by **RPI (Realty Publications, Inc.)** Form 421, is not created for use without major modification when wrapping an adjustable rate mortgage (ARM). [See **RPI** Form 433; see Chapter 16]*

When the underlying mortgage is an ARM, the seller needs to ensure the AITD is adjusted concurrent with adjustments in the underlying ARM to avoid a negative cash flow.

Preparing the all-inclusive note

The following instructions are for the use and preparation of an all-inclusive note, **RPI** Form 421. Form 421 consists of provisions from a regular interest-included installment note modified with additional provisions which disclose:

- that the amount of the all-inclusive note includes the principal balance on one or more underlying mortgages; and

- the payment on the underlying mortgages remains the responsibility of the carryback seller. [See Form 421 §3.1 and 3.2 accompanying this chapter]

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — You are to **check** and **enter** items throughout the form in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Identification and preparation of the all-inclusive note

Enter the dollar amount of the all-inclusive note, the date the note is prepared and the name of the city where the note is prepared. This information is used when referencing this note and is to conform to the dollar amount, date and location entered on the trust deed used to secure the debt evidenced by the note.

1. *Promise to pay*: **States** the payor's promise to pay the debt on the terms and provisions contained in the note.

 1.1 *Payee*: **Enter** the name of the person who is to receive the payments, typically the carryback seller, their assignee or an Internal revenue Code (IRC) §1031 buyer's trustee. The AITD identifies the payee as the **beneficiary.**

 1.2 *Place of payment*: **Enter** the city where payments are to be delivered to the payee.

 1.3 *Debt amount*: **Enter** the amount of the principal to be paid on the note.

Editor's note — The principal amount is the same as in the document identification section above, unless escrow is instructed to enter a different debt amount on closing due to adjustments in price or down payment.

 1.4 Interest accrual date: Enter the date interest begins to accrue, usually the date escrow closes.

Editor's note — The closing date of escrow is usually uncertain until it occurs. Thus, the space for commencement of accrual is left blank when the note is prepared. Escrow is instructed to enter the closing date when it is known.

 1.5 *Interest rate*: **Enter** the interest rate negotiated and agreed to in the purchase agreement.

*Editor's note — The all-inclusive note is not formulated for adjustable interest rates. Use **RPI** Form 433 and add AITD provisions noted in the instructions for its use.*

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

Installment payments

2. *Installment payments*: **Enter** the dollar amount to be paid as scheduled installments. If scheduled installments change during the life of the note, also **enter** an asterisk here and at section 5 and, following the asterisk at Section 5, **enter** the dollar amount of each change and the date the change will begin.

   2.1 *Payment schedule*: **Enter** the day and **check** the box of the frequency of the periodic payment.

   2.2 *First payment date*: **Enter** the due date (day and month) for the first payment, typically agreed to as 30 days after the commencement of interest, or the first day of the month first following 30 days after the close of escrow in which case escrow credits the seller with interest which will accrue through the end of the month of closing.

Editor's note — A payment is delinquent after the due date, unless a grace period, by statute or by special provision included in the note, extends the date on which payments may be delivered to the holder before becoming delinquent.

   2.3 *Date of final installment*: **Enter** the words "paid" following "continuing until" if the all-inclusive note is to be fully amortized by constant monthly payments, or the date when any remaining balance is due. If the due date is on an anniversary of the close of escrow, such as five years after close of escrow, **instruct** escrow to enter this date on closing.

   2.4 *Form of payment*: **States** principal and interest payments are to be paid in United States dollars.

   2.5 *Interest accrual*: **States** the installment payments are credited first toward interest accrued and then the remainder to principal.

AITD provisions

3. *AITD provisions*: **Provides** that the dollar amount of the existing debt encumbering the property is included in the amount of principal of the all-inclusive note.

   3.1 *First underlying encumbrance*: **Enter** the dollar amount of the principal balance on the first mortgage as of the close of escrow, **enter** the name of the current mortgage holder (beneficiary), and **enter** the original dollar amount of the first mortgage. It is good practice to order a beneficiary statement to disclose this information. [See **RPI** Form 415]

   3.2 *Second underlying encumbrance*: **Enter** the dollar amount of the principal balance on the second mortgage as of the close of escrow, **enter** the name of the current mortgage holder, and **enter** the original dollar amount of the second mortgage. A beneficiary statement is the primary source for disclosure of this information. [See **RPI** Form 415]

ALL-INCLUSIVE PROMISSORY NOTE SECURED BY DEED OF TRUST
Installment — Interest Included

Prepared by: Agent ______________________ **Phone** ______________________
Broker ______________________ **Email** ______________________

NOTE: This form is used by a transaction agent or escrow officer when a seller carries back a note which includes the principal remaining on an existing mortgage, to evidence the debt owed the seller on terms calling for installment payments of principal and interest with the carryback seller remaining responsible for payments on the existing mortgage. [See **RPI** Form 442 and 443]

$____________, dated ____________, 20____, at ______________________________, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to
- 1.1 ______________________________, as the Payee, or order,
- 1.2 at ______________________________,
- 1.3 the sum of ______________________________ DOLLARS,
- 1.4 with interest from ____________, 20____, on unpaid principal
- 1.5 at the rate of ______% per annum.

2. Principal and interest payable in installments of ______________________ DOLLARS, or more,
- 2.1 on the __________ day of every □ month, □ quarter, □ year,
- 2.2 beginning on the __________ day of __________, 20____,
- 2.3 and continuing until ____________, 20____, when the principal is due and payable.
- 2.4 Principal and interest payable in lawful money of the United States.
- 2.5 Each payment is to be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:
- 3.1 The present unpaid balance of $__________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ______________________________, in the original amount of $____________, which debt remains the obligation of Payee.
- 3.2 The present unpaid balance of $__________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ______________________________, in the original amount of $____________, which debt remains the obligation of Payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. ____

6. In any action to enforce this Note, the prevailing party will receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

8. □ See attached Signature Page Addendum. [**RPI** Form 251]

Payor's Name: ____________________	Payor's Name: ____________________
Signature: ____________________	Signature: ____________________
Payor's Name: ____________________	Payor's Name: ____________________
Signature: ____________________	Signature: ____________________

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Form 421

All-Inclusive Promissory Note Secured by Deed of Trust

4. *Default provision*: **Provides** for the mortgage holder to declare the entire amount of the note due and immediately payable on failure of the payee to timely pay an installment. However, a properly executed *call* is unenforceable until the reinstatement period during a foreclosure has expired, except in the case of an incurable breach under trust deed provisions for *alienation* or *waste*.

5. *Special provisions*: **Enter** any special provisions to be included in the note, such as a late charge, grace period or final/balloon payment notice if allowed.

call
A lender's demand for the balance of the loan to be immediately paid in full. [See **RPI** From 418-3]

6. *Attorney fees*: **Provides** for the prevailing party in any litigation on the note to recover their attorney fees incurred in the litigation.

7. *Identification of security*: **States** the note is secured by a trust deed. The link up with the property which is the security is made through the trust deed which references this note by amount, date prepared and city of preparation, naming the original payor and payee of this note as the trustor and beneficiary under the trust deed.

Preparation of the AITD addenda

The two variations of the AITD, the **full payoff** and the **equity payoff**, are differentiated by the amount of the payoff demand the carryback seller may request for satisfaction of the all-inclusive note and reconveyance of the AITD. [See Form 442 and 443 accompanying this chapter]

Each variety is documented by a different addendum which is attached to a regular form trust deed, thus converting the trust deed into an AITD.

The two types of AITD addenda contain differing formulas for the amount of the payoff and foreclosure sale demands. Other than their payoff formulas which occur in Section 7 and 8 of the form, the two AITD addenda contain the same information and provisions.

The following instructions are for the use and preparation of AITD addenda to be attached to a regular trust deed. [See Form 450 in Chapter 10]

When attaching an AITD addendum to a trust deed, state on the face of the trust deed, "The attached AITD addendum is a part of this Deed of Trust."

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — You are to **check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Identification and facts

Enter the date and name of the city where the AITD addendum is prepared. This date is used when referencing this document.

Enter the same date and name of the city as entered on the trust deed to which this addendum is attached. The same date is also entered on the all-inclusive note.

Enter as the trustor the name of each individual or entity signing the trust deed, typically all persons signing the note, except co-signers.

Enter as the beneficiary the payee named in the all-inclusive note, be it the seller of the real estate, their assignee or an IRC §1031 trustee.

ALL-INCLUSIVE TRUST DEED ADDENDUM
Equity Payoff

NOTE: This form is used by an agent or escrow officer when a seller of property carries back an all-inclusive note and trust deed (AITD) evidencing a principal debt which includes the balance owed on an existing mortgage and the payoff demand negotiated is payment of the difference between the amount remaining unpaid on the AITD note and the underlying mortgage, to prepare and attach as a referenced addendum to a regular trust deed. [See **RPI** Form 421 and 450]

DATE:_______________, 20_____, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:
This is an addendum to the trust deed dated _______________, at ____________________________, California,
between ____, as the Trustor,
and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:
   1.1 A trust deed recorded on ________________________, as Instrument No. ________________________,
   in ____ County Records, California,
   executed by ____, as the Trustor,
   in which ____ is the Beneficiary,
   securing a note in the original amount of $_____________ with an unpaid balance of $_____________,
   payable in installments of $_____________ monthly, including _____% interest, ☐ ARM, ☐ plus impounds.
   1.2 A trust deed recorded on ______________________________, as Instrument No.______________,
   in ____ County Records, California,
   executed by ____, as the Trustor,
   in which ____ is the Beneficiary,
   securing a note in the original amount of $_____________ with an unpaid balance of $_____________,
   payable in installments of $_____________ monthly, including _____% interest, ☐ ARM, all due _____________, 20_____.
   1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.
2. ☐ Check, if applicable:
   Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.
3. ☐ Check, if applicable: [This provision may cause adverse income tax consequences for Beneficiary.]
   Beneficiary will place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection will disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining will be disbursed to the holders of the Note.
4. If Beneficiary defaults in their performance under this trust deed, Trustor, provided that they are not in default, will have the right, at their option, to cure Beneficiary's default including the Underlying Obligations by either: (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.
5. In the event of any monetary default by Trustor, Beneficiary's obligations will be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses is to be added to the Note and be payable by Trustor with the next payment.
6. Any additional principal paid on the Note will, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or interest under the Note.
7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on the Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.
8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid will be reduced by the then unpaid balance of the Underlying Obligations.

FORM 442 03-11

Form 442

All-Inclusive Trust Deed Addendum — Equity Payoff

1. *Existing financing*: **Provides** information identifying the existing encumbrances on the property, the principal amounts of which are included in the all-inclusive note amount.

   1.1 *First trust deed*: **Enter** the date the underlying first trust deed was recorded, its instrument number and the county of record. **Enter** the name of the borrower (trustor) and the mortgage holder (beneficiary) named in the underlying first trust deed. **Enter** the original amount of the underlying first trust deed, the principal

Form 443

All-Inclusive Trust Deed Addendum — Full Payoff

ALL-INCLUSIVE TRUST DEED ADDENDUM
Full Payoff

NOTE: This form is used by an agent or escrow officer when the seller of property carries back an all-inclusive note and trust deed (AITD) evidencing a principal debt which includes the balance owed on an existing mortgage and the payoff demand negotiated is payment of the remaining debt on the AITD note, to prepare and attach as a referenced addendum to a regular trust deed. [See **RPI** Form 421 and 450]

DATE:______________, 20_____, at______________________________, California.
Items left blank or unchecked are not applicable.

FACTS:
This is an addendum to the trust deed dated ______________, at ______________________, California,
between ____, as the Trustor,
and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:
   1.1 A trust deed recorded on ______________________, as Instrument No. ______________,
   in ______________________________ County Records, California,
   executed by ______________________________________, as the Trustor,
   in which ______________________________________ is the Beneficiary,
   securing a note in the original amount of $______________ with an unpaid balance of $______________,
   payable in installments of $______________ monthly, including ______% interest, ☐ ARM, ☐ plus impounds.
   1.2 A trust deed recorded on ______________________, as Instrument No.______________,
   in ______________________________ County Records, California,
   executed by ______________________________________, as the Trustor,
   in which ______________________________________ is the Beneficiary,
   securing a note in the original amount of $______________ with an unpaid balance of $______________,
   payable in installments of $______________ monthly, including ______% interest, ☐ ARM, all due ______________, 20_____.
   1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.
2. ☐ Check, if applicable:
   Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $______________ from Trustor has been received by Beneficiary.
3. ☐ Check, if applicable: [This provision may cause adverse income tax consequences for Beneficiary.]
   Beneficiary will place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection will disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining will be disbursed to the holders of the Note.
4. If Beneficiary defaults in their performance under this trust deed, Trustor, provided they are not then in default, will have the right, at their option, to cure Beneficiary's default including the Underlying Obligations by either: (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.
5. In the event of any monetary default by Trustor, Beneficiary's obligations will be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses is to be added to the Note and be payable by Trustor with the next payment.
6. Any additional principal paid on the Note will, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or interest under the Note.
7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.
8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff will be the then unpaid principal and interest, and on receipt of payoff funds, Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

FORM 443 03-11

balance, the dollar amount of the monthly payment and the interest rate. **Check** the appropriate boxes to indicate an adjustable interest rate or impounds are provided for in the first mortgage.

1.2 *Second trust deed*: **Enter** the date the underlying second trust deed was recorded, its instrument number and the county of record. **Enter** the name of the borrower (trustor) and the mortgage holder (beneficiary) named in the underlying second trust deed. **Enter** the original amount of the underlying second trust deed, the principal balance, the dollar amount of the monthly payment and the interest rate. **Check** the box to indicate an adjustable interest rate. **Enter** the due date of the second mortgage.

1.3 *Payment of wrapped mortgages*: **States** the seller, as the beneficiary of the trust deed, remains responsible for payment of the underlying wrapped mortgages referenced in Sections 1.1 and 1.2, subject to the terms of the addendum.

Addendum provisions

2. *Impounds*: **Check** if monthly impounds will be paid to the seller by the buyer for property taxes and casualty insurance.

Editor's note — If a wrapped mortgage is impounded, then the AITD should also be impounded.

3. *Contract collection*: **Check** if the seller has agreed with the buyer to place the mortgage on contract collection with a third party.

Editor's note — The seller does not agree to a contract collection provision if they intend to receive the full tax benefits of an installment sale. The collection agent under a mutual agreement with the buyer is deemed to be the agent of the buyer, thus relieving the seller of responsibility for payments on the underlying mortgage.

4. *Seller's default/buyer's remedies*: **States** if the seller defaults on the underlying wrapped encumbrances, the buyer may cure the defaults and make payments directly on the delinquent underlying encumbrance. Payments advanced by the buyer either apply against the agreed-to AITD installments or, alternatively, are refunded by the seller on demand. One is an out-of-pocket set-off, the other is a refund.

5. *Buyer's default/seller's remedies*: **States** if the buyer fails to make payments on the AITD, the seller is no longer required to make payments on the underlying wrapped encumbrances unless the AITD is reinstated.

Editor's note — Any late charges or foreclosure costs incurred by the seller on the underlying wrapped encumbrances due to the buyer's default in AITD payments are "passed through" to the defaulting buyer as future advances due to the seller if the all-inclusive note does not itself contain a late charge provision.

6. *Prepayment penalty pass-through*: **States** a payoff of an underlying encumbrance caused by the buyer or made at the request of the buyer which incurs a prepayment penalty places responsibility for payment of the penalty on the buyer.

7. **(RPI Form 442)** *Foreclosure bid, equity payoff AITD*: **States** the seller's demand on foreclosure of the AITD will be the amount of their equity in the AITD. The AITD equity is the difference between the balance remaining on the all-inclusive note and the balance(s) remaining on the underlying encumbrance(s). The buyer at the foreclosure sale takes the trustee's deed subject to the underlying encumbrance(s).

7. (**RPI Form 443**) *Foreclosure bid, full payoff AITD*: **States**, on foreclosure under the AITD, the seller will demand and bid the entire balance of the all-inclusive note. Concurrent with the foreclosure sale, the seller will satisfy and obtain a reconveyance of the underlying encumbrance, unless the seller is the successful bidder and credits themselves with the underlying mortgage amount they assume.

8. (**RPI Form 442**) *Payoff demand, equity payoff AITD*: **States** the payoff demand for reconveyance of the AITD is the difference in the amounts remaining unpaid on the all-inclusive note and the underlying wrapped encumbrances.

Chapter 15 Summary

A note in an all-inclusive trust deed (AITD) transaction is evidence of an installment debt created to pay the balance due on the buyer's purchase price of real estate after a down payment. In turn, the seller remains responsible for the underlying mortgage encumbering the property sold.

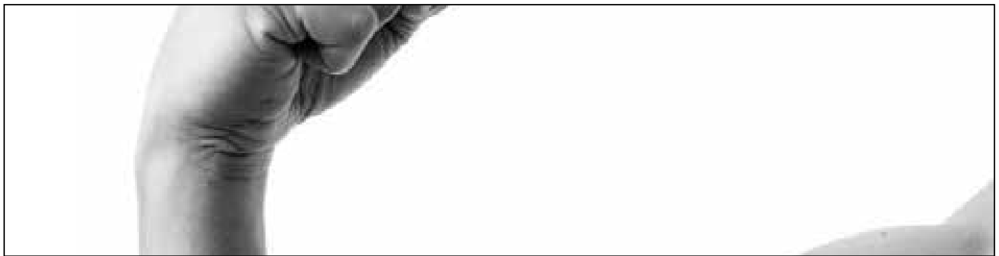
The interest rate charged by the seller carrying back an AITD varies greatly with the needs and expectations of the seller and buyer.

Prior to closing the carryback sale, the seller needs to request the existing mortgage holder waive their right to call the mortgage on the sale and carryback of the AITD. In exchange for the mortgage holder's written waiver of the due-on clause, the seller agrees to a modification of the note and the payment of a fee.

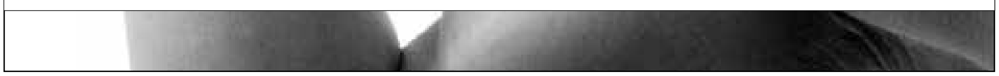
The all-inclusive note is used with either the equity payoff or full payoff varieties of AITD addenda attached to a regular trust deed, thus converting the trust deed into an AITD. These two variations of the AITD are differentiated by the amount of the payoff demand the carryback seller may request for satisfaction of the all-inclusive note and reconveyance of the AITD.

Chapter 15 Key Terms

Chapter 16



Adjustable rate mortgages



Learning Objectives

After reading this chapter, you will be able to:

- trace the history of the adjustable rate mortgage in the United States;
- understand the economic function of an adjustable rate mortgage (ARM);
- identify the various components of an ARM, their purposes and effects;
- describe different widely adopted ARM mortgages that have influenced the mortgage market in the last ten years; and
- make the required consumer disclosures for ARMs on origination.

Key Terms

5/1 ARM
adjustment interval
carryover provision
fully-indexed rate
hybrid ARM
index
introductory interest rate
negative amortization
subprime

The genesis of the ARM

The most consumer-friendly and commonly used type of mortgage financing in the United States is the **30-year fixed rate mortgage (FRM)**. Up until the early 1980s, the *FRM* was essentially the only type of mortgage available for the purchase of a single family residence (SFR). While some tightly controlled variables and alternative mortgage products did exist, **adjustable rate mortgages (ARMs)** as they are now known were not yet authorized by federal regulators.

Until the early 1980s, the main sources of mortgage funds were financial entities known as **savings and loan associations (S&Ls)**. *S&Ls* operated by taking deposits and using them to lend mortgage money at a higher interest rate than was paid to the depositors. The S&Ls kept the spread between the two interest rates as profit, and continued the savings-and-loan cycle.

Market vulnerability

Prior to the 1980s, federal law prohibited S&Ls from dabbling in other types of consumer finance. Mortgage lending was thus their sole source of income. The large and multi-faceted banks familiar today were unlawful during this period, and S&Ls were highly dependent on continuing deposits to fund mortgages and stay in business.

The mortgages originated by S&Ls were 30-year FRMs. This committed the S&L lender to a **fixed interest rate** over a long period of time. Depositors, on the other hand, collected interest at rates set at federally regulated levels until the introduction of *money market accounts* in the late 1970s. S&Ls were viable while deposit interest rates remained below mortgage rates. However, this dynamic left S&Ls vulnerable to interest rate fluctuations.

Congress attempted to mitigate this vulnerability in 1966 by capping the savings interest rate for S&L depositors. It set this cap higher than the cap for commercial banks to encourage depositors to place their money with S&Ls, ensuring the mortgage money continued to flow.

When economic conditions and monetary policy in the 1970s triggered excessive inflation, S&L lending became restricted by the cap on interest rates they paid on savings deposits. Other financial companies not subject to interest rate caps paid market-level interest. S&L depositors began withdrawing their savings in droves, seeking to place their funds in higher-yield investments. [See Chapters 1 and 2]

S&Ls are thrown a life preserver

In an attempt to save the moribund S&Ls, Congress and regulatory agencies did two things in the early 1980s:

- passed the *Depository Institutions Deregulation and Monetary Control Act of 1980* (DIDMCA), which:
  - o allowed S&Ls to diversify their investments to make money through means other than 30-year FRMs; and
  - o removed interest rate caps on depositor funds; and
- adopted regulations allowing S&Ls to offer *adjustable rate mortgages (ARMs)*.

Unlike FRMs, ARMs allow lenders to float interest rates to the market after a specified amount of time, an expectation from the prior decade that rates would continue to rise. Allowing mortgage rates to change with the market pulled the insolvent S&Ls out of the red, at least temporarily. However, ARMs also shifted inflationary and economic risk from the mortgage holder to the borrower.

By the late 1980s the S&Ls had failed, but for other reasons. However, despite their absence, ARMs remained. From the 1980s onward, the ARM has largely been as deleterious to uninformed borrowers as it was ineffective in ultimately rescuing the S&Ls.

The modern-day ARM

The face of the ARM has changed over the years, most markedly during the **Millennium Boom**.

20 years after ARMs entered the mortgage landscape, the housing market experienced an unprecedented explosion of activity. Low interest rates and speculative fever caused housing prices to skyrocket. [See Chapter 3]

Mortgage lending standards went lax due to rapacious investor demand for **mortgage-backed bonds (MBBs)** and the hubristic belief real estate prices were to rise indefinitely. Inflated property prices, rather than the borrower's creditworthiness, were expected to carry the mortgages.

By the time mortgage demand peaked in mid-2005—one year following a rise in short-term interest rates—Wall Street had perfected its vertically integrated system for originating, bundling and reselling mortgages through the MBB market to millions of investors worldwide.

All these bonds were dependent on exotic new mortgage products, the most infamous of these being **subprime mortgages.** A multitude of creative new types of ARMs were created—or revived—during this era as well.

subprime
In mortgage lending, a borrower who poses a higher risk of not timely repaying a mortgage, or a mortgage with a high risk of default due to inferior underwriting standards.

The purpose and popularity of ARMs

FRMs guarantee a set rate of return over a long period of time. Lenders build the long-term cost of a fixed return into the FRM interest rate. During the *Millennium Boom,* ARMs offered lower initial rates because the initial rate was fixed for a matter of only a few months to a year (if at all), rather than 30 years. Thus, borrowers unqualified for an FRM were suddenly able to qualify for ARMs which offered low initial interest rates and very low payment schedule options for up to ten years.

An ARM allows for periodic adjustments to both the interest rate and the dollar amount of scheduled payments. This is in contrast to an FRM, which has a fixed interest rate and fixed scheduled payments for the life of the mortgage.

ARMs are typically very popular when property prices or FRM interest rates rise in tandem. Up to and during the Millennium Boom, ARMs allowed homebuyers to **leverage** the lower initial interest rate on an ARM into higher borrowing amounts than possible with an FRM. In turn, buyers were able to pay a higher price for a home. This scenario attracted homebuyers who planned to:

- move within the fixed period of the mortgage;
- refinance the mortgage into a lower rate after they improved their credit; and/or

- use the money saved on ARM interest payments in higher-yield investments.

ARMs are in vogue

Different types of ARMs fall in and out of favor in response to the housing market and current interest rates. During the Millennium Boom, overall ARM use was exceptionally high. In 2004, 33% of all prime mortgage applications nationally were for ARMs. ARM use in California rose to 78% in 2005.[1]

In 2013, ARMs accounted for approximately 10% of all mortgages originated. This is on the lower end of the historical ratio between ARMs and FRMs, which typically fluctuates between 11% and 30% annually.[2]

The disparity between the 2004 and 2013 ARM-to-FRM ratio is due to the unique type of **borrower demand** in 2004. During this time, many under-qualified buyers were enticed to purchase property in the frenzied real estate market.

However, these buyers' grasp on ownership was tenuous at best. They lacked **sufficient income** to make monthly payments on a 30-year FRM with a principal amount large enough to purchase homes at the steeply inflated prices of the period. This abundance of willingness but dearth of ability to purchase led many buyers to opt for high-risk ARMs, expecting to either refinance or resell the property (at a profit) before their ARMs reset.

However, the value of buyers' properties did not increase as they were led to believe by the gatekeepers of real estate. Instead, prices dropped dramatically as forecast by some, preventing them from escaping the obligations of their resetting ARMs. Mass defaults were soon to follow. [See Chapter 3]

The real estate pricing implosion caused homebuyers to view ARMs to be both *excessively risky* and *less favorable* for purchasing homes in the years following the Millennium Boom and bust.

Currently, ARM use is at a non-disruptive low ebb due to continued lender risk aversion following the **financial crisis**. However, interest rates are basically at zero and cannot go lower (without the Federal Reserve going "negative" on rates). In the coming decades, any borrower who takes out an ARM will do so at the mercy of rising interest rates.

ARMs today

5/1 ARM
A common type of adjustable rate mortgage with an introductory fixed rate period of five years followed by an annually-adjusted interest rate for the life of the mortgage.

The most popular type of ARM with homebuyers today is the **5/1 ARM**, a type of *hybrid ARM*. However, most homebuyers, having been burned in recent years, prefer FRMs to ARMs. In 2012 to mid-2013, many homeowners refinanced to trade in their existing ARMs for FRMs.

Of the mortgages refinanced by Freddie Mac in the second quarter (Q2) of 2014:

- 40% were for shorter than the original mortgage term; and

1 Freddie Mac, 23rd Annual ARM Survey
2 Freddie Mac, 29th Annual ARM Survey

- 76% of hybrid ARMs were refinanced as FRMs.[3]

Currently, the majority of ARMs originated are tied to the **12-Month Treasury Average**. In 2013, 80% of lenders offered Treasury-tied ARMs, with the remainder offering ARMs tied to the London Interbank Offered Rate (LIBOR).

Although a larger number of lenders offer Treasury-indexed ARMs, large national banks typically tie their ARM products to the LIBOR index. Thus, more than half of ARM originations in 2013 were indexed to LIBOR.[4]

As in the past, ARM use will increase as interest rates on 30-year FRMs rise and home prices rise, a scenario that played out in 2014.

ARMs in the future

Going into California's next economic boom, circa 2020, the following trends will conspire to move ARM usage above 20%:

- the coming 30-year cycle of rising interest rates;
- the current secular income stagnation; and
- the present upward pressure of asset inflation in home prices.

However, this is not necessarily beneficial as ARMs are inherently riskier for homeowners than FRMs. Worse, they are used by low- and mid-tier homebuyers to overextend their finances in an effort to overreach on the price of a home. [See Figure 1]

Elements of an ARM

All ARMs are comprised of:

- an **introductory interest rate**, also known as a **teaser rate**;
- an **index**;
- a **margin**; and
- an **adjustment interval**.

The introductory interest rate

The *introductory interest rate* is the initial interest rate charged on the ARM. The introductory rate stays fixed for a set amount of time known as the **introductory period**, lasting anywhere from a month to ten years.

A mortgage lender is able to set the introductory rate however it chooses depending on whether it wants to attract ARM borrowers. In most cases, the introductory rate is lower than the rate which will be experienced during the remainder of the mortgage.

In the past (and certainly during the Millennium Boom), many lenders evaluated borrowers' mortgage applications as if the introductory interest rate were fixed for the life of the mortgage. When the introductory period expired and the rate adjusted, homebuyers were too often unprepared for the payment increase and experienced *payment shock.*

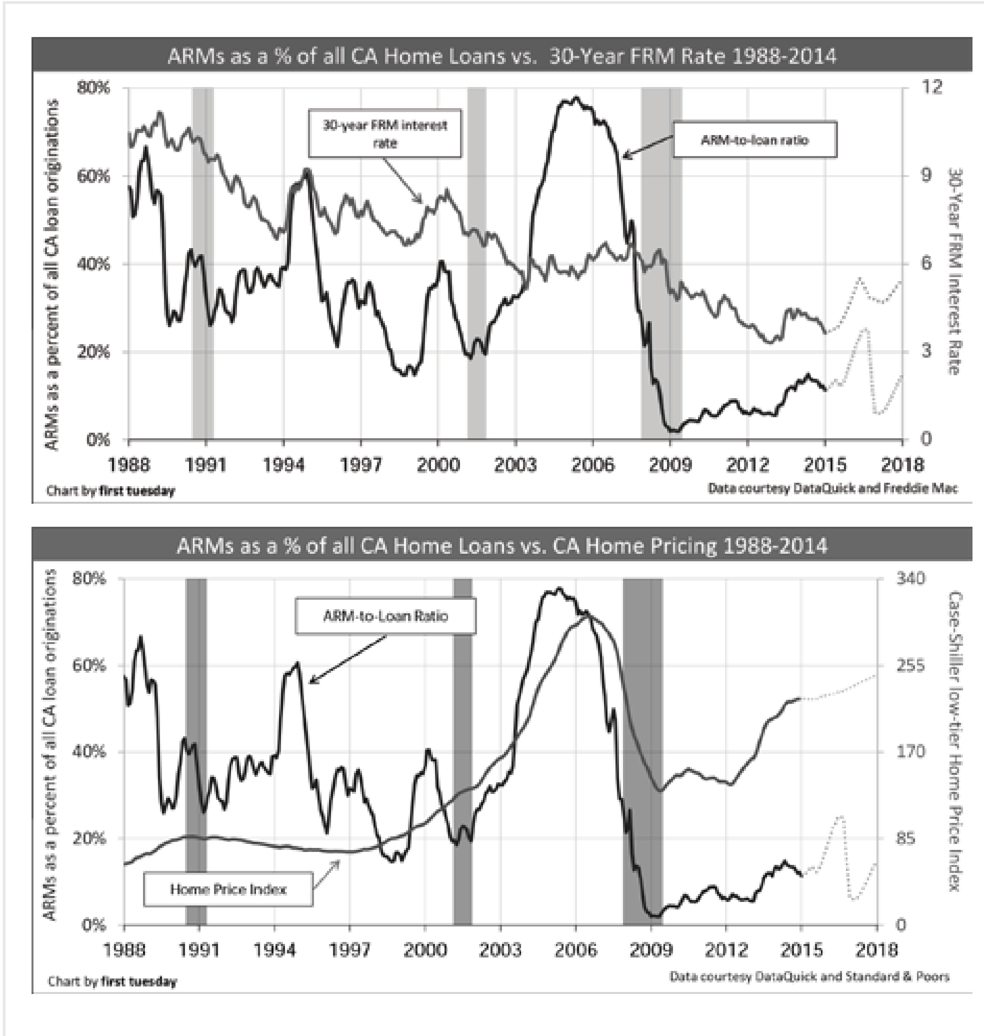
introductory interest rate
The initial rate of interest on an adjustable rate mortgage (ARM), typically lower than the fully-indexed note rate and lasting for a set introductory period, allowing for a greater loan amount to be borrowed. Also known as a teaser rate.

3 Freddie Mac, Refinance Activities Report Q2 2014

4 Freddie Mac, 30th Annual ARM Survey (2013)

Figure 1

ARMs vs. 30 Year Rate & ARMs vs. Home Pricing



fully-indexed rate
For adjustable-rate notes, the index figure at the time of application plus the gross margin stated in the note.

However, on virtually all new consumer mortgages, federal **ability-to-repay (ATR) rules** require lenders to underwrite homebuyers based on the **fully-indexed rate**, or the highest possible rate on the ARM during the first five years of its term. [5] [See Chapter 4]

The index

index
A regularly issued composite market interest rate for an investment such as Treasury Securities or inter-bank loans used to set the basis for periodic interest rate adjustments.

The *ARM index* is the first of two components which, when combined, set the adjusted interest rate after the introductory period. An ARM is said to be "tied" to an index. The index is meant to be a proxy of the change in the cost of lending for a lender—as costs rise and fall, so do the index and thus the ARM's interest rate.

ARM rates can be tied to a variety of indices each of which adjusts based on criteria set by the "owner" of the index. Common indices for ARMs are the:

- 11^{th} District Cost-of-Funds Index (COFI);
- 12-month Treasury Average; and
- LIBOR.

5 12 Code of Federal Regulations §1026.43(c)(5)(i)

How the indices are set

The *COFI* is compiled monthly based on the price lenders paid for funds to be lent in the prior month. The COFI is appropriate for ARMs since it is a short-term benchmark.

The *12-month Treasury Average* is released weekly by the *Federal Reserve Board*. It is based on the average yield on Treasury Securities with 12 months of their maturity remaining. This yield is based on the winning bid amounts on Treasury Securities in the over-the-counter stock market.

The *LIBOR* is set daily when and international network of financial exchanges give an estimate for their cost of funds. The average of these five estimates is rounded to the nearest 1/16 and used as the LIBOR index rate.

Editor's note—Until late 2012, LIBOR was set by an association of London banks—hence its name. Administration of the index was transferred to an independent international group with UK government oversight in early 2014.

The more frequently its affiliated index changes, the more erratic the interest rate on an ARM is. Thus, ARMs tied to the COFI or 12-month Treasury Average are more stable than those tied to the LIBOR.

Editor's note — Current interest rates can be found online at http://firsttuesdayjournal.com

A consumer mortgage holder is not permitted to arbitrarily make changes to a consumer's interest rate on an ARM. **Regulation D** of the *Alternative Mortgage Transaction Parity Act* requires the index used to be:

- readily available and verifiable by the borrower and beyond the control of the mortgage holder; or
- based on a formula or schedule identifying the amount and circumstances triggering increases in the interest rate.[6]

The margin

The *margin* is the second component used to set the adjusted ARM rate. Essentially, the margin equals the *points* a mortgage holder adds to the index figure to determine its earnings. Margins vary by mortgage holder, but stay fixed for the life of the mortgage.

The ARM's adjusted interest rate is determined by adding the index to the margin (at set intervals, and subject to any caps). Together, this equals the *fully-indexed rate*.

For instance, an ARM with an index of 4% and a margin of 2% has a fully-indexed rate of 6%. If the index falls to 2%, the fully-indexed rate falls to 4%.

6 12 CFR §1004.4(a)(2)(i); (ii)

The adjustment interval

adjustment interval
The predetermined period of time after which the interest rate and payment amount on an adjustable rate mortgage (ARM) or other variable rate mortgage is recast.

The *adjustment interval* is the time which elapses between rate changes. ARMs are scheduled to adjust periodically, e.g., every month, every year, every three years, etc.

At the end of each adjustment interval the interest rate resets to the current index, plus the margin. Thus, the monthly mortgage payment changes each time the ARM adjusts to retain the original amortization period for payoff of the mortgage.

ARMs are generally identified by their adjustment intervals. For example, an ARM with payments scheduled to adjust every year is called a *1-year ARM*. An ARM with payments scheduled to adjust every three years is *a 3-year ARM*. ARMs with a fixed-rate introductory period (say, five years) followed by a one-year adjustment interval is called a *5/1 ARM*.

Rate caps and other ARM features

Some ARMs have other features affecting how the interest rate or payments adjust, including:

- initial, periodic and lifetime interest rate caps and floors;
- periodic payment caps;
- conversion features; and
- prepayment penalties (if permitted).

A *cap* is a ceiling on the interest rate or adjusted payment amount.

Interest rate caps

The **initial interest rate cap** sets a limit on the amount the interest rate is permitted to change on the first adjustment. A **periodic interest rate cap** places a ceiling on the amount an interest rate is permitted to increase with each subsequent adjustment after the first. A **lifetime interest rate cap** (or floor) is the maximum (or minimum) amount an interest rate is able to increase (or decrease) over the entire life of the mortgage.

In response to the potential for never-ending ARM rate increases, Congress amended *Regulation D* in 1987 to require all consumer ARMs secured by one-to-four unit dwellings to have lifetime interest rate caps. Neither the law nor the ensuing regulation actually set guidelines for minimum or maximum allowable caps.[7]

The most common rate cap arrangements are the *5/2/5* or *2/2/6*. The first number refers to the initial rate increase cap over the initial fully-indexed note rate. The second number is the future periodic rate increase cap for later adjustments. The third number is the lifetime rate increase cap over the initial fully-indexed note rate. [See Figure 2]

carryover provision
An adjustable rate note provision allowing the lender to apply any margin exceeding a periodic rate cap on a given adjustment to the next scheduled rate adjustment.

Additionally, some ARMs with interest rate caps contain a **carryover** feature in the mortgage documentation which allows the lender to "carry over" rate increases exceeding the periodic adjustment limits to the next adjustment. [See Figure 3]

7 12 United States Code §1004.4, 3806(d)

Figure 2

Example 1

Consider a buyer who obtains a$200,000 ARM with an initial 3.25% fully-indexed interest rate. The ARM adjusts annually and has a 5/2/5 cap structure.

For the 5/2/5 rate cap arrangement:

- *the initial rate increase is not to exceed 5% over the initial fully-indexed rate;*
- *future periodic rate increases is not to exceed 2% over the prior period's rate; and*
- *the lifetime rate increase is not to exceed 5% over the initial fully-indexed rate.*

At the first adjustment, the index increases by 3%. At the second year, the index goes up another 3%. The interest rate after the second adjustment after applying the lifetime cap is 8.25% as follows:

ARM Interest Rate	***Monthly Payment (rounded to nearest dollar)***
Initial year @ 3.25%	*$ 870**
2nd year @ 6.25%	*$ 1,221**
3rd year @ 8.25%	*$ 1,478**
3rd year (without lifetime cap) @ 9.25%	*$ 1,614**

**Calculations do not include taxes, insurance, homeowners' association fees or similar impound items.*

The first adjustment (the second year rate) is within the 5% initial interest rate increase cap. With a 3% index increase, the interest rate adjusts to 6.25%. The second adjustment, also with a 3% index increase, is limited by the lifetime interest rate cap. Without the lifetime interest rate cap, the interest rate during the third year shifts to 9.25%.

Instead, due to the 5% ***lifetime interest rate increase cap****, the maximum interest rate of 8.25% is reached in the third year. In this case, the lifetime cap saves the owner $136 per month after the third year.*

The examples in Figures 2 and 3 are based on **fully-indexed initial interest rates**. Most ARMs start with **discounted interest rates,** which are not fully-indexed, meaning the first adjustment will incorporate the margin as well as any change in the index. [See Figures 2 and 3]

These illustrations highlight the importance of the rate cap structure. If a 5/2/5 ARM has a very low **teaser rate**, it is possible the rate will increase significantly—up to 5% on the first adjustment—a payment shock for most homebuyers.

However, homebuyers intent on using an ARM are best advised to search for similar mortgages with a lower initial interest rate cap – say, a 2/2/6 structure, which allows for more gradual interest rate increases.

Payment caps

Another type of ARM cap is known as a *payment cap*. This limits the total payment due on the mortgage at each adjustment. For a borrower with a $1,000 monthly mortgage payment with a payment cap of 10%, the maximum payment increase with a periodic adjustment is $100, for a total payment of $1,100 – regardless of interest rate changes.

Figure 3

Example 2

*Consider an owner with a 3.25% fully-indexed interest rate on a $200,000 ARM. The ARM adjusts annually and has a **carryover provision** in the note. There is no initial year interest rate cap, but the ARM has a 2% periodic interest rate cap and a 5% lifetime interest rate cap. At the first adjustment, the index goes up 3%. At the second year, the index goes down 1%.*

The interest rate after the second adjustment is 5.25%. The index goes up by 3%, but it is capped by the 2% periodic interest rate cap. The remaining 1% increase is carried over to the next adjustment period. At the second adjustment, the 1% carryover increase cancels out the 1% drop in the index. Thus, the interest rate remains 5.25% as follows:

ARM Interest Rate	*Monthly Payment (rounded to nearest dollar)*
Initial year @ 3.25%	*$ 870**
2nd year @ 5.25%	*$ 1,098**
3rd year @ 5.25%	*$ 1,098**

**Calculations do not include taxes, insurance, homeowners' association fees or similar impound items.*

negative amortization
An increase in the principal balance of a mortgage debt which occurs when monthly installment payments are insufficient to fully pay the interest accruing on the principal balance.

With payment caps, however, any additional interest due above the 10% payment cap is not simply forgiven. Instead, it is added to the mortgage balance. Thus, payment caps can cause **negative amortization**, in which unpaid interest is added to the principal balance of the mortgage. Some ARMs have both periodic interest rate caps and payment caps.

On consumer mortgages, *negative amortization*, when allowed, triggers a variety of mandatory disclosures and regulatory restrictions. Mortgage holders subject to **Regulation Z (Reg Z)** are only permitted to make negatively amortizing ARMs to first-time homebuyers if they first document that the homebuyer has received special counseling on the risks.[8]

As a further restriction on the lender, negative amortization mortgages are not classified as **qualified mortgages** and thus are ineligible for purchase by Fannie Mae or Freddie Mac or insurance from the Federal Housing Administration (FHA).[9] [See Chapter 4]

Prepayment penalties

Prepayment penalties are fees charged by a mortgage holder when a borrower pays a mortgage off early.

For **business mortgages**, prepayment penalties are usually limited to the prepayments made in the first three to seven years of the mortgage. When analyzing whether an investor may want to refinance, the prepayment penalty needs to be considered by the investor and their agent.

8 12 CFR 1026.36(k)
9 12 CFR 1026.43(b)(4)

Consider an investor who takes out a 3/1 business ARM in the amount of $200,000 with an initial rate of 6%. The mortgage has a prepayment penalty of six months' interest on the remaining principal balance.

Two years later, the investor decides to refinance and pay off the 3/1 ARM. The principal balance is $194,936. Under the prepayment penalty provision, the investor owes a penalty of $5,850, more than the principal reduction in two years of payments.

Not all ARMs have a prepayment penalty. If a mortgage has an adjustable interest rate and is secured by one-to-four residential units, a mortgage holder may not bar the borrower's voluntary prepayment within 90 days of notification of a change in the rate.[10]

Additionally, under Reg Z, **consumer ARMs** may not contain a prepayment penalty provision.[11] [See Chapter 9]

Different ARM products

Many variants of the ARM exist, each with different terms. Common types of ARMs popular during the Millennium Boom include:

- hybrid ARMs;
- option ARMs;
- conversion ARMs; and
- interest-only ARMs.

Most of these ARM products carry unacceptably high risks for both the property owner and the mortgage holder. Since the roll-out of Reg Z's **ability-to-repay (ATR)** rules and **qualified mortgage (QM)** definition in January 2014, these exotic instruments have been relegated back to their rightful place as niche products for extremely well-qualified borrowers. [See Chapter 4]

Hybrid arms, however, meet the requirements for *qualified mortgages* under some conditions. This is the only type of ARM which survived the dawn of ATR-QM standards.

Hybrid ARMs

The **hybrid ARM** is the "traditional" type of ARM. By its terms, the interest rate is fixed for an initial term, after which it is periodically adjusted.

hybrid ARM
A type of adjustable rate mortgage which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

Hybrid ARMs are often named for the initial rate period and the period for later adjustments, like the *5/1 ARM*. *5/1* refers to the length of the period during which the introductory interest rate applies—fixed for the first five years of the mortgage—and the one-year intervals for rate adjustments after the initial rate period expires.

Other common hybrid ARMs include:

- 3/1 (fixed for three years, then adjusts annually);

10 CC §1916.5(a)(5)
11 12 CFR 1026.43(g)

Negotiating a carryback ARM

*Consider an agent who solicits a seller to list their income-producing property for sale on terms which include short-term carryback financing by the seller, called an **installment sale**. This business carryback mortgage will assist a buyer in financing the purchase price to be paid for the property. The competitive market rate for a comparable FRM made by a second trust deed lender is currently 10%.*

*To hedge against rising rates, the seller wants an **adjustable interest rate** on any note they agree to carry. The initial interest rate sought for the first six months will be the current market rate for private mortgages.*

*When the initial interest period expires, the **note rate** will adjust upward every six months to match any periodic rate increases, indexed to short-term interest rates for Treasury Bills.*

*The carryback seller wants their interest rate adjustments to be set by an **index figure** based on short-term rates. In addition to an index figure, an **interest rate margin** needs to be set to establish the periodic interest rate on the carryback mortgage.*

The amount of the margin is set for the life of the carryback mortgage. Thus, the carryback seller's yield will change every sixth month in accordance with the index figures issued by the government, reflecting any increase or decrease in short-term interest rates.

*The index agreed to is the **1-year Constant Maturity Treasury Index**, which is 4%. The margin agreed to is 6% — the difference between the market rate on private FRMs (10%) and the index figure (4%).*

Thus, when short-term interest rates increase as the economy or inflation picks up, and the index figure rises as a result, the interest rate on the note will be adjusted upward accordingly.

- 7/1 (fixed for seven years, then adjusts annually); and
- 10/1 (fixed for ten years, then adjusts annually).

Similar hybrid arms are intended for those with less-than-perfect credit. The short initial rate allows the borrower to qualify for a mortgage with the intent of improving their credit and refinancing out of the hybrid ARM before the adjustment occurs. Common hybrid arms named under this convention are:

- 2/28 (fixed for two years, adjustable for 28 years); and
- 3/27 (fixed for three years, adjustable for 27 years).

2/28 and 3/27 ARMs adjust either every six months or every twelve months depending on the terms of the mortgage.

Conversion ARMs

Some ARMs have built-in terms which allow its conversion to an FRM at some point at the borrower's election during the mortgage term, and according to the rules set in the mortgage documents.

However, **conversion ARMs** have some drawbacks:

- the interest rate on conversion will possibly be higher than the average FRM rate at the time of the conversion;

- the lender is able to charge a higher interest rate during the ARM portion of the mortgage than for other mortgages without conversion features; and/or
- the lender is able to charge a fee for the conversion.

Editor's note — Consumer mortgages with rates exceeding the average prime offer rate for comparable mortgages by a percentage threshold become higher priced consumer mortgages, and in some cases, Section 32 high-cost consumer mortgages. Each of these is subject to special rules and restrictions. [See Chapter 9]

Conversion is not mandatory. For example, a borrower who takes out a conversion ARM is able to adopt a fixed interest rate five years into the mortgage term, or choose to adhere to the traditional ARM terms with an interest rate that periodically adjusts based on a predetermined formula.

Lenders originating consumer mortgages subject to Reg Z are required to inform borrowers of the existence of a conversion option. Since conversion will potentially incur increased costs and fees to the borrower, the mortgage holder is also required to disclose what fees are associated with the conversion and how the converted fixed rate is determined.[12]

Disclosing the risks of an ARM

Risks in consumer ARMs are of critical concern to regulatory agencies. In 2011, the regulators began requiring greater mortgage holder transparency with ARMs made for **consumer purposes**. Lenders originating consumer ARMs under Reg Z are required to provide disclosures that clearly detail the specific time and circumstances that will change the interest rate or payment schedule of a mortgage. [See **RPI** Form 320-1]

These regulations require disclosures made in plain language, laid out in a format that clearly illustrates the risks of loss from variable terms associated with the mortgage.

Under the guidelines, lenders are required to disclose the fact the ability to refinance to a lower rate after the mortgage adjusts is not assured. Additionally, lenders are required to plainly state the **maximum interest rate** possible on the mortgage — a "worst case" rate scenario previously buried deep in the jargon of prior mortgage documents.

Required disclosures for consumer ARMs

The **Truth in Lending Act (TILA)** and its **Reg Z** require that all features of an ARM, including the existence of a carryover feature, be disclosed to a borrower upon application.

Required disclosures include:

- the *Consumer Handbook on Adjustable Rate Mortgages*;
- notice that the mortgage terms are subject to change, including:
  - o the interest rate; and
  - o the mortgage payments;

12 CFPB Official Interpretation of 12 CFR 1026.19(b)(2)(viii) (Supplement I)

- information regarding the index to which the mortgage is tied;
- an explanation of how the interest rate and payments are calculated;
- an explanation of how the ARM index is adjusted;
- a recommendation that the borrower seek more information about the current margin value and current interest rate;
- notice that the current interest rate is discounted;
- a recommendation that the borrower ask the amount of the rate discount;
- the frequency of interest rate and payment adjustments;
- any payment caps provided by the mortgage terms;
- the possibility of negative amortization;
- the possibility of interest rate carryover;
- instructions for calculating mortgage payments;
- notice of the mortgage's demand provision;
- a description and schedule of notices for upcoming adjustments;
- a notice that the borrower has access to disclosure forms for the mortgage holder's other ARM programs;[13] and
- either:
  - a historical example of an ARM to illustrate the effect of interest rate changes on the borrower's payments and mortgage balance. This example is to be based on a $10,000 mortgage amount and the past 15 years of index values and include a description of negative amortization, interest rate carryover, interest rate discounts and payment caps; or
  - the maximum interest rate and payment for a $10,000 ARM under the current mortgage terms and a disclosure that the borrower's payments may increase or decrease significantly.

These avuncular regulations are among the most user-friendly and effective requirements of Reg Z. Previously, public policy demanded the government refrain from any type of consumer protection, at great cost to consumers and to the larger economy.

13 12 USC §1026.19(b) et. seq.

Chapter 16 Summary

An adjustable rate mortgage (ARM) allows for periodic adjustments to both the interest rate and the dollar amount of scheduled payments. ARMs allow homebuyers to leverage the lower initial interest rate into higher borrowing amounts than possible with an FRM.

All ARMs are comprised of:

- an introductory interest rate;
- an index;
- a margin; and
- an adjustment interval.

The introductory interest rate, sometimes called the teaser rate, is the initial rate which stays fixed for a set amount of time called the introductory period. The index is the first of two components which set the adjusted interest rate after the introductory period. An ARM is said to be "tied" to an index, meant to be a proxy of the change in the cost of lending for a lender. Common indices for ARMs are:

- 11th District Cost-of-Funds Index (COFI);
- 12-month Treasury Average; and
- London Interbank Offered Rate (LIBOR).

The margin is the second component used to set the adjusted ARM rate. The margin is the points a mortgage holder adds to the index figure to determine its earnings.

The adjustment interval is the time between rate changes. ARMs are scheduled to adjust periodically, e.g., every month, every year, every three years, etc. At the end of each adjustment interval the interest rate resets to the current index, plus the margin.

ARMs are generally identified by their adjustment intervals. For example, an ARM with a fixed-rate introductory period of five years followed by a one-year adjustment interval is called a 5/1 ARM.

Some ARMs have initial, periodic and lifetime interest rate caps and floors or periodic payment caps which act as a ceiling on the interest rate or adjusted payment amount.

Interest rate caps set limits on the amount the interest rate is permitted to change on the first or subsequent adjustments, or over the life of the ARM.

Some ARMs with interest rate caps contain a carryover feature which allows the lender to "carry over" rate increases exceeding the periodic adjustment limits to the next adjustment.

Payment caps limit the total payment due on the mortgage at each adjustment regardless of interest rate changes. Payment caps can sometimes cause negative amortization, in which unpaid interest is added to the principal balance of the mortgage.

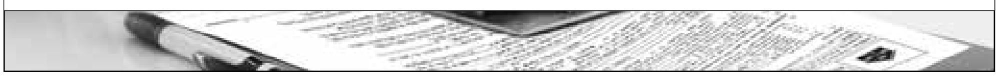
The hybrid ARM is the "traditional" type of ARM. By its terms, the interest rate is fixed for an initial term, after which it is periodically adjusted. This is the only type of ARM which survived the dawn of ATR-QM standards.

Lenders originating consumer ARMs under Reg Z are required to provide disclosures that clearly detail the specific time and circumstances that will change the interest rate or payment schedule of a mortgage. The Truth in Lending Act (TILA) and Reg Z require that all features of an ARM, including the existence of a carryover feature, be disclosed to a borrower upon application.

Chapter 16 Key Terms

Chapter 17

Subordination of a trust deed



Learning Objectives

After reading this chapter, you will be able to:

- understand the priorities of trust deeds that are the subject of subordination agreements;
- prepare purchase agreement provisions for the subordination of a seller carryback trust deed to concurrent or future financing; and
- analyze the enforceability of subordination provisions in purchase agreements for seller carryback transactions.

Key Terms

assumption

subordination agreement

subordination

Altering priorities by agreement

A seller who agrees to carryback a mortgage to help the buyer finance the purchase of their property enters into a **subordination agreement** as a provision in the purchase agreement. Under the *subordination agreement*, the seller will alter their present ownership position on title to the property by accepting a secured position **junior in priority** to a mortgage lender. The nature of the provision subordinating the carryback mortgage as junior to another mortgage alters the seller's interest in the property, either:

- concurrent with the recording of their trust deed on the close of the sales escrow; or
- at a later date on a request to subordinate.

subordination agreement
An agreement entered into by a mortgage holder to permit their security interest in title to the mortgaged property to take an inferior position to another encumbrance. [See **RPI** Form 281]

When the mortgage holder is a carryback seller, **subordination** means accepting a less secure and more risky position for their trust deed lien on either the close of escrow or a later recording of a new trust deed than the equity position they hold as owner. Thus, they alter the priority of their interest in the chain of title while at the same time changing their rights in the property from an ownership interest to a security interest.

For instance, consider a seller of unencumbered or under-encumbered property (very low loan-to-value ratio (LTV)) who agrees to carry back a mortgage. It will be a second, junior to a new mortgage originated by the buyer to fund a portion of the price the seller receives on the sale. The seller's interest in the property on closing, a second trust deed lien security interest, is now a more risky position on title than their previous ownership interest.

The purchase-assist mortgage which was not previously a lien on title to the seller's property now has priority to the seller's security interest retained in title, evidenced by the trust deed they carried back as payment for a portion of their equity.

The garden variety subordination agreement

subordination
The rearrangement of mortgage lien priorities on title in which a mortgage lien takes a lesser or junior position to another mortgage lien on a property.

The *subordination* of a trust deed lien may be **voluntary** or **involuntary**, with different consequence for the junior mortgage holder.

A **voluntary subordination** of a trust deed is agreed to in three situations:

- **concurrent subordination** — escrow is instructed to record the trust deeds in a specified order, such as the carryback trust deed will be second in priority to a buyer's newly originated purchase-assist mortgage [See **RPI** Form 401 §2.3 f and h];
- **future subordination** — a carryback seller entering into a purchase agreement agrees to later, after the close of their sales escrow, subordinate their carryback trust deed to a trust deed to be recorded in the future [See **RPI** Form 281 accompanying this chapter]; or
- **specific subordination** — a carryback seller on request from the buyer performs under their previous (future subordination) agreement to reposition their recorded trust deed to become junior and second in priority on title to a specifically described note and trust deed now being recorded.

An **involuntary subordination** of a junior trust deed results from the modification of a senior mortgage holder's debt without the junior's consent, **impairing** the security interest of the junior mortgage holder, as discussed later in this chapter.

Listing broker's duty owed to seller

A seller who agrees to subordinate their carryback trust deed to a new mortgage, either concurrent with the recording of their trust deed or at a future date, is agreeing to accept a lesser position in the property's title as their security than the position they held before the subordination. Thus, subordination exposes a seller to an increased **risk of loss** when compared to the title position they held before subordinating their trust deed.

The need for a *concurrent subordination agreement* arises when a carryback seller enters into a purchase agreement with provisions calling for the buyer

Form 281

Agreement to Subordinate

AGREEMENT TO SUBORDINATE

NOTE: This form is used by an agent when negotiating terms for the subordination of trust deed debt, to state the conditions under which the trust deed holder will subordinate their trust deed to a future debt and trust deed the owner will record.

DATE: ______________, 20_____, at ______________________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
   ☐ Purchase agreement
   ☐ Escrow instructions
   ☐ Trust deed
   ☐ ______________________________
   1.1 dated ____________, 20____, at ______________________________, California,
   1.2 entered into by ______________________________, as the Buyer/Trustor,
   and ______________________________, as the Seller/Beneficiary,
   1.3 regarding real estate referred to as ______________________________
   ______________________________.

AGREEMENT:

2. Provided Trustor is not in default on the Beneficiary's trust deed, Beneficiary will, on written request of Trustor, subordinate their trust deed to a new first trust deed loan to be obtained by Trustor prior to ____________, 20 ____.
3. The terms of the new first trust deed loan will include:
   3.1 A principal amount not to exceed $____________.
   3.2 An annual rate of interest not exceeding ____ %.
   3.3 Interest to accrue on the remaining balance at a ☐ fixed rate, or ☐ adjustable rate.
   3.4 A term not less than ______ years, and not more than ______ years.
   3.5 Amortization of the loan payable monthly over ______ years ☐ until paid, or ☐ with a final/balloon payment due in not less than ______ years.
   3.6 Origination fees and finance charges to be disbursed from the loan proceeds may not exceed ______ points and $______________, respectively.
   3.7 Other ______________________________
4. ☐ Trustor is to use the net proceeds from this loan to improve the real property, both onsite and offsite. The primary construction to be ______________________________
5. ☐ Trustor is to use the net proceeds from this loan to pay ______________________________
6. Trustor is to receive $______________ cash back from the loan proceeds. These funds to be used for the following purpose(s) ______________________________
7. ☐ **NOTICE: This subordination agreement contains a provision allowing the person obligated on your real property security device to obtain a loan, a portion of which may be expended on purposes other than improvements on the real property.**

☐ See attached Signature Page Addendum. [RPI Form 251]	☐ See attached Signature Page Addendum. [RPI Form 251]
Date: ______________, 20______	Date: ______________, 20______
Buyer/Trustor: ______________	Seller/Beneficiary: ______________
Buyer/Trustor: ______________	Seller/Beneficiary: ______________

FORM 281 03-11

to record a first mortgage on the property and the seller to carryback a second trust deed to secure a note they receive for a portion of the sales price. [See **RPI** Form 150 §§8 and 8.6]

The seller's broker negotiating a carryback transaction has a duty as the seller's agent to inform the carryback seller about the risks of a *concurrent* or *future subordination*. Further, they need to give the advice before the seller enters into a purchase agreement to sell a property on carryback terms as a carryback creates different lender-type risks of loss their seller is not likely to understand.

The failure of the seller's broker to advise the carryback seller about these lender-type risks of loss subjects the broker to liability for any losses sustained by the seller due to the broker's neglect to inform them of the risk.[1]

A buyer's broker who negotiates the terms of a subordination agreement as the exclusive agent of the buyer needs to be certain the subordination agreement is sufficiently complete in its terms to be enforceable by the buyer. If not, the error subjects the buyer's broker to liability for the losses incurred by the buyer due to the inability to later enforce the subordination agreement and record a mortgage.

Terms for subordination

A future subordination agreement needed by a buyer in a carryback transaction to meet their expectations for financing their future use of a property is set out in an attachment to the purchase agreement. When the buyer is to originate a new first mortgage in the future and the seller's carryback trust deed is to remain of record, the recorded carryback trust deed needs to provide for subordination of the carryback mortgage since it will not yet be paid in full and reconveyed.

When the seller accepts the purchase offer, the attached subordination agreement is used in the escrow process. On the close of escrow, the agreement to subordinate (or its replacement) will be recorded as an attachment to the carryback trust deed.

For a subordination agreement to be enforceable, provisions in the agreement need to include:

- the maximum principal amount of the new mortgage;
- the maximum interest rate;
- the type of interest rate — variable or fixed;
- the repayment schedule;
- the minimum and maximum length of time prior to the due date for the final/balloon payment;
- the financing charges to be added to or deducted from the principal; and
- a description of the purpose and use of the mortgage proceeds. [See Form 281]

Even when the subordination agreement adequately states the parameters of the new mortgage, it may otherwise be unenforceable. The *final test* of the enforceability of any subordination agreement is the *reasonableness* of the risks of loss placed on the seller by subordination.

A subordination agreement, to be enforceable, may not subject a carryback seller to more than a *fair and reasonable* risk of loss at the time of the subordination.[2]

1 **Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860

2 Calif. Civil Code §3391

Concurrent vs. future subordination

Consider a buyer who agrees to purchase real estate on terms calling for the seller to carry back a note secured by a trust deed. A provision in the purchase agreement calls for the carryback mortgage to be junior to a new first mortgage to also be recorded on the close of escrow, called a *concurrent subordination agreement*. [See **RPI** Form 150 §8]

Sequentially on the close of escrow, the lender's trust deed is recorded first with the seller's carryback trust deed recorded second in time. Since the trust deed recorded first automatically receives priority, the **concurrent recording** of the seller's carryback trust deed second in time makes it junior and subordinate to the trust deed held by the lender.

Prior to closing, the seller's ownership interest in the property was not subject to the lender's mortgage. On closing the sale, the seller receives a security interest in the property subordinate to a lender's mortgage not previously affecting their interest in title, a change of position exposing the seller to a greater risk of loss.

In contrast, a *future subordination agreement* calls for a carryback seller on the buyer's later request of the seller to take the necessary steps to subordinate their recorded carryback trust deed to a new mortgage to be originated by the buyer.

A recorded carryback trust deed with an attached future subordination agreement is loosely called a *subordinated first trust deed* — it records first in time. However, on the later execution of a *specific subordination agreement* by the carryback seller as agreed, the carryback trust deed becomes second in priority and subject to the terms of a later recorded trust deed.

Purchase-assist mortgage or construction loan

The enforceability of a subordination agreement under the *reasonable-risk doctrine* depends on:

- whether the subordination is concurrent or is to occur in the future; and
- the purpose of the mortgage to be given priority.

For example, a seller agrees to carry back a mortgage which on the close of escrow will be subordinate to new **purchase-assist financing** with principal not to exceed a fixed percentage of the purchase price or a set dollar amount, an arrangement called a *concurrent subordination*. The mortgage proceeds will be used exclusively to fund a portion of the purchase price paid to the seller for the property. [See **RPI** Form 150 §8]

However, the subordination provision in the purchase agreement does not state the maximum interest rate or other financial parameters for installments and the term of the purchase-assist mortgage. [See **RPI** Form 150 §§6 and 8.6]

The carryback seller attempts to cancel the purchase agreement, claiming the purchase agreement's subordination provision is unenforceable since it fails to specify the maximum interest rate and installment schedule on the new purchase-assist mortgage the carryback trust deed with be junior to.

Can the buyer enforce a subordination provision in the purchase agreement which does not specify the interest rate and installment parameters for the new purchase-assist mortgage when the seller carries back a trust deed note?

Yes! A carryback trust deed subordinated by agreement to a purchase-assist mortgage provides the seller with a security interest in the property they sold. The carryback trust deed is junior to a mortgage from which the seller received all the net proceeds and no funds were to be used to improve or add value to the property.

Thus, the agreement to subordinate a carryback trust deed to a purchase-assist mortgage without establishing the interest rate or payment parameters is enforceable. The agreement is *just and reasonable*. Here, the seller receives all the net proceeds of the mortgage no differently than had they placed the mortgage on the property themselves. Further, no impairment of the seller's junior trust deed exists, such as the need to complete construction to provide improvements as additional security for the carryback seller to render the subordination agreement unenforceable.[3]

Argument to subordinate to a construction loan

In contrast, an agreement to subordinate a carryback trust deed to a trust deed securing a **construction loan** requires specification of all essential aspects of the *construction loan* in the subordination agreement. Here, the purpose for the loan is not to fund the acquisition of the property, but to construct improvements which will become additional security for the carryback trust deed.

However, the specific terms and conditions of a loan to be negotiated and recorded in the future are not known at the time a buyer enters into a purchase agreement. To require specific details concerning the exact amount, precise monthly payments, a stated rate of interest and a specific due date for the construction loan is usually too inflexible to establish a meaningful arrangement for a buyer.

Thus, an agreement to subordinate to a construction loan is reasonable and enforceable when it includes parameters for the new loan's terms and conditions, such as stating the loan amount as either:

- a maximum dollar amount;
- a percentage of the construction costs; or
- the completed value of the property.

Additionally, the maximum interest rate and minimum term for repayment of the construction loan needs to be included. Loan amounts, interest rates, repayment terms and use of proceeds for construction have consequences on the carryback seller's risk of loss of their security interest held under their recorded trust deed. Thus, the scope of the risk undertaken by the seller needs to be spelled out in the agreement to subordinate, and be reasonable to be enforced.[4]

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3 **Ray Thomas Enterprises** v. **Fox** (1982) 128 CA3d 361

4 **Stockwell** v. **Lindeman** (1964) 229 CA2d 750

Specific subordination to a future mortgage

A *specific subordination agreement* contains the pertinent terms for a mortgage to be secured by a trust deed lien which when recorded is given priority over a previously recorded carryback trust deed. Entering into the specific subordination agreement is the performance the seller previously agreed to in the future subordination agreement attached to the carryback trust deed.

For a concurrent subordination of a carryback trust deed at the close of escrow, a separate specific subordination agreement is not required. To set priorities, the carryback trust deed is actually recorded second in time to the recording of a first trust deed, per instruction to escrow. [See **RPI** Form 150 §8]

For example, after recording a carryback trust deed containing a future subordination agreement, the buyer obtains a commitment for a construction loan. The buyer makes a demand on the carryback seller to subordinate their trust deed to the construction loan in compliance with the future subordination agreement.

To actually subordinate the carryback trust deed, the seller signs a separate specific subordination agreement, a form provided by the title insurance company issuing the policy insuring the priority of the construction loan. The specific subordination agreement is then recorded with the construction loan trust deed, completing the performance of the seller's prior promise to subordinate their trust deed.

Construction lender's duty

When subordinating a carryback trust deed to a construction loan, a seller's chances for recovery of the unpaid balance of their sales price are no better than a buyer's competency and business acumen, or the adverse consequences of a cyclical local or general economic downturn — a recession.

When a seller subordinates their trust deed to a construction loan, they bet on an anticipated **increase in value** of the property created by the construction. Until construction of improvements is complete, the property is over-encumbered. Thus, without completion of planned improvements, the value of the property will be less than the amount of the construction loan.

When construction is not completed, a property's value will fail to increase as anticipated. Without a completed structure or improvements, a carryback seller faces the loss of their trust deed security interest in the property to foreclosure by the construction lender.

However, the construction lender has a duty owed to the carryback seller to properly disburse the construction loan proceeds.

For example, consider a seller who subordinates their trust deed to a construction loan. The loan's net proceeds will fund the cost of improvements on the property. The construction lender is aware the seller has subordinated their trust deed to the lender's construction loan.

The lender controls the disbursement of funds from the construction loan. However, the construction lender allows the buyer to use funds for non-construction purposes.

The misappropriation of loan funds for non-construction purposes leaves insufficient funds to complete construction and the project is abandoned. Thus, the property value does not increase as anticipated to support the balance owed both the construction lender and the carryback seller.

The construction lender forecloses on the real estate and the subordinated trust deed held by the seller is wiped out — the note's security exhausted by the foreclosure sale. No excess funds from the foreclosure sale exist beyond the debt owed the lender.

The seller claims the construction lender's misappropriation of loan funds caused their trust deed to become worthless. Thus, they have priority over that portion of the loan funds improperly disbursed.

Does the seller have priority over the construction loan amounts which were misappropriated for non-construction purposes?

Yes! The seller is entitled to those funds from the foreclosure sale, whether paid by a cash bidder or the lender's credit bid, in excess of the construction loan funds dispersed for construction purposes. The recovery is of course limited to the amount due the seller on their second trust deed. The construction lender voluntarily took control of the disbursement of the construction loan, aware the carryback seller subordinated their trust deed to the construction loan in reliance on the funds being applied to construction purposes only.[5]

Involuntary future subordination

Consider a carryback seller who subordinates their trust deed to a senior mortgage. The senior mortgage holder, without the consent of the carryback seller, later *modifies the note* by increasing the interest rate and mortgage amount, and shortening the due date on the note.

After the modification, the buyer defaults in payments. The mortgage holder forecloses, wiping out the seller's junior trust deed interest in the property.

However, the seller claims their trust deed was not eliminated by the foreclosure since their trust deed became senior to the mortgage holder's trust deed on the date the mortgage holder materially modified the note and in doing so **impaired** the seller's interest in the property without their consent, called an *involuntary subordination*.

Is the carryback seller's trust deed senior to the mortgage holder's trust deed as a result of the modification and thus unaffected by the foreclosure sale?

Yes! The carryback seller's trust deed took priority over the mortgage holder's trust deed at the time of the modification. The mortgage holder's trust deed became subordinated due to the modification since the note modification

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5 **Middlebrook-Anderson Co.** v. **Southwest Savings and Loan Association** (1971) 18 CA3d 1023

significantly increased the risk of default and foreclosure causing the first trust deed securing the modified note to **lose priority** at the time of the modification.

Upon foreclosure, the mortgage holder acquires ownership and title to the property since the owner defaulted. Thus the mortgage holder's ownership of the property is subject to the seller's carryback trust deed since the mortgage holder's trust deed lost priority to the carryback seller's trust deed due to a material modification of the debt secured by the first trust deed without the carryback seller's consent.[6]

Recasting the first

Consider a seller who carries back a second trust deed on the sale of property, junior to an existing first mortgage previously placed on the property by the seller. The seller did not obtain a *waiver* from the first mortgage holder to avoid enforcement of their due-on clause at the time of the sale, commonly called an **assumption**.

assumption
A promise to pay the debt of another, typically a mortgage, given by a buyer of property.

The first mortgage holder learns of the sale and calls the mortgage under the due-on and acceleration clauses in the trust deed. To avoid the mortgage holder's call, the buyer negotiates an *assumption* of the first mortgage with the mortgage holder. The note is modified by increasing the interest rate and shortening the due date. The buyer defaults on the modified first mortgage. The mortgage holder forecloses, wiping out the seller's trust deed.

The carryback seller claims their second trust deed now has priority over the trust deed securing the senior mortgage since the modification substantially impaired the carryback seller's security by increasing the risk of default and foreclosure.

The mortgage holder claims its trust deed retained priority on the modification since the mortgage holder owes no duty to the carryback seller to obtain the seller's consent to a modification when the seller breached the due-on clause.

Does the lender have a duty to the second trust deed holder who violated the lender's due-on clause to obtain their consent prior to the modification?

No! The modification of the note secured by the first trust deed does not result in a change in trust deed priorities, in part or in whole. Here, the junior trust deed was created without the mortgage holder's consent, in violation of the due-on clause in the mortgage holder's trust deed.

The mortgage holder owes no duty to a carryback seller who violates the terms of the mortgage holder's due-on provision in its trust deed, to obtain the seller's consent to a modification of the mortgage holder's note when the buyer assumes the mortgage.[7]

6 **Gluskin** v. **Atlantic Savings and Loan Association** (1973) 32 CA3d 307

7 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869

In a related situation with an entirely different result, a second trust deed is recorded without violating any provisions in the existing first trust deed. Later, the first trust deed holder modifies their note by extending its maturity date and increasing the principal amount.

The modification adversely affects the second mortgage holder's security interest by exposing them to a greater risk of loss.

On discovery of the modification, the second mortgage holder claims the first mortgage lost its priority and is now second in priority to their trust deed since they did not consent to the modification which impaired their security.

In this example, the first mortgage did not lose its priority. However, the modifications made to the first trust deed note were entered into after the second mortgage was recorded. Thus, the **modification arrangements** are junior to the second mortgage when a foreclosure occurs or the modified mortgage is paid off by the second mortgage holder after foreclosing.

Due to the loss of priority for the modifications, the second mortgage holder retains the right to enforce the terms of the first mortgage as they existed before the first mortgage was modified. The modifications are enforceable against the owner, but not the second mortgage holder.[8]

Thus, when the second mortgage holder forecloses, the modified portion of the first trust deed which was junior to the recording of the second mortgage is eliminated along with the owner's interest.

Waiver of the subordination agreement

A buyer's enforceability of a concurrent subordination provision in a purchase agreement and escrow instructions for a carryback transaction will only, if ever, be in dispute prior to the close of escrow. Subordination will occur on the close of escrow, if it is to occur at all.

Conversely, neither a buyer nor a seller can refuse to close escrow based on the unenforceability of a fully negotiated *future subordination agreement*.

The time for determining the enforceability of a future subordination agreement is when the buyer makes a demand on the seller to sign the specific subordination agreement and allow the recording of a new mortgage with priority, not before the sales escrow closes. The request to subordinate (and thus any subordination) takes place after the close of escrow, at a later time when the buyer obtains a new mortgage commitment and makes a demand on the seller to actually subordinate their trust deed.[9]

When a concurrent subordination provision in a purchase agreement for a carryback transaction which calls for the priority of a purchase-assist mortgage is challenged as unenforceable, flexibility exists for the buyer. Thus, the buyer may to waive the provision before escrow closes. Here, the buyer's

8 **Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576

9 Stockwell, *supra*

waiver of the concurrent subordination provision does not render the entire purchase agreement unenforceable since the buyer does not seek to enforce the provision when waived.

For example, consider a carryback seller who refuses to close escrow. The buyer makes a demand on the seller to specifically perform on the purchase agreement by closing escrow. The purchase agreement contains a subordination provision calling for the concurrent subordination of the carryback mortgage to a construction loan on the close of escrow.

However, the subordination provision in the purchase agreement fails to establish the parameters of the essential terms of the construction loan to state the risks the seller is willing to take.

As a result, the seller claims the entire purchase agreement is unenforceable since the subordination provision is **fatally defective**.

However, the buyer **waives** their right to enforce the subordination provision and seeks to enforce the remaining terms and provisions of the purchase agreement.

May the buyer waive the defective and unenforceable subordination provision and then enforce the remainder of the purchase agreement?

Yes! The buyer may waive a subordination provision in the purchase agreement calling for the concurrent subordination of the seller's carryback trust deed while leaving the remainder of the purchase agreement intact. Here, the subordination provision was included solely for the **buyer's benefit**. Thus, the purchase agreement is enforceable even when its provisions for subordination are not, provided the subordination agreement is unconditionally waived before the buyer makes a demand on the seller to close escrow.[10]

10 **Reeder** v. **Longo** (1982) 131 CA3d 291

Chapter 17 Key Terms

A seller who agrees to carryback a mortgage to help the buyer finance the purchase of their property enters into a subordination agreement as a provision in the purchase agreement. When the mortgage holder is a carryback seller, subordination means accepting a less secure and more risky position for their trust deed lien on either the close of escrow or a later recording of a new trust deed than the equity position they hold as owner.

The subordination of a trust deed lien may be voluntary or involuntary, with different consequence for the junior mortgage holder.

Subordination exposes a carryback seller to an increased risk of loss when compared to the title position they held before subordinating their trust deed.

The seller's broker negotiating a carryback transaction has a duty as the seller's agent to inform the carryback seller about the risks of a concurrent or future subordination. A buyer's broker who negotiates the terms of a subordination agreement as the exclusive agent of the buyer needs to be certain the subordination agreement is sufficiently complete in its terms to be enforceable by the buyer.

On the close of escrow, the agreement to subordinate is recorded as an attachment to the carryback trust deed.

An agreement to subordinate a carryback trust deed to a purchase-assist mortgage without establishing the interest rate or payment parameters is enforceable. In contrast, an agreement to subordinate a carryback trust deed to a trust deed securing a construction loan requires specification of all essential aspects of the construction loan in the subordination agreement.

When a seller subordinates their trust deed to a construction loan, they bet on an anticipated increase in value of the property created by the construction. The construction lender has a duty owed to the carryback seller to properly disburse the construction loan proceeds. When construction is not completed, a property's value will fail to increase as anticipated. Without a completed structure or improvements, a carryback seller faces the loss of their trust deed security interest in the property to foreclosure by the construction lender.

A senior mortgage holder who modifies their note without the consent of the carryback seller becomes subordinated and loses priority at the time of the modification. However, when a carryback trust deed is created without the existing mortgage holder's consent and violates the terms of the mortgage holder's due-on provision in its trust deed by not obtaining a waiver, the mortgage holder owes no duty to the junior mortgage holder to obtain the seller's consent to a modification of the mortgage holder's note when the buyer assumes the mortgage.

When a concurrent subordination provision in a purchase agreement for a carryback transaction which calls for the priority of a purchase-assist mortgage is challenged as unenforceable, the buyer may to waive the provision before escrow closes. The buyer's waiver of the concurrent subordination provision does not render the entire purchase agreement unenforceable since the buyer does not seek to enforce the provision when waived.

Chapter 17 Key Terms

Chapter 18

Converting nonrecourse debt to recourse debt

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the liability distinctions between recourse and nonrecourse debt; and
- understand how a nonrecourse mortgage becomes recourse debt through later agreements.

Key Terms

anti-deficiency
nonrecourse mortgage
reconveyance
recourse
subordination

Eliminating or substituting the security

Consider a seller who holds a carryback mortgage secured solely by a junior trust deed on real estate they sold. The carryback mortgage is considered **nonrecourse** debt since it is incurred to purchase property. Thus, a deficiency in the value of the mortgaged property to provide a full recovery of the debt in the event the buyer defaults is protected by **anti-deficiency** rules, and is therefore not collectible.

anti-deficiency
A limitation placed on a mortgage holder barring recovery of losses on a default resulting when the mortgaged property's value is insufficient to satisfy a nonrecourse mortgage debt, and a recourse mortgage debt if nonjudicially foreclosed.

Later, the buyer defaults. On investigating the financial feasibility of foreclosing and selling the property, the seller decides to forgo foreclosure. [See Form 303 in Chapter 21]

The buyer locates mortgage financing which will allow them to retain the property if the seller will agree to **subordinate** their mortgage to the new mortgage obtained by the buyer.

reconveyance
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

The seller offers to cancel the note and **reconvey** their trust deed. In exchange, the buyer is to execute a new note in favor of the seller for the debt owed secured by a junior trust deed on real estate other than the property sold. Thus, the buyer provides security – a trust deed position on another property – which the seller accepts.

By mutual agreement between the buyer and the seller:

- the seller cancels the carryback note and *reconveys* the trust deed releasing the property they sold; and
- the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer and subject to an existing mortgage.

Substitution of security

To continue our previous example, the buyer provides *substitute security* for an existing debt owed to the seller. The new note merely evidences the same carryback debt represented by the cancelled note, but secured by other property.

Later, the buyer defaults on the senior mortgage of the substitute security and the mortgage holder forecloses. The forclosure eliminating the seller's mortgage from title, called an **exhaustion of the security**.

Since the carryback seller's substitute-security interest has been eliminated and the buyer refuses to pay on the carryback debt, the carryback seller sues the buyer on the note to obtain a money judgment for the unpaid amount of the carryback debt.

nonrecourse mortgage
A mortgage subject to anti-deficiency laws which do not permit the mortgage holder (lender or carryback seller) to pursue a borrower to collect any loss due to a deficiency in the value of the secured property on foreclosure or a short payoff.

The buyer claims the seller is barred by *anti-deficiency* rules from collecting on the note since the note evidences a *nonrecourse* debt created by the buyer and the seller to finance the purchase of real estate.[1]

The carryback seller claims anti-deficiency rules no longer bar them from obtaining a money judgment on the carryback debt since the debt was no longer secured by the property sold and the substitute security was eliminated by foreclosure of a senior mortgage.

Is the seller able to enforce collection of a carryback debt which became secured, separately or collaterally, by real estate other than the property sold?

Yes! The seller may obtain a money judgment to enforce collection on the note even though it evidences a carryback debt.

Anti-deficiency rules no longer apply to a carryback debt when the debt becomes secured by real estate other than the property sold, called a **substitution of security**. Further, the carryback seller is able to sue directly on the note without first judicially foreclosing since their substitute-security interest in another property was exhausted when the senior mortgage holder foreclosed.[2]

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1 Calif. Code of Civil Procedure §580b

2 **Goodyear** v. **Mack** (1984) 159 CA3d 654

If a seller is barred from obtaining a money judgment to enforce collection of a carryback note secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property they purchased.

Subordination to a construction loan

Construction loans are inherently precarious arrangements. They carry the risk that improvements which will provide security for repayment of the debt may never be completed to create the anticipated property value.

For example, consider a carryback seller who subordinates their trust deed to a trust deed recorded to secure a *construction loan*. The loan will fund the cost of improvements to be made on the property they sold. Since the carryback mortgage is subordinated to the mortgage securing the construction loan, the risk of loss due to a failure of the development is thrust upon the seller.

To cover the added risk of loss presented by the buyer's need to add value to the property by completing the construction, the note's interest rate is increased. Further, interest is prepaid for the period anticipated for construction.

Here, the carryback mortgage becomes a **recourse debt** since it is subordinated to a new trust deed securing a construction loan. The seller is not expected to assume the risk that the value of the yet-to-be-built improvements may not prove to be adequate security for their carryback mortgage and thus cause them to suffer a loss.

recourse
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

Essentially, the developer/buyer who promises to construct improvements as **additional security** is not protected by anti-deficiency rules from personal liability if the value of the property proves to be inadequate to satisfy the subordinated carryback mortgage. As a *recourse debt*, the seller is allowed to judicially foreclosure to collect their losses from the developer if the property value at the time of the sale is insufficient to satisfy the carryback debt.[3]

Agreement to subordinate a security interest

However, an **agreement to subordinate** a carryback mortgage to a future mortgage for a construction loan does not itself cause the mortgage to lose its nonrecourse character. [See Form 281 in Chapter 17]

It is the actual subordination to the recording of a mortgage securing a construction loan that causes the carryback mortgage to become a recourse debt.[4]

subordination
The rearrangement of mortgage lien priorities on title in which a mortgage lien takes a lesser or junior position to another mortgage lien on a property.

Conversely, the subordination of a carryback mortgage as junior to a buyer's purchase-assist mortgage, or a later refinancing of a senior mortgage, does not present a change in the use or nature of the property as security for the carryback.[5]

3 **Spangler** v. **Memel** (1972) 7 C3d 603
4 **Jack Erickson and Associates** v. **Hesselgesser** (1996) 50 CA4th 182
5 **Shepherd** v. **Robinson** (1981) 128 CA3d 615

When a carryback seller agrees to subordinate their carryback mortgage to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no construction of improvements promised) or the nonrecourse nature of the seller's (now under-secured) carryback mortgage.[6]

A seller who carries back a mortgage, secured only by a subordinated interest in the property sold, is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

For example, a lack of value may exist at the time of the subordination. Additionally, a market-induced reduction in the value of the property sold may later occur due to overpricing, a recession or other event that lowers a property's value (other than *waste*). Here, the buyer is not personally liable on a carryback mortgage secured by the property sold, even if the mortgage is later subordinated to new financing which is not a construction loan.[7]

Does choice-of-law avoid anti-deficiency rules?

Consider a buyer who executes a purchase-assist mortgage secured by a trust deed on California real estate. The note contains a provision which adopts the law of another state to control the legal consequences of the mortgage financing.

Both the buyer and the lender are based in a state which does not have anti-deficiency laws.

The buyer defaults on the mortgage. The lender judicially forecloses on the property and is awarded a deficiency judgment.

The buyer claims the lender is barred from recovery by way of a deficiency judgment since the debt is secured by California real estate and is therefore subject to anti-deficiency rules.

The lender claims it is not barred from seeking a deficiency judgment since the transaction is governed by the laws of another state which allow for a deficiency judgment on a purchase-assist mortgage.

Is the lender entitled to a deficiency judgment?

Yes and no!

The yes part: The trust deed contained a choice-of-law provision which controls enforcement of the California purchase-assist mortgage under **out-of-state law** which does not have anti-deficiency protections. Here, the buyer and lender are not California residents and are based out-of-state.

As a result, California's public policy regarding anti-deficiency is not adversely affected since no California residents are involved. Thus, the deficiency in the value of the mortgaged property to cover the debt is collectible by a money judgment.[8]

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6 **Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462

7 **Brown** v. **Jensen** (1953) 41 C2d 193

8 **Guardian Savings and Loan Association** v. **MD Associates** (1998) 64 CA4th 309

*Editor's note — The no part: The **Guardian** court's holding is limited to the narrow residency facts of the case, i.e., the buyer and lender were not California residents, were based out-of-state and chose to abide by the laws of a "recourse state." Conversely, to allow **choice-of-law provisions** applying the laws of a recourse state to a **resident owner** of property located in California would impermissibly open the door for out-of-state lenders to circumvent California's anti-deficiency laws designed to protect its residents from the vicissitudes of the real estate market.*

Further, choice-of-law provisions also apply to seller-carryback financing where both the buyer and seller reside in a "recourse state."

Reconveying to become unsecured

A mortgage holder may not **unilaterally waive and reconvey** the security for a debt, then proceed against the borrower as though the debt – now unsecured – was converted to a recourse debt by the release of the security.

A release of the security needs to be *mutually agreed to* by the mortgage holder and property owner for the secured debt to become a recourse debt.

For example, consider a carryback seller who holds a note for the balance due on the purchase price of real estate. The note is secured by a junior trust deed on the property sold.

The property value has decreased below the amount owed on the note due to a cyclically-destabilized real estate market. The buyer defaults and the seller considers a pre-foreclosure workout arrangement.

The carryback seller agrees with the buyer to modify the terms of the note and release the security. The carryback seller senses the security interest they hold under the junior mortgage on the property is insufficient in value to fully recover the debt if the senior mortgage holder forecloses.

By agreement, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See **RPI** Form 472]

Modification of the note

Continuing our previous example, the **Modification of the Promissory Note**, executed by the buyer in favor of the seller, is attached to the note as an **allonge.** It states the changes in its terms and the release of the trust deed lien by reconveyance. [See **RPI** Form 425]

Later, the buyer defaults on the now unsecured note held by the carryback seller. In turn, the seller sues the buyer for a money judgment to recover the balance due on the note.

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note evidenced a nonrecourse debt as it was created to finance the sale of the property.

Letters of Credit

A lender may require a borrower to obtain a letter of credit as a condition for funding a purchase-assist mortgage. Also, a seller agreeing to carry back a mortgage may demand a letter of credit as additional security.

The lender or carryback seller may draw on a letter of credit before or after a trustee's sale without violating anti-deficiency statutes or the security first rule which requires the agreed-to security be exhausted first before pursuing other remedies. [Calif. Code of Civil Procedure §580.5(b)]

However, the letter of credit is unenforceable if:

- *it is issued to a mortgage holder to cover a future default on the mortgage debt; and*
- *the mortgage debt is subject to an anti-deficiency defense for funding the purchase of an owner-occupied, one-to-four unit residential property. [CCP §580.7(b)]*

Thus, a carryback seller or a purchase-assist lender on a one-to-four unit residential property intended to be occupied by the buyer is barred from drawing on a letter of credit at any time.

However, the anti-deficiency rules no longer apply to the carryback debt. The buyer and seller mutually agreed to a reconveyance of the trust deed to release the security initially provided for repayment of the debt on a default.

The carryback seller may pursue the buyer to collect the balance due on the note since the security was released by *mutual agreement*.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — does not advance the purposes of anti-deficiency rules. To bar recovery would allow the buyer to realize a windfall profit as they would be able to both:

- keep the property; and
- pay less than the agreed-to price.

The unsecured carryback seller's lien rights

In contrast, the debt on a carryback mortgage which becomes unsecured by mutual agreement is legally distinct from the debt on a carryback note which was *unsecured from the outset* of the sales transaction, even though both are recourse debts.

A seller who carries back an unsecured note on the close of a sales transaction has a **vendor's lien right** which they may impose on the property sold and then judicially foreclose (if it is still owned by the buyer). Here, the note was unsecured at all times and represents the debt owed for the purchase price remaining unpaid, contrary to the note held by the initially secured carryback seller.[9]

9 Calif. Civil Code §3046

In a related situation, a lender or carryback seller who requires a buyer to execute two notes for the *same debt* — one note stating it is secured by the real estate purchased, the other purportedly unsecured — is barred from collecting a deficiency on the debt. The underlying debt, evidenced in its entirety by each of the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which may only be collected from the value of the property sold.[10]

Additional security

Now consider the holder of a nonrecourse mortgage which is a senior trust deed lien on a parcel of real estate. Local real estate values have become depressed, causing the real estate occupied by the buyer as their personal residence to no longer be adequate security for the note, a condition called **negative equity**.

The owner defaults on the note. To cure the default, the mortgage holder and owner mutually agree:

- to modify the terms of the note; and
- the owner will additionally secure the note by executing a trust deed to create a lien on another property they own.

Later, the owner defaults again. The mortgage holder judicially forecloses on both the owner's personal residence and the additional security. A deficiency exits after the two properties are sold, leaving the debt unsatisfied.

May the mortgage holder obtain a money judgment to collect the deficiency in value when judicially foreclosing on both the buyer's residence and the additional security?

Yes! Anti-deficiency rules do not bar the mortgage holder from pursuing a money judgment when a nonrecourse debt becomes **additionally secured** by executing a trust deed lien on another property.[11]

However, a mortgage holder seeking a money judgment on a recourse debt needs to concurrently foreclose on all of the secured properties in one judicial foreclosure action. No **piecemeal foreclosure sales** are allowed under a judicial foreclosure when multiple properties are used as security and a deficiency judgment is sought.[12]

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10 **Freedland** v. **Greco** (1955) 45 C2d 462

11 CCP §580b

12 CCP §726(a)

Chapter 18 Summary

A carryback mortgage is considered a nonrecourse debt since it is an extension of credit by the seller to purchase the property sold. A deficiency in the value of the mortgaged property to provide a full recovery of the debt on a default is protected by anti-deficiency rules and not collectible.

When carryback debt becomes secured by real estate other than the property sold, called a substitution of security, anti-deficiency rules do not apply.

Construction loans provide for future improvements and increased property value which will provide additional security for repayment of the debt. A carryback mortgage becomes a recourse debt when it is subordinated to a new trust deed securing a construction loan.

A seller who carries back an unsecured note on the close of a sales transaction has a vendor's lien right which they may impose on the property sold and then judicially foreclose.

However, when a lender or carryback seller who requires a buyer to execute two notes for the same debt, one note stating it is secured by the real estate purchased and the other purportedly unsecured, the debt is secured and considered nonrecourse debt. Thus, the carryback seller or lender is barred from collecting a deficiency on the debt.

When a nonrecourse debt becomes additionally secured by executing a trust deed lien on another property, anti-deficiency rules do not bar the mortgage holder from pursuing a money judgment. However, a mortgage holder seeking a money judgment on a recourse debt needs to concurrently foreclose on all of the secured properties in one judicial foreclosure action.

Chapter 18 Key Terms

Chapter 19

No down payment carryback sales

Learning Objectives

After reading this chapter, you will be able to:

- understand the seller's financial risks in an installment sale structured with little to no cash down payment from the buyer;
- differentiate between recourse and nonrecourse debt; and
- analyze the steps taken to offset and reduce a seller's risk of loss in a carryback transaction.

Key Terms

anti-deficiency
blanket mortgage
collateral assignment
cross-collateralization
nonrecourse
recourse

Minimizing the risks of default

Consider a couple that decides to purchase income-producing property. They want to build a long-term real estate investment program – an estate – to create wealth for the family as an alternative to holding shares in businesses.

Each spouse earns a significant annual income, with a combined *discretionary disposable income* in excess of $125,000 annually, an amount they are prepared to commit to real estate investments.

In the past, the couple spent most of their disposable income on the costs of living the highlife. Consequently, they have accumulated insufficient cash savings for a meaningful down payment on a purchase.

Despite their lack of substantial savings, the couple's large stable income enables them to make significant additional monthly or quarterly payments to pay the seller for property they acquire, payments far greater than regular amortized monthly payments. Thus, the couple is willing to subject themselves to a self-enforcing savings program by committing themselves to **build equity** in real estate through large front-loaded debt reduction, called a **deferred down payment plan**.

The periodic installments of principal are in addition to regular monthly payments. The seller views the principal payments as a **deferral** of the cash down payment.

The additional principal payments are made during the first two years following the purchase of the property. With the couple's $125,000 in excess annual income to invest, they have the capacity to pay a seller at least an additional $200,000 in principal over a two-year period.

Terms for purchase

Continuing our previous example, at their agent's suggestion, the couple signs a purchase agreement offer to acquire a suitable income-producing property on the following terms:

- a purchase price of $1,500,000;
- no cash down payment;
- the buyer pays all closing costs;
- a note and trust deed to be executed by the buyer in favor of the seller for the entire amount of the seller's equity in the property;
- the interest rate on the note set at current mortgage rates;
- monthly payments based on a 30-year amortization schedule;
- eight additional quarterly payments of $25,000 each towards principal due on the note; and
- a 10-year due date for a final/balloon payment. [See **RPI** Form 150]

Attached to the offer is a **carryback disclosure statement** prepared by the buyer's agent. [See Form 300 in Chapter 3]

The buyer's agent delivers the offer to the seller's agent.

The risk of default and foreclosure

Before submitting the offer to the seller, the seller's agent concludes the offer, as it stands, is unsuitable for their client.

Is the seller's agent required to present the no-down offer to the seller they represent?

Yes! A seller's agent, acting on behalf of their broker, is duty bound to present *all offers they receive* to their client, regardless of content or presentation. A seller's agent must present all offers no matter what form they may take, even though they may consider an offer to be unsound or otherwise unacceptable to the client.[1]

1 *California Bureau of Real Estate Bulletin*, Fall 2013 "A Licensee's Duty to Present All Offers"

The seller's agent, on fulfilling their fiduciary duty and submitting the offer to their client, points out the carryback aspects of the offer which present additional legal and financial risks to them. These risks include:

- the seller is not cashed out since the net proceeds of the sale are in the form of a note — thus, the seller needs to consider countering with a greater down payment, a higher-than-market interest rate or a higher-than-market price for their property to compensate for the risk of loss eliminated by an all-cash sale[2];
- the carryback note evidences a **nonrecourse debt** — if the buyer defaults, the seller's only remedy is to foreclose on the property since a money judgment is not allowed on *nonrecourse debt*[3]; and
- without a down payment, cash proceeds from the sale do not exist to absorb the out-of-pocket cash costs to foreclose on a default.

nonrecourse
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

For the property to support the financial burdens imposed on the carryback seller by a foreclosure, an equity of no less than 10% to 15% needs to exist in the property above the seller's carryback mortgage. Without a cash down payment large enough to generate net cash proceeds for the seller on closing, the buyer has no net equity in the property at the time of closing.

Foreclosure Cost Sheet

To demonstrate the financial risk facing the seller if the buyer defaults and the seller forecloses, the seller's agent prepares a **Foreclosure Cost Sheet** and reviews it with the seller. Using the cost sheet, the agent reveals the costs the seller will incur during a foreclosure and later resale of the property. The disclosure is used to estimate the cash reserves the seller needs to cover the costs of foreclosure on the property. [See Form 303 in Chapter 21]

The seller's agent also prepares a **carryback disclosure statement** on a form designed to comply with mandatory financial and legal disclosures for carryback sales of one-to-four unit residential properties. Although its specific use is not required on other types of property, the financial disclosures of carryback consequences still fully apply and may be documented with the *carryback disclosure statement* designed for one-to-four unit residential properties. [See Form 300 in Chapter 3]

Presenting the offer with advice

The seller's agent owes a fiduciary duty to the seller of care and protection by providing advice throughout the transaction. When presenting an offer to the seller, the seller's agent needs to disclose aspects of the proposed transaction which are *known or readily knowable* by the agent that might affect a prudent seller's decision to accept or reject the offer.

This advice includes:

- the **legal aspects** of carryback financing since the seller takes on the rights and obligations of a mortgage lender[4];

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2 **Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860
3 Calif. Code of Civil Procedure §580b
4 Calif. Civil Code §2956

- the **tax aspects** of the profit and income reportable in an installment sale[5] [See Chapter 26]; and
- the **financial suitability** for the seller of the risks of loss involved in carrying a mortgage.[6]

Instead of accepting the offer or returning it as rejected, the seller's agent suggests a *counteroffer* to restructure the transaction so it is financially suitable for the seller.

The agent considers that one hundred percent carryback financing on a no-down payment transaction provides benefits for a seller (along with risks).

A seller may be motivated to enter into a no-down offer on some terms by their desire to:

- increase their likelihood of selling the property at the asking price;
- receive a monthly flow of interest income; and
- defer profit tax reporting on the sale until the principal is paid.

Seller motivation to extend financing

The seller who is willing to provide carryback financing may sell their property more readily if the property is not aggressively (properly) priced to sell for cash. Buyers often prefer to use the least amount of cash funds required for a down payment. For this reason, buyers are typically more interested in acquiring one property over another if the seller provides the financing buyers need to acquire property. Thus, seller carryback financing allows the buyer and seller to handle all the financing of the sale without the cost and effort of arranging financing with a lender.

The seller contemplating a no-down payment transaction may be motivated by benefits in tax considerations:

- no profit reported in the year of sale except for *pro rata profit* in principal received in the monthly payments through amortization;
- no debt relief occurs to trigger profit tax in the year of the sale, unless a mortgage exists with a balance greater than the seller's cost basis (in which case the seller may use an all-inclusive trust deed (AITD) note to defer taxes on that amount of profit); and
- profit in the carryback note is only reported when principal is paid or the note is assigned in a sale or as collateral. [See Chapter 26]

Default and beyond

In a little- to no-down payment carryback sale, the major legal and financial risk the carryback seller faces is a default by the buyer on the carryback mortgage. A default and failure of a pre-foreclosure workout forces the seller to initiate foreclosure to recover the amounts still owed.

Regarding foreclosure, first recall the sum of the combined amounts of the carryback mortgage, first mortgage and the costs of foreclosure and resale

5 26 United States Code §453

6 Timmsen, *supra*

are supported solely by the value of the property. Further, the amount of the down payment is insufficient to cover the cost incurred to foreclose and resell the property.

As a result, on commencing foreclosure, the seller will need to use separate cash reserves to pay the costs of foreclosure and the carrying costs of the property until resold if they are to protect the value of their security interest in the property.

Unless the property value rises after the sale, funds expended on a foreclosure by the seller in a little- to no-down payment sale will not be recovered on resale of the property.

Also, an actual decrease in the marketability, and thus the value of the property, is foreseeable due to deferred maintenance and upkeep which often accompanies a default as the buyer knows they may lose the property.

Even if the carryback seller immediately initiates the steps necessary to foreclosure on a default, completing a typical problem-free second mortgage **foreclosure and resale** of the property can easily consume cash funds equal to 15% of the property's value, paid approximately 50:50 from the seller's cash reserves and cash proceeds from a resale.

Minimizing the seller's risk of loss

All carryback sales involve some degree of risk of loss, as do all mortgages. However, a seller does not need to avoid a sale or a carryback mortgage solely because a potential risk of loss exists.

A prudent approach for the seller and their agent is to analyze the extent of the risk and take steps to *offset and cover* the risk. This is done by:

- reducing the degree of risk with a proportionately **larger down payment** sufficient in amount to cover the cost of foreclosure and resale;
- receiving a **premium** in the form of an increased price, a higher interest rate or greater principal reductions on the carryback mortgage than provided by monthly amortization; or
- acquiring **additional security**, guarantees or letters of credit.

The seller does not need to rely solely on the real estate sold to secure their carryback note in a no-down transaction. Through discussions and counteroffers, sellers negotiate with buyers for *additional security* acceptable to the seller. The additional security can be in the form of real estate or personal property owned by the buyer or others.

Also, a carryback debt becomes **recourse debt** when it is secured by property other than, or in addition to, the property sold. However, carryback debt on real estate sold with, and additionally secured by, personal property sold as part of the transaction does not become *recourse debt*.

recourse
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

anti-deficiency
A limitation placed on a mortgage holder barring recovery of losses on a default resulting when the mortgaged property's value is insufficient to satisfy a nonrecourse mortgage debt, and a recourse mortgage debt if nonjudicially foreclosed.

cross-collateralization
The use of one trust deed to describe multiple parcels of real estate or a UCC-1 financing statement encumbering personal property together with a trust deed as additional security for payment of a debt. [See **RPI** Form 436]

blanket mortgage
A mortgage which is secured by two or more parcels of real property. [See **RPI** Form 450]

With recourse debt, the seller may foreclose judicially and pursue a money judgment against the buyer if the fair market value (FMV) of the mortgaged property becomes insufficient to satisfy the seller's carryback debt at the time of the judicial foreclosure sale.[7]

On preparing and presenting a counteroffer, the carryback seller and their agent negotiates to include provisions such as:

- a **continuing guarantee** for the carryback mortgage (guarantors are not protected by **anti-deficiency** laws as is the buyer who signed the note) [See **RPI** Form 439];
- a **security interest** in personal property or other real estate, called **cross-collateralization** [See **RPI** Form 436]; and
- the **carryback of an unsecured note** for part of the price (5% to 10% of the price). [See Form 424 accompanying this chapter]

The seller can negotiate to *cross-collateralize* the carryback note by securing it by both the property purchased and other property, personal or real. *Cross-collateralization* may be used by the buyer to secure the carryback note with **one trust deed** describing multiple parcels of real estate as security for payment of the carryback note, called a **blanket mortgage**.

A *blanket mortgage* encumbering the property sold and other property provides the seller with more security and protection as the debt becomes a recourse debt. Thus, the seller is able to obtain a money judgment against the buyer when the combined market value of the properties on the date of a judicial foreclosure sale does not cover the balance due on the cross-collateralized carryback note.[8]

The brokerage fee in a no-down deal

Payment of the *brokerage fee* is a personal concern for brokers and sellers involved in minimal or no down payment transactions.

The problem is not negotiating the amount of the fee, but when and how the broker will collect the fee in a cashless transaction, as occurs in a no-down sale or an exchange of equities (properties).

In cash sales, the fee is paid in cash by the seller on the close of escrow. When the sale or exchange includes little- to no-cash down payment and no new financing to generate cash funds, the broker, like the seller, often waits to be paid.

Typically, the broker's fee in a carryback sale or exchange is paid by the seller out of the first payments made by the buyer on the carryback note.

Alternatively, the buyer may pay the broker fees by signing a separate note to the broker for the amount of the fee (and reduce the seller's carryback note by an equal amount) secured by a junior trust deed on the property acquired. The purchase price for the real estate and transaction costs incurred by the buyer remain the same.

7 CCP §580b

8 CCP §§580a, 580c

PROMISSORY NOTE — UNSECURED

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This form is used by a loan broker or escrow officer when originating an unsecured loan or seller extension of credit to a buyer without a trust deed lien on real estate, to evidence the debt owed and the terms for payment.

DATE: __________, 20_____, at ______________________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. On or before __________, 20 _____, without a grace period, or ☐ on demand,

1.1 ______________________________, as the Payor,

promises to pay to the order of:

1.2 ______________________________, as the Payee,

address ______________________________

1.3 the sum of $__________

2. Interest will be charged from Date at the rate of _____% per annum until paid.

3. Principal and interest will be payable in lawful money of the United States.

4. If a default occurs in payments when due, the entire sum of principal and interest will become immediately due at the option of the payee.

5. In any action to enforce this agreement, the prevailing party will receive attorney fees.

☐ See attached Signature Page Addendum. **[RPI** Form 251**]**

Signature of Payor: ______________________________

Signature of Payor: ______________________________

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Form 424

Promissory Note — Unsecured

However, the broker needs to understand that a note signed by the buyer and secured by one-to-four unit residential property, purchased and occupied by the buyer, is nonrecourse debt.[9]

Thus, if the buyer defaults and a senior mortgage holder (i.e., the seller) forecloses on the property, the broker's trust deed is wiped out, leaving the nonrecourse note unsecured. Here, the broker simply loses their fee.

Editor's note — This anti-deficiency rule only applies if the buyer purchases and occupies a one-to-four unit residential property. Under all other buyer situations, the broker may recover a money judgment for their unpaid services evidenced by the note previously secured by a now wiped-out trust deed.[10]

The broker considering nonrecourse debt

To avoid being wiped out by the foreclosure of a senior mortgage, a broker may wish to avoid holding a nonrecourse mortgage.

Several other options are available:

- a seller may guarantee a buyer's junior mortgage making the seller personally liable to the broker if a foreclosure wipes out the broker's security;

9 CCP §580b

10 **Kistler** v. **Vasi** (1969) 71 C2d 261

- the buyer or seller may provide property other than the real estate being sold or personal property included as part of the transaction as additional or substitute security;
- the broker may become a co-owner/beneficiary of a pro rata share of the carryback note;
- the broker may carry an unsecured note payable by the seller or by the buyer which is a recourse debt; or
- the brokerage fee may be a note signed by the seller and secured by a **collateral assignment** of the seller's carryback mortgage, a recourse debt. Here, a security agreement is needed calling for all or part of the carryback payments to be received by the broker until the brokerage fee is paid in full. When the fee is fully paid, the broker reassigns the trust deed to the seller. [See **RPI** Form 438]

collateral assignment
An agreement providing additional, cumulative and concurrent security for a debt, in the form of personal property, to additionally secure the property owner's performance under the debt. [See **RPI** Form 437 and 446]

However, the seller takes on an additional risk of loss under any arrangement in which they agree to pay the deferred broker fee. The risk arises when the buyer defaults on payments and the carryback seller is then required to pay the fee, whether or not they foreclose on the property.

If the broker owns a percentage of the carryback note, the carryback seller and the broker become partners in any foreclosure process. To avoid anarchy, they need to enter into a co-ownership agreement as the beneficiaries of the trust deed before the closing of the sales escrow. Otherwise, on a foreclosure, they need to find a way to cooperate as tenants-in-common without the benefit of a previously written co-ownership agreement, which can be chaotic.

If the broker holds a note for the fee signed by the seller, whether or not *collateralized* by the seller's carryback note, the note for the fee is a recourse debt. The seller may be forced to pay — even when the carryback sale sours and the seller is faced with a loss — unless the note held by the broker provides for relief in the event the buyer defaults on the carryback mortgage.

Chapter 19 Summary

A seller of real estate takes on financial risk when extending carryback financing to a buyer. The seller's agent prepares a Foreclosure Cost Sheet to demonstrate the financial risk if the seller ever has to recover the property on a buyer's default, including the estimated costs incurred during a foreclosure and later resale of the property.

The carryback note is a nonrecourse debt. If the buyer defaults, the seller's only remedy is to foreclose on the property.

A seller may be motivated to enter into a no-down offer on some terms by their desire to:

- increase their likelihood of selling the property at the asking price;
- receive a monthly flow of interest income; and
- defer profit tax reporting on the sale until the principal is paid.

In a little- to no-down payment carryback sale, a default by the buyer is the major financial risk the seller faces.

A carryback seller needs to promptly start a pre-foreclosure workout or foreclosure proceedings on a default due to the value of any equity securing the carryback note diminishing daily.

A prudent approach for the seller and their agent is to analyze the extent of the risk and take steps to offset and cover the risk is done by:

- reducing the degree of risk with a proportionately larger down payment sufficient in amount to cover the cost of foreclosure and resale;
- receiving a premium in the form of an increased price, a higher interest rate or greater principal reductions on the carryback mortgage than provided by monthly amortization; or
- acquiring additional security, guarantees or letters of credit.

A carryback note becomes a recourse debt when it is secured by property other than, or in addition to, the property sold, unless it is included as part of the transaction.

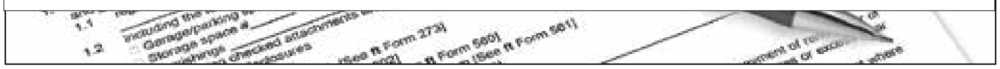
The seller may negotiate to cross-collateralize the carryback note, also known as a blanket mortgage, by securing it by both the property purchased and other property owned by the buyer.

Typically, the broker's fee in a carryback sale is paid by the seller from the first payments made on the carryback mortgage. Alternatively, the buyer may create a separate note for the amount of the broker's fee, secured by a junior trust deed on the property acquired. However, the broker needs to understand that a note secured by one-to-four unit residential property, purchased and occupied by the buyer, is a nonrecourse debt.

Chapter 19 Key Terms

Chapter 20

The down payment note



Learning Objectives

After reading this chapter, you will be able to:

- discuss a buyer's use of their equity in property they own to secure a note they execute in favor of a seller of property they want to buy, given as a down payment on the seller's price in lieu of cash; and
- understand purchase transactions involving the payment of a portion of a seller's price by executing a note carried back by the seller but secured by real estate other than the property sold.

Key Terms

all-inclusive trust deed (AITD) note
blanket mortgage
bridge loan
cross-collateralized
due-on clause
exculpatory clause
hypothecate
nonrecourse
prepayment penalty
recourse
waiver

Buying property by creating paper

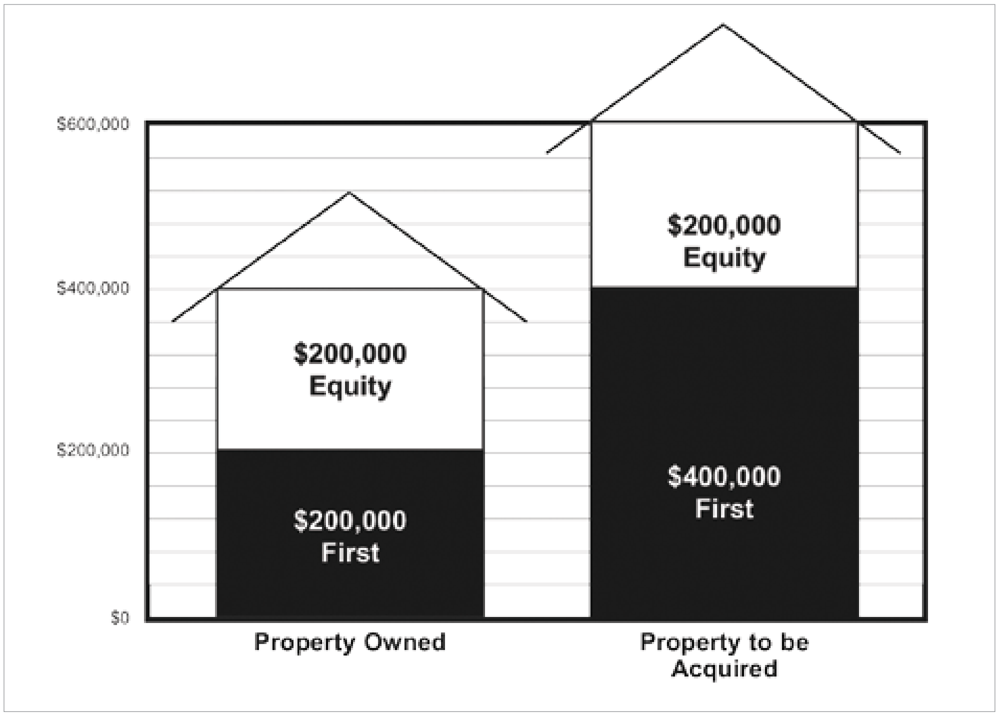
A cash-poor real estate investor, during a post-recessionary period of still weakened real estate prices and tight credit, perceives the scarcity of willing buyers on the departure of speculators as their opportunity to purchase additional real estate on favorable terms.

The investor presently owns a rental property valued at $400,000, encumbered by a first mortgage with a $200,000 balance. [See Figure 1]

However, the investor does not currently, nor in the foreseeable future, want to *sell or exchange* the real estate they now own since it is a consistent

Figure 1

Debt and Equity



income producer. Their long-term investment goal is to buy properties and then keep those which routinely produce **net operating income (NOI)** and are located in relatively recession-proof areas that are likely to appreciate in the future — primarily urban center areas.

To this end, the investor will not submit offers to buy property **contingent on the sale** of other property they own in an effort to generate cash for a down payment — even though their present cash reserves are inadequate to purchase property.

Likewise, the investor will not consider raising down payment funds by borrowing against the equity in the property they currently own due to lost time, expenses and risks involved with new financing attributable to:

- loan origination costs (points, fees, title);
- the non-negotiability of interest rates, often tied to volatile lender cost-of-funds indexes; and
- the lengthy and uncertain qualification process.

For the same reasons, the investor is not interested in arranging purchase-assist financing to buy property. Instead, they want to assume or take title subject to an existing mortgage when the interest rate and assumption fees to do so are favorable. Thus, they are not interested in cash-to-new-loan acquisitions.

To increase their holdings, the investor will place their existing equity at risk by putting it up as security to buy property on credit — financing by a different name. The factual matrix of their offer to buy another property will include:

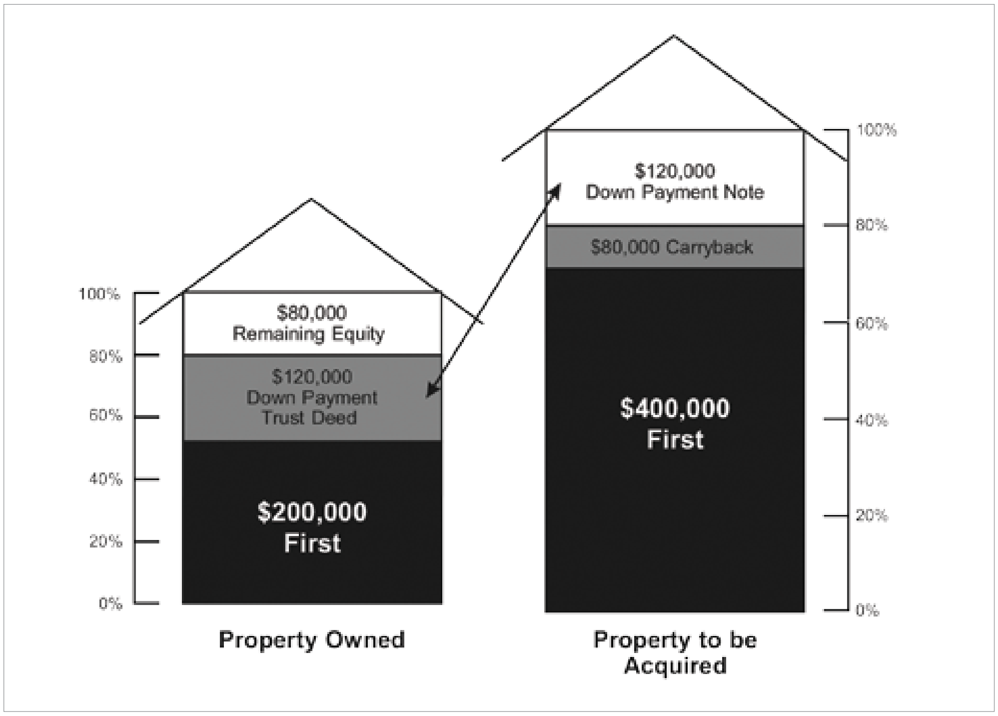


Figure 2

Papering Out the Seller

- executing a note for the dollar amount of a 20% **down payment**; and
- encumbering the property they own up to a loan-to-value ratio (LTV) of 80% with a trust deed to secure their down payment note.

Papering out the seller

With insufficient funds for a 20% cash down payment, the investor's offer to acquire property will include terms calling for them to execute an installment note for the amount of a 20% down payment, given in lieu of a cash down payment. The installment note will be secured by a trust deed on the equity in the property the investor presently owns, up to an 80% LTV. [See Form 420 in Chapter 8]

For example, consider a broker employed by the investor under an exclusive right-to-buy retainer agreement who locates a suitable property worth $600,000, encumbered by a $400,000 first mortgage. [See Figure 1]

The seller wants to liquidate their investment in the property with the goal of converting its equity into management-free interest bearing assets.

The investor's broker views the seller's aspirations as a prime match to satisfy the investor's real estate acquisition objectives.

Both the property owned by the investor and the seller's property have adequate equity to support additional financing for up to 80% of their value. Thus, both properties could be properly used as security for new institutional financing to generate enough cash to pay the entire purchase price of the seller's property — if the investor were to so choose.

An offer is prepared by the investor's broker calling for the investor to acquire the seller's real estate by creating **two notes**, both in favor of the seller and given in exchange for their equity:

1. a $120,000 **down payment note** to be secured by a second trust deed on the property presently owned by the investor; and
2. an $80,000 **carryback note** to be secured by a second trust deed on the seller's property to be purchased by the investor.

The investor is to assume or take title subject to the existing mortgage on the seller's property. [See Figure 2]

Thus, the further encumbering of both properties with second trust deeds will leave each a combined LTV of 80%, a sufficient 20%-of-value cushion to allow full recovery on the notes in the event the seller needs to foreclose on either trust deed.

By using the equity in each property and assuming the existing mortgage on the property being acquired, the investor finances 100% of the purchase price. However, some cash will be needed to pay the closing costs and brokerage fees (transaction costs which can be controlled through negotiations with providers), often called *the* **creation of wealth formula**, or **papering out the seller**.

Overlapping goals make a match

For the seller, this 100% financing arrangement meets their investment goals. Selling the property on a down payment note and a carryback note converts the seller's real estate equity into:

- investment income with a high level of safety (secured by a trust deed with an 80% LTV);
- a higher yield on the carryback notes than offered on savings accounts; and
- fairly liquid assets if the investor suddenly needs to sell or collateralize the notes to quickly obtain cash.

Instead of a $120,000 down payment in cash, the investor executes an installment note for $120,000 in favor of the seller, literally a **deferred down payment** arrangement. The use of a down payment note secured by a redeemable equity in real estate is for many sellers a viable substitute for an immediate cash down payment.

The balance of the seller's equity remaining after deducting the $120,000 down payment is $80,000. To pay this amount, the investor will execute an $80,000 carryback note in favor of the seller. The security for this note will be a second trust deed on the property sold by the seller.

Consequently, the broker structures the transaction calling for:

- two *notes*, each for separate portions of the total $200,000 equity in the seller's property;

- two *trust deeds*, each securing one note and recorded as liens on the separate properties; and
- two *California Land Title Association (CLTA) joint-protection (JP) standard coverage policies*, one for each property insuring the priority of the trust deed which encumbers it.

Motivated sellers

Sellers who are in their retirement years, or at least trying to retire from property ownership, need to be informed so they can consider the many reasons for being "*papered out*" (using 100% carryback financing), including:

- the **deferral of profit taxes** on an installment sale until the principal is paid or the notes assigned;[1]
- the **solid equity cushions** provided by the LTVs for the down payment note and purchase-money note, with each secured by separate trust deeds encumbering different parcels of real estate;
- the **conversion of the seller's income flow** from *management-intense* rental (passive category) income, which may have long lost its depreciation shelter, to relatively *management-free* interest (portfolio category) income; and
- the **ability to collect on a deficiency** from the buyer on the down payment note which is **recourse paper** since the note is secured by property other than the property being purchased.[2]

recourse
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

Taxwise, a seller taking a profit on the sale of property (price minus cost equals profit) will eventually pay approximately 25% to 30% in combined state and federal taxes on the entire profit.

Many carryback notes secured by second trust deeds on income property are comprised entirely of profit. This is due largely to the sold property's depreciation schedules, refinancing and increased value resulting from inflation, appreciation and maintenance. On a cash-out sale, the seller ends up retaining around 70% of their net proceeds, the balance being lost to the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) as profit tax due for the year of sale. Thus, the seller will earn no interest in the following years (at the note rate) on the taxes they paid when cashed out.

However, profit taken on a sale which is allocated to an installment note is not taxed when the sale takes place. The profit allocated to the principal amounts of the down payment note and carryback note remain untaxed until the principal is received. The profit allocated to the principal will thus *bear interest* until the principal is paid.

As principal on the note is paid or when the note is sold or **hypothecated**, the profit allocated to the principal is taxed. Until payoff, sale or *hypothecation* of the notes, a seller collects interest on the 30% of the profit they will ultimately pay in taxes — the *earning power* of the unpaid profit tax is retained by the seller.

hypothecate
To pledge a thing as security without the necessity of giving up possession of it. To mortgage a property. [See **RPI** Form 242]

1 26 United States Code §453
2 Calif. Code of Civil Procedure §580b

Thus, the typical seller in a carryback installment sale is earning a yield 50% to 100% greater than the after-tax yield on a taxable cash transaction.

To prevent a premature loss of principal due to the payment of taxes on an early payoff, an informed seller will consider negotiating the inclusion of a **prepayment penalty.** The amount of the penalty assessed with be equal in amount to the profit tax they will pay when a portion or the entire balance of the note is prepaid. [See **RPI** Form 154 §4.3]

prepayment penalty
A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision. [See **RPI** Form 418-2]

Additionally, an **all-inclusive trust deed (AITD) note** with the proper collection provisions, carried back and secured by the property sold, will defer even greater amounts of profit tax when the property sold has an existing encumbrance of any amount. [See Chapter 14]

Only existing property owners may try this

The down payment note arrangement only works for buyers who already own real estate with a financeable equity. Before locating a willing seller, a buyer needs to already own a property with an equity adequate to secure a down payment note given to purchase the seller's property.

Thus, first-time buyers cannot use the down payment note technique — they own no real estate and thus have no equity to offer as security for the down payment note. In some instances, a relative (i.e., a parent) may provide the security needed to get first-time buyers started in real estate ownership,

Properties with qualifying equity

Real estate presently *owned* by a buyer and the real estate they will *acquire* need to each possess sufficient amounts of equity to support the note it will secure. Otherwise, the properties will not provide adequate security in the event of a default, foreclosure and resale of the property.

Thus, the property owned and the property to be acquired need to each have existing equities well in excess of 20% of the property's total value. To make any economic sense, the further encumbrances placed on the respective properties in the form of a down payment note and a carryback note need to be for dollar amounts calculated to leave each property encumbered with an LTV no greater than 80%. [See Figure 2]

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

In our previous example, the real estate owned by the investor has an LTV of 50%. Thus, the real estate they own has 30% of its value available to provide adequate security (up to an LTV of 80%) for a down payment note created to buy the seller's property.

The real estate the investor wants to acquire is encumbered by a first trust deed with a 67% LTV ($400,000 debt/$600,000 value). Thus, the seller's real estate has $80,000 of equity available to secure an equal dollar amount of carryback financing and be encumbered at an 80% LTV.

With an 80% LTV, the seller has adequate security in the property sold to provide a cushion sufficient to allow for a full recovery on the carryback note from the present value of the real estate if they foreclose on the property.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of .... $ __________

4. A note, to be executed by Buyer in favor of Seller, in the amount of .... $ __________
as a down payment through escrow, payable $__________ monthly, or more, beginning one month after closing, including interest at ________% per annum from closing, due __________, 20______.

4.1 This note is to be secured by a __________ trust deed on real estate referred to as ______________________________

4.2 This trust deed to be junior to current taxes, CC&Rs and the following encumbrances:

First encumbrance:	Second encumbrance:
Amount ....$__________	Amount ....$__________
Monthly payment...... $__________	Monthly payment...... $__________
Interest rate ....______%	Interest rate ....______%
Due date __________	Due date __________
Lender __________	Lender __________

4.3 This note and trust deed to contain provisions to be provided by Seller for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________________________

4.4 This note and trust deed are subject to the purchase money anti-deficiency provisions of California Code of Civil Procedure §580b.

4.5 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]

4.6 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]

4.7 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [See **RPI** Form 183]

4.8 This trust deed to be insured by a Lender's ☐ CLTA, or ☐ ALTA, form policy of title insurance paid for by Buyer. If Buyer is unable to deliver this insured trust deed, or if the improvements on the secured real estate are destroyed or materially damaged prior to closing, then Seller may terminate this agreement and demand all instruments and funds be returned to the parties depositing them, and Buyer is to pay all reasonable escrow costs and charges.

Figure 3

Excerpt from Form 154

Purchase Agreement

The costs of foreclosure and resale of a property by a junior mortgage holder typically represent around 20% of its resale value. [See **RPI** Form 303 accompanying Chapter 21]

Paper in the real estate market

Buyers purchase real estate by giving a seller U.S. dollar-denominated assets, such as:

- cash;
- notes, existing or to be created;
- an exchange of an equity in real estate or personal property; or
- a percentage participation in the ownership of a limited liability company (LLC), partnership, corporation or real estate investment trust (REIT).

The actual assets a buyer may use to buy real estate and the form of consideration acceptable to sellers depend on the economic condition of the real estate market and the seller's objectives at the time of the transaction.

In times of easy, low-interest money accompanied by a reciprocal rise in real estate prices, a seller is more likely to demand all cash since an abundance of cheap money is available to marginally creditworthy buyers.

Conversely, when institutional lenders and federal monetary policy combine to tighten the availability of money necessary to finance a continuing high-volume of real estate sales transactions, the alternative for buyers and sellers is to *create* the needed supply of credit (carryback financing) themselves.

The financial alternative to borrowing cash to fund a purchase or exchange of properties is a credit sale evidenced by notes executed by the buyer and secured by real estate.

In a credit sale, the buyer also *creates wealth* for themselves. The buyer is able to purchase real estate during a vicious cycle in the market which has become nonresponsive for financially distressed sellers. An enterprising buyer looks forward to a future with an improving economic environment; a conflicted seller views the market retrospectively as producing continuously declining prices.

Additionally, the use of carryback paper eliminates all the problems associated with institutional financing, except for the assumption of the existing mortgage.

For example, in times of tight mortgage money, the use of a down payment note may be the only way for a seller to close a sale at the price they seek, since interest rates or prices (or both) are too high to allow real estate to be readily sold.

A down payment note permits the buyer to qualify for financing, not just based on their personal income, but rather on their credit history as a debtor and the solid value in two parcels of real estate as perceived by the seller.

Structuring the two paper legs

A down payment note transaction is structured in sets of two:

- two notes;
- two trust deeds; and
- two title insurance policies.

A buyer's first step when making an offer to buy property begins with a form purchase agreement drafted specifically for the down payment note transaction. It contains an additional provision for the down payment note in lieu of a cash down payment. [See Figure 3]

A good-faith cash deposit, or cash through escrow, in an amount at least equal to the seller's closing costs and brokerage fees needs to be considered. Logically, the down payment note is reduced by the amount of cash the seller needs for closing costs.

The terms of the down payment note and trust deed set forth in the purchase agreement include:

- the amount of interest and principal payments;
- the due date for the final/balloon payment;
- identification of the property securing the note;
- the terms of existing financing on the property securing the note; and
- any provisions for a late charge, *prepayment penalty* and *due-on-sale* interference. [See Figure 3]

All other terms contained in a regular purchase agreement for income property are included in the purchase agreement in addition to the down payment note provision.

Ironically, the longer the period before the **due date** for the final/balloon payment, the more lucrative the transaction is for both a long-term investor and a tax-minded seller. The buyer, being an investor, wants the greatest period of time to pay off or arrange financing to pay off the notes. The seller wants to retain the benefits of the deferred tax liability on installment sales reporting for as long as feasible, a motivation parallel in time to the buyer's.

exculpatory clause
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **RPI** Form 418-5]

For the seller, the down payment note is *recourse paper* since it is secured by property other than the property sold.[3]

However, the buyer is able to remove the **recourse nature** of the down payment note by the inclusion of an anti-deficiency provision in the purchase agreement, called an **exculpatory clause**. [See Figure 3; see **RPI** Form 154 §4.4]

nonrecourse
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

The regular carryback note

In addition to the down payment note, the buyer executes a separate carryback note secured by the property acquired. The dollar amount of the note represents the balance of the purchase price remaining to be paid after subtracting from the purchase price the principal amounts of the down payment note and the existing mortgage the buyer assumes.

Carryback paper secured only by the property sold is **nonrecourse paper**. It is seller-extended credit which assists the buyer to finance the purchase of the real estate that is the security for repayment.[4]

Unlike the elimination of the *recourse nature* of the down payment note by inclusion of an *exculpatory clause*, the *nonrecourse nature* of the carryback note cannot be eliminated by conduct or agreement, called **waiver**.

waiver
A mortgage holder's consent to forego a right to enforce a provision or agreement.

Title insurance on two parcels

Two policies of title insurance are required to insure the down payment note transaction. One policy will jointly insure both the grant deed and the carryback trust deed on the property sold, called a **California Land Title Association (CLTA) Joint-Protection (JP)** policy.

The second policy will insure the trust deed on the property owned by the buyer, a lender's policy of title insurance most likely similar to a *CLTA policy* since the seller will have inspected the property and not need **American Land Title Association (ALTA)** protection.

3 CCP §580b
4 CCP §580b

Bridge loan aspect for a cash sale

Conceptually for sellers, a down payment note may be used as a **bridge loan** to complete their sale of real estate when down payment funds are not yet available to their buyer and escrow needs to be closed. This situation frequently arises as the "sale-of-other-property" contingency in a purchase agreement. [See **RPI** Form 150 §10.4]

bridge loan
A short-term mortgage arranged for a buyer to fund the purchase of a property but encumbering other real estate owned by the buyer, pending the arrangement of long-term financing or the sale of the other real estate as the source of funds for its repayment.

When the cash down payment to be made by the buyer is not forthcoming and the seller is willing to wait several months or a year to receive the cash, a down payment note may be negotiated as a temporary substitute for the buyer's cash down payment so the sale can be closed.

For example, consider a buyer and seller who enter into a purchase agreement contingent on the *sale of other property* the buyer owns.

On the date the buyer is to close their purchase escrow, the *sale-of-other-property contingency* has not been waived. The buyer has not yet closed a sale on their other property. Without the cash net proceeds from the sale of their property, the buyer cannot acquire the seller's property as agreed in the purchase agreement.

cross-collateralization
The use of one trust deed to describe multiple parcels of real estate or a UCC-1 financing statement encumbering personal property together with a trust deed as additional security for payment of a debt. [See **RPI** Form 436]

The seller's broker advises the seller to consider accepting a down payment note executed by the buyer and secured by the buyer's unsold property. When suitable and the seller agrees, the buyer will be able to close the sale using this temporary *bridge loan* in lieu of cash.

In this scenario, the equity in the buyer's other property not yet sold needs to be confirmed by the broker as sufficient to justify accepting it as security for the delayed cash down payment evidenced by the note. The bridge loan note may also be **cross-collateralized**, securing it with a trust deed describing both parcels, the seller's and the buyer's — an encumbrance called a **blanket mortgage**.

blanket mortgage
A mortgage which is secured by two or more parcels of real property. [See **RPI** Form 450]

If the buyer's property does not sell, the buyer will need to negotiate an extension of the note, refinance or further encumber the properties to generate cash to meet the seller's payoff demand and avoid foreclosure.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

A word of caution: creating a further encumbrance on property, other than one-to-four residential units, junior to an existing trust deed containing a **due-on clause**, triggers the lender's right to call or recast the existing mortgage. Before recording a second trust deed on a property which is not a one-to-four unit residential property, it is prudent to obtain a *waiver* by the mortgage holder of the first trust deed containing the *due-on clause*.

Chapter 20 Summary

Investors who do not want to buy property contingent on the sale of other property they own or raise down payment funds by borrowing against the equity in their property may consider assuming or taking title subject to an existing mortgage when the interest rate and assumption fees to do so are favorable.

To increase their holdings, an investor places their existing equity at risk by putting it up as security to buy property on credit.

The use of a down payment note secured by a redeemable equity in real estate is for many sellers a viable substitute for an immediate cash down payment.

Sellers need to consider the many reasons for being "papered out," including:

- the deferral of profit taxes on an installment sale;
- the solid equity cushions provided by the loan-to-value ratios (LTVs) for the down payment note and purchase-money note;
- the conversion of the seller's income flow from management-intense rental income to relatively management-free interest income; and
- the ability to collect on a deficiency from the buyer on the down payment note.

To prevent a premature loss of principal due to the payment of taxes on an early payoff, a seller will consider negotiating the inclusion of a prepayment penalty.

Further, the longer the period before the due date for the final/balloon payment, the more lucrative the transaction is for both a long-term investor and a tax-minded seller.

The down payment note is recourse paper since it is secured by property other than the property sold. Conversely, a carryback note secured only by the property sold is nonrecourse paper.

A down payment note may also be used by a seller as a bridge loan to complete their sale of real estate when down payment funds are not yet available to their buyer and escrow needs to be closed.

Chapter 20 Key Terms

Chapter 21

Carryback foreclosure and resale costs

Learning Objectives

After reading this chapter, you will be able to:

- advise a seller on the inherent risk of loss and mitigating factors that exist when carrying back a mortgage;
- understand the carryback seller's rights and obligations when a buyer defaults; and
- distinguish between a deed-in-lieu of foreclosure remedy, a pre-foreclosure workout (such as a short sale or modification of the note) and a trustee's foreclosure sale.

Key Terms

cross-collateralization
deed-in-lieu of foreclosure
further-approval contingency
guarantor
mortgage-in-fact
power-of-sale
private mortgage insurance (PMI)
put option
recourse
security interest

Protecting the seller begins with advice

Consider an absentee owner who is unable to effectively manage a small income-producing property they own. The absentee owner is confronted with:

- below market rents;
- unreliable tenants; and
- deferred maintenance.

The condition of the property and its income will continue to deteriorate until it is sold to a local buyer who has cash reserves and can provide hands-on management.

The owner contacts an agent and lists the property for sale. The property has an existing fixed-rate, long-term mortgage which a qualified buyer may assume. The owner's agent believes the owner's asking price for the property is properly set to attract a buyer.

To pursue their asking price and pass on the cost of deferred maintenance and the delinquent rent situation to the buyer, the listing terms include **seller carryback financing** with a **low down payment**.

Further-approval contingency

further-approval contingency
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

The owner and their agent agree an acceptable offer needs to include a **further-approval contingency** calling for the owner to confirm that the buyer:

- is financially and personally qualified to purchase the property; and
- has sufficient cash reserves to cure the deferred maintenance and upgrade the tenancies on the property. [See **RPI** Form 159 §§8.4 and 8.5]

However, the owner's agent quickly concludes the owner is not familiar with real estate financing techniques and does not fully understand the **risk of loss** involved in carrying back a second mortgage. The risks, if known and understood, may cause a prudent owner to take additional steps beyond a carryback trust deed to cover the risks and protect their continuing investment in the property represented by the carryback note.

The owner's agent understands they are **duty bound to inform** the owner of the risks in carrying back a second mortgage. With advice, the seller may make appropriate decisions regarding the terms for payment of the sale price and management of the carryback mortgage. [See Form 303 accompanying this chapter]

Agency duties and carryback risks

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

Sellers often do not know the extent of the risks which exist when carrying back a mortgage, much less understand or even ask about them. Brokers and their agents who represent carryback sellers need to be knowledgeable enough to provide essential *risk-management information* for the care and protection of their clients.

Seller's agents who do not know or understand the risks of carrying back a mortgage on a sale often brush them aside as minimal. However, a seller, to be best served by their agent, needs advice so they can consider risk-reduction remedies other than just "taking back the property" if the buyer defaults.

When a seller does not inquire about the risks, the seller's agent has an **affirmative duty** to voluntarily advise them of the **risks known** or readily knowable to the broker and the agent. Further, the agent is to recommend any due diligence investigation or analysis they believe needs to be undertaken by the seller or themselves in a carryback sale.

Risks posed to a carryback seller differ dramatically from the more commonly understood risks of owning real estate. When the seller carries back a mortgage on the sale of property, their ownership interest is conveyed in exchange for a mortgage holder's lien on title to the property, called a **security interest**.

recourse
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

Covering the risks of junior financing

The risks of carrying back a mortgage are similar to the risks taken by an *equity lender* holding a comparable junior lien position on title to a property. The risks of a junior mortgage holder, and thus a carryback seller, are covered or compensated by employing several techniques and variables:

1. The amount of the buyer's **down payment**, as it sets the amount of both the equity the buyer feels compelled to protect and the cash sales proceeds the seller nets to cover the risk of future advances they may have to make if the buyer defaults;
2. **Further collateral**, as additional security to the equity in the property, be it personal property or other real estate, a situation sometimes called **cross-collateralization**, an event which converts a carryback mortgage to a **recourse debt** and avoids anti-deficiency laws;
3. A **personal guarantee** from someone other than the buyer, which may be secured by real estate owned by the **guarantor**, a "**put option**" requiring the *guarantor* to pay off (buy by assignment) the carryback mortgage on the buyer's default;
4. A **premium interest rate** on the note greater than the current market rate to further cover the risks created by an inadequate down payment to provide the seller with cash sales proceeds sufficient to pay all the costs of foreclosure and resale of the property if the buyer defaults;
5. **Monthly payments** based on a shorter amortization schedule to more quickly reduce the principal balance remaining on the note and increase the seller's cash reserves before a default (which usually does not occur for three to five years, except during a period of severe declines in property values);
6. **Private mortgage insurance** (PMI), available to some sellers from insurance companies if the buyer qualifies, to cover any loss of principal and interest due to a default by the buyer;
7. **Assignment of rents** as additional security on the sale of income property, rents which may be readily collected by the use of pre-

cross-collateralization
The use of one trust deed to describe multiple parcels of real estate or a UCC-1 financing statement encumbering personal property together with a trust deed as additional security for payment of a debt. [See **RPI** Form 436]

guarantor
A person who agrees to pay a money obligation owed by another to a mortgage holder or a landlord under a lease agreement on a default in the obligation and demand for the sums remaining unpaid. [See **RPI** Form 439 and 553-1]

put option
The provision in all trust deeds which, in tandem with anti-deficiency laws, grants an owner-occupant of a one-to-four unit residential property under a purchase-assist mortgage the right to defulat and force the lender to buy the property through foreclosure for the remaining loan amount.

printed notices sent to both the buyer and the tenants informing them to pay the carryback seller or be personally liable to the carryback seller for nonpayment;

8. A **credit application** and a **net worth statement** (balance sheet) from the buyer, authorization to order a credit report to confirm the buyer's propensity to timely pay their debts, debt-to-income ratios, several months cash reserves for payments, tax documentation and a review of the buyer's assets for sufficient equity to bolster the buyer's ability to pay the carryback mortgage (and possibly provide additional security for the carryback note) [See Form 302 in Chapter 4 and **RPI** Form 209-3]; and

9. **Inspect and investigate** the buyer's care and management of the real estate to confirm it is properly maintained.

The foreseeability of a default

A mortgage holder becomes acutely aware of their rights and obligations when a **buyer defaults**, a foreseeable occurrence for which the trust deed lien provides the first line of defense.

When the buyer defaults on a mortgage, the carryback seller may proceed with a foreclosure. Only through foreclosure can the carryback seller recover what is owed to them, limited to the value of their *security interest* in the property.

security interest
A generic term designating the interest held in real estate or personal property by a lender, carryback seller or judgment creditor which is evidenced by either a trust deed, UCC-1 financing statement or abstract of judgment. [See **RPI** Form 450 and 436-1]

Defaults on a mortgage include the buyer's failure to:

- pay installments on the carryback note;
- pay property taxes, assessments and hazard insurance premiums;
- pay senior mortgage holders; or
- maintain the property.

During the foreclosure period, the carryback seller may need to draw on their cash reserves to keep the senior mortgage current and avoid the initiation of foreclosure proceedings by a senior mortgage holder. Commencement of foreclosure by the senior mortgage holder is part of the carryback seller's costs of recovering the property.

If the down payment amount is a small percentage of the price, which results in a high *loan-to-value (LTV) ratio* for the carryback seller, the seller who begins foreclosure and makes a full credit bid stands a good chance of taking the property back at the trustee's sale.

Most importantly, the seller's source of recovery on a carryback mortgage which is secured solely by the property sold is limited to the value of their security interest held under the second trust deed lien. The dollar value of a junior mortgage holder's secured position on the property's title is the property's fair market value (FMV), minus:

- the balance remaining due on the senior mortgage;

- the dollar amount of foreclosure;
- resale costs; and
- carrying costs (taxes, insurance, operating expenses) until the property is resold.

Any rents collected from tenants by the seller's enforcement of their assignment of rents lien (in the trust deed) are applied to offset the costs of "carrying" the property during foreclosure and the amounts due the seller when setting the bid at the trustee's sale. Also, interest on the carryback note will be unpaid and uncollected unless paid by a cash buyer bidding at the trustee's sale or the price received on a resale when the seller takes back the property at the trustee's sale.

For the seller to limit their risk of lost equity and interest on non-income producing property, the cash proceeds from the buyer's down payment on the initial sale of the property need to equal or exceed the total of:

- eight to twelve months of senior mortgage payments;
- other carrying costs incurred during the foreclosure process; and
- foreclosure and resale costs.

If the buyer's down payment is large enough, the value of the seller's security interest in the property needs to be sufficient to recoup:

- the principal balance and interest on the carryback note;
- the property's carrying costs during the foreclosure process; and
- the costs to foreclose and resell the property.

Seller's foreclosure cost sheet illustrates risks

Continuing our previous example, the seller's agent prepares and reviews a **Foreclosure Cost Sheet** with the carryback seller to impress upon them the need for:

- an adequate down payment;
- sufficient cash reserves;
- additional security; or
- a guarantee.

The information in the disclosure aids everyone in an analysis of the risks a second mortgage holder is exposed to and the steps to be taken and premiums needed to cover those risks. [See Form 303]

The *Foreclosure Cost Sheet* is a useful illustration of the financial risks of a carryback sale. The worksheet also documents the agents' disclosure of the potential expenditures, and the cash reserves required to cover the risk of the buyer's default.

Foreclosure cost calculations are made by the agent and reviewed with the seller who is considering an installment sale on each of two occasions:

- once when accepting the listing; and

Form 303

Foreclosure Cost Sheet

FORECLOSURE COST SHEET
Costs and Net Proceeds on Foreclosure and Resale

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This form is used by a seller's agent or mortgage loan broker when the transaction involves a carryback seller or lender secured by a junior trust deed, to advise them of the funding necessary to foreclose and the likely net proceeds of a foreclosure and resale of the encumbered property.

1. This estimate of costs incurred to foreclose and resell property under a trust deed is prepared for the following:
   - ☐ Purchase Agreement ☐ Loan Agreement ☐ Exchange Agreement
   - ☐ Trust Deed and Note ☐ Option
   - 1.1 dated __________, 20____, at ______________________________, California,
   - 1.2 entered into by ______________________________.
   - 1.3 regarding property referred to as ______________________________.
2. Estimated resale value of the real estate..........$__________
3. Balances on senior trust deeds at the time of resale
   - 3.1 Underlying first trust deed..........$__________
   - 3.2 Underlying second trust deed..........$__________
4. Cash advances from the time of default through closing of a resale
   - 4.1 Taxes..........$__________
   - 4.2 Insurance..........$__________
   - 4.3 Improvement bond assessments..........$__________
   - 4.4 Common interest development (CID) assessments (condos)..........$__________
   - 4.5 Payments on underlying trust deeds (number of months _____)..........$__________
5. Foreclosure costs and fees to recover a property
   - 5.1 Trustee's guarantee policy..........$__________
   - 5.2 Recording notices..........$__________
   - 5.3 Publishing notices..........$__________
   - 5.4 Postage..........$__________
   - 5.5 Trustee's fees..........$__________
   - 5.6 Miscellaneous charges..........$__________
6. Resale costs after foreclosure and recovery of the property
   - 6.1 Repairs and fixer-up costs..........$__________
   - 6.2 Title insurance premiums..........$__________
   - 6.3 Escrow fees and charges..........$__________
   - 6.4 Broker fees and charges..........$__________
7. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): .... (-)$__________
8. Estimated net proceeds available to pay off carryback trust deed..........$__________

I have diligently prepared this estimate
Date: ______________, 20 ______
Seller's Broker: ____________________
CalBRE #: ____________________

By: ____________________

I have read and received a copy of this estimate.
Date: ______________, 20 ______
Seller's Name: ____________________

Seller's Signature: ____________________

Seller's Signature: ____________________

FORM 303 03-11 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

- a second time when presenting an offer or counteroffer.

The risk of having to sell the property again due to a foreclosure is often shared by the brokers and agents in the transaction through various deferred fee arrangements to reduce any *moral hazards* present in an overly optimistic agent's encouragement of the seller to accept the terms of an offer calling for a carryback mortgage.

A deed-in-lieu

When the amount of an underlying senior mortgage is more than 75% of the property's current market value and a buyer defaults on the seller's carryback mortgage, the seller needs to first negotiate with the buyer for a **deed-in-lieu of foreclosure** and possession to the property before initiating foreclosure. Negotiations for a *deed-in-lieu of foreclosure* are best considered at the time of the default, but do need to be considered before commencing foreclosure.

deed-in-lieu of foreclosure
A deed to real property accepted by a lender from a defaulting borrower to avoid the necessity of foreclosure proceedings by the lender. [See **RPI** Form 406]

A deed-in-lieu is a grant deed containing special language to assure title insurers the debt has been cancelled, and no lease-option or other lender/debtor relationships has been created to cause the deed-in-lieu to be re-characterized as a **mortgage-in-fact**. [See **RPI** Form 406]

A deed-in-lieu of foreclosure is a pre-foreclosure workout technique which eliminates many of the financial risks of foreclosing. The deed-in-lieu potentially benefits both parties, saving the carryback seller the high cost of foreclosure, while providing the buyer with some "walking money" or "cash for keys" in exchange for conveying title and transferring possession back to the seller.

mortgage-in-fact
A grant deed given by an owner for the sole purpose of securing the performance of an obligation owed a creditor, such as payment of a debt.

Also, the deed-in-lieu needs to be insured by a title insurance policy before the prudent seller accepts it. Without title insurance on the deed-in-lieu to confirm the condition of the title, liens may have attached to the property or a change in vesting may have occurred, rendering the deed unacceptable to a mortgage holder.

Trustee's foreclosure remedy

If a deed-in-lieu remedy or other pre-foreclosure workout (such as a short sale or modification of the note) does not resolve a default, a trustee's foreclosure sale is the next most expedient procedure for recovery.

However, due to a foreclosure, the financial benefits of a carryback mortgage may be reduced by the:

- carrying costs and trustee's charges incurred during a trustee's foreclosure if the down payment is inadequate (less than 15% to 20% of the price);
- lack of or minimal increase in value of the property; or
- seller's procrastination in commencing foreclosure on a default.

For example, consider a buyer who makes a $100,000 down payment and assumes $800,000 in existing mortgages on a $1,000,000 sales price. The seller carries back a $100,000 mortgage on the property sold for the balance remaining to be paid on the purchase price.

The brokerage fees and other costs, credits and adjustments associated with the sale amount to $50,000. Thus, the seller's net proceeds on the sale are $50,000 cash and the $100,000 carryback mortgage. [See **RPI** Form 310]

However, foreclosure and resale costs can run from 15% to 20% of the property's resale value, which in this case totals $150,000 or more. More than half of this amount is required from the seller's cash reserves to pay foreclosure and other carrying costs until the property is resold. Foreclosure on income producing property can be less demanding on a seller's cash reserves since the carrying costs may be offset by rent received under the trust deed's assignment of rents provision.

The carryback seller is also subject to the risk the buyer may file a **bankruptcy petition** to preserve any equity they may have in the property. The carryback seller's foreclosure sale is automatically halted by filing the petition, called a **stay**, and remains in effect until the bankruptcy court releases the *stay*.

Any delay in the foreclosure process results in further expenditures by the seller to pay the property's carrying costs. Further, a buyer who realizes they will lose the property often fails to continue to properly maintain it, called **impairment of the security** or **waste**.

If only deferred maintenance occurs, the carryback mortgage holder will incur the expense for **fixing up** the property to resell it (or to keep it and rent it out).

Managing the risk

These above conditions are common risks any mortgage lender is exposed to. As with all mortgage risks, the risks are manageable and capable of being covered by a mix of:

- a sufficient down payment;
- a premium interest rate;
- an assignment of rents on income property;
- a short amortization period;
- additional security; and
- guarantees.

A real estate market of rising values — when it is not rapid and is sustainable — is always a cure for a failure to adequately cover the risks of loss.

Eviction by the involuntary landlord

An owner wiped out by a foreclosure sale needs to vacate and deliver possession of the property to the carryback mortgage holder who acquires it at a foreclosure sale. If the owner does not vacate, the carryback mortgage holder serves them with a written **Three-Day Notice to Quit Due to Foreclosure**.[1] [See **RPI** Form 578]

However, if a wiped-out owner refuses to vacate the property on expiration of the *three-day notice*, the carryback mortgage holder will need to proceed with an **unlawful detainer (UD) action**, as would any landlord dealing with any tenant who unlawfully detains the property after their right to possession has be terminated.

1 Calif. Code of Civil Procedure §1161a(b)

To evict the wiped-out owner at the *UD* hearing, the carryback mortgage holder needs to show the property was acquired at a trustee's sale and all statutory notice requirements for the sale and the UD action have been satisfied.

After foreclosure and recovery of possession, the carryback mortgage holder who reacquires the property is back to square one — they own the property they do not want again, minus their out-of-pocket expenses due to foreclose.

Further, when a tenant or subtenant is in possession of a residential unit at the time of a foreclosure sale, they are given a **90-day notice to quit due to foreclosure** if the carryback mortgage holder (as the owner-by-foreclosure) intends to force the tenant to vacate. [See **RPI** Form 573]

Also, a residential tenant has the right to enforce the terms of their rental or lease agreement entered into with the prior owner and live out the remainder of the lease term if:

- the tenant holds a **bona fide** lease agreement;
- the lease agreement was entered into before title was transferred to the owner-by-foreclosure; and
- the owner-by-foreclosure is not going to occupy the property as their primary residence.[2]

A lease agreement is *bona fide* only if it calls for rent that is substantially the fair market rent for the property.[3] [See **RPI** Form 550]

Other security devices

Some types of **installment sales** typically include the additional risk and cost of a **judicial foreclosure** if the buyer defaults and challenges an eviction action, including:

- land sales contracts;
- reverse trust deeds;
- unexecuted purchase agreements with occupancy (lease-purchase sale); and
- lease-option sales.

The completion of a foreclosure of the lien created by any security device is a requisite to recovering possession. The buyer's **right of redemption** (to pay off the debt) needs to be eliminated to clear title of the buyer's equitable or legal ownership interests in the property. These alternative security devices do not usually contain a **power-of-sale** clause to authorize the more efficient, less expensive trustee's foreclosure sale. [See Chapters 21]

power-of-sale
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

The exposure to the repossession risk of a judicial foreclosure outweighs any purported benefit these alternative security devices might offer on a small-down payment installment sale to a buyer.

2 Public Law 111-22 §§701, 702, 703
3 12 United States Code §5220

Chapter 21 Summary

Sellers often do not know the extent of the risks which exist when carrying back a mortgage. Brokers and their agents who represent carryback sellers need to be knowledgeable enough to provide essential risk-management information for the care and protection of their clients.

When the buyer defaults on a mortgage, the carryback seller may proceed with a foreclosure. Only through foreclosure can the carryback seller recover what is owed to them, limited to the value of their security interest in the property.

Defaults on a mortgage include the buyer's failure to:

- pay installments on the carryback note;
- pay property taxes, assessments and hazard insurance premiums;
- pay senior mortgage holders; or
- maintain the property.

For the seller to limit their risk of lost equity and interest on non-income producing property, the cash proceeds from the buyer's down payment on the initial sale of the property need to equal or exceed the total of:

- eight to twelve months of senior mortgage payments;
- other carrying costs incurred during the foreclosure process; and
- foreclosure and resale costs.

The Foreclosure Cost Sheet is a useful illustration of the financial risks of a carryback sale.

When the amount of an underlying senior mortgage is more than 75% of the property's current market value and a buyer defaults on the seller's carryback mortgage, the seller needs to first negotiate with the buyer for a deed-in-lieu of foreclosure and possession to the property before initiating foreclosure.

If a deed-in-lieu remedy or other pre-foreclosure workout does not resolve a default, a trustee's foreclosure sale is the next most expedient procedure for recovery.

If an owner wiped out by a foreclosure sale does not vacate and deliver possession of the property back to the carryback mortgage holder who acquires it at a foreclosure sale, the carryback mortgage holder serves them with a written Three-Day Notice to Quit Due to Foreclosure.

If the wiped-out owner refuses to vacate the property on expiration of the three-day notice, the carryback mortgage holder will need to proceed with an unlawful detainer (UD) action.

A tenant or subtenant is in possession of a residential unit at the time of a foreclosure sale is to be given a 90-day notice to quit due to foreclosure if the owner-by-foreclosure intends to force the tenant to vacate.

Chapter 21 Key Terms

Notes:

Chapter 22

The unsecured carryback seller

Learning Objectives

After reading this chapter, you will be able to:

- discuss the merits of an unsecured carryback note when the seller's equity is less than 20% of the property's market value;
- distinguish between a vendor's lien and a trust deed lien;
- identify the process of establishing a vendor's lien; and
- advise a seller on their use of a vendor's lien when the buyer owes unsecured amounts remaining unpaid on the purchase price after the close of escrow.

Key Terms

abstract of judgment	**lis pendens**
anti-deficiency law	**nonrecourse**
land sales contract	**vendor's lien**

Vendor's lien allows foreclosure on default

Consider a seller whose equity in their income-producing real estate is less than 20% of the value of the property. Also, the rental income produced by the property is insufficient to pay its operating costs and the mortgage payments. Thus, a *negative cash flow* exists on the property.

The seller wants to sell the property to rid themselves of the carrying costs and avoid what they anticipate will be a further decline in its value.

A creditworthy buyer is located who sees potential in the property and has substantial net worth according to their financial statements.

The buyer offers to purchase the property at a price based on:

- a 5% down payment;

nonrecourse
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

anti-deficiency law
California legislation limiting a mortgage holder's ability to recover losses on a default when the mortgaged property's value is insufficient to satisfy the mortgage debt.

- the assumption of the existing first mortgage equal to 80% of the price; and
- a seller carryback mortgage for 15% of the purchase price.

The seller and their broker know a carryback note secured by the property sold is **nonrecourse paper**. Thus, the carryback seller holding a trust deed note is limited in their recovery on a default by the buyer to solely foreclosing on their security interest in the property they sold. A money judgment for any deficiency in property value is barred by **anti-deficiency law**.[1]

Further, if the buyer defaults on the first mortgage, the seller will face the loss of their second trust deed on a foreclosure by the first mortgage holder. A default on the first mortgage forces the seller to either bring the first mortgage current and keep it current or pay it off. Otherwise, a foreclosure sale will be held by the first mortgage holder causing the seller's carryback trust deed to be eliminated from title.

However, the property lacks sufficient equity to allow the seller to foreclose and recover on a carryback note which is junior to a first mortgage with an 80% or greater loan-to-value ratio (LTV). The seller's remedy of foreclosure under these conditions provides little financial incentive to secure the carryback note with a trust deed on the property.

As disclosed by their broker, the costs to foreclose, carry and resell the property are equal to about 20% of the property value by the time of the resale. Consequently, most of these costs will be paid in cash before reacquiring and reselling the property. [See **RPI** Form 303]

The financial aspects of the carryback trust deed note do not justify foreclosing and taking title to the property unless the property's value increases in excess of 10% — an unlikely development in a flat or declining real estate market.

Little equity: go unsecured

Continuing with our previous example, the seller agrees to carry back a note. However, the note as agreed will not be secured by a trust deed. Thus, the carryback seller avoids the *nonrecourse* risk of not being able to recover for failure of the property's value to satisfy both the first mortgage and their carryback note. The risk of loss inherent in a nonrecourse note needs to be reviewed when the carryback note is secured by a trust deed on the property sold, called the **value-deficiency risk**.

Now consider a seller whose equity is 40% of the value of the property they are selling. A buyer makes a no-cash offer to buy the property, agreeing to take over the existing mortgage and execute two separate notes in favor of the seller:

- a note for 20% of the purchase price to be secured by the property; and
- an unsecured note for the remaining 20% of the price.

1 Calif. Code of Civil Procedure §580b

The buyer has substantial net worth, including equities in other real estate they own. However, the buyer does not want to use the other real estate they owns as primary, additional or substitute security for either of the two carryback notes. [See **RPI** Form 154]

The buyer wants the real estate they presently own to remain unencumbered so they have easy access to cash to manage their real estate acquisition programs.

Do the sellers in the previous unsecured carryback examples have any remedy besides obtaining a judgment for monies due on their unsecured carryback notes when the buyers default?

Yes! The carryback sellers also have a **vendor's lien** on the property they sold. The lien allows the sellers to foreclose on the property for the amount of the purchase price which remains unpaid. The lien was not waived since the debt owed to them by the buyers was always unsecured.[2]

vendor's lien
An unrecorded interest on title to property sold granting the seller the right to foreclose on the property when the buyer defaults on payment of remaining amounts owed on the purchase price.

On a default in payment, the seller may exercise their *vendor's lien* and foreclose on the property sold. However, unlike a money judgment lien which attaches to all properties owned by the debtor, the vendor's lien only attaches to the property sold, and only when the *buyer still owns it.*

Money judgement for a deficiency in value

When the value in the property is insufficient to recover the unsecured balance remaining due on the purchase price as evidenced by the carryback note, the seller may obtain a money judgment for the deficiency. The seller may also obtain a money judgment when:

- the vendor's lien rights are wiped out by a foreclosure sale on the first mortgage secured by the property sold; or
- the property has been resold to a buyer or further encumbered by a lender who did not know the buyer still owed the seller a portion of the purchase price.

On obtaining a money judgment for a deficiency in value, an **abstract of judgment** is recorded. Unlike the vendor's lien, a judgment lien attaches on title to all of the properties in the county vested in the buyer's name.

abstract of judgment
A condensed written summary of the essential holdings of a court judgment.

Now further consider our seller who carries back both a secured note and an unsecured note to evidence *separate amounts* owed on the purchase price, as occurred in our last example.

The buyer defaults on both debts and the seller forecloses on the debt secured by the property sold. On completion of their foreclosure, the seller's right to a vendor's lien for the amount owned on the separate unsecured debt is wiped out. However, the seller is still entitled to a general money judgment for the amount of the unpaid balance remaining on the unsecured note.

2 Calif. Civil Code §3046

Further, when a buyer misrepresents their net worth to the seller to induce them to carry back the unsecured note and then later files a bankruptcy petition, the carryback note is a non-dischargeable debt. Here, the seller financing was obtained through the misrepresentation of the buyer.[3]

Establishing a vendor's lien

Vendor's lien rights are not available to sellers for amounts remaining due on the purchase price when legal title to the real estate has not been transferred to the buyer. A vendor's lien is an unrecorded interest held by the seller in the property they sold.

land sales contract
An agreement infrequently used by a carryback seller in a sale of real property to retain title to the property until all or an agreed part of the purchase price has been paid. Also commonly called a land-contract, conditional sales contract, installment sales contract or real property sales contract.

For example, consider a buyer and seller who enter into a **land sales contract** (or lease-option sales agreement). In it, the seller agrees to convey title to the buyer on the buyer's completion of payments on the purchase price.

The buyer later defaults on payments due under the *land sales contract*. The seller attempts to obtain a vendor's lien against the buyer's interest in the property since the value in the property has fallen below the amount remaining due on the land sales contract. If the seller is permitted to enforce a vendor's lien, they will be entitled to a money judgment for the deficiency in the property's value to satisfy the principal remaining unpaid on the land sales contract.

The buyer claims the seller, due to their retaining title to the property under a land sales contract, is a secured creditor who is barred from using the vendor's lien to recover the money due on the purchase price.

Is the seller entitled to a vendor's lien?

No! The vendor's lien is *waived* and does not exist when the seller sells real estate and by agreement retains the title (as security) until the amount remaining due is paid. The seller is entitled to a vendor's lien only when they convey legal title and receive no security for the portion of the purchase price remaining to be paid.[4]

An unrecorded equitable interest

A land sales contract is a **security device,** different in purpose than a trust deed lien on property. The contract is evidence of the buyer's debt owed to the seller for the unpaid amount of the purchase price. It states the conditions allowing the seller to retain title to the property.

When the buyer defaults on a land sales contract, the seller needs to foreclose by holding a sale of the property, even though the property remained vested in the seller's name. Foreclosure is mandated since the seller needs to terminate the buyer's *right of redemption* as the only method for eliminating the buyer's right to pay off the land sales contract and obtain clear title — unless they enter into a deed in lieu of foreclosure.

3 11 United States Code §523(a)(2)(A)

4 **Allen** v. **Wilson** (1918) 178 C 674

Thus, a vendor's lien is not a *security device*, as is a trust deed, mortgage, land sales contract or lease-option sales agreement. A vendor's lien is an unrecorded equitable interest in the property sold, retained by the seller for monies due on the sales price. Further, the lien does not attach to title until it is *judicially imposed* in an action brought by the seller to judicially foreclose.

lis pendens
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

A seller records a **lis pendens** on filing an action to foreclose on their vendor's lien since the action is a claim to an interest in title. From the time of recording, the *lis pendens* puts any subsequent buyer or lender on constructive notice of the seller's claim to an interest as a lienholder in the title to the real estate.[5]

Priority of the vendor's lien

A vendor's lien has *priority* against all later acquired interests in the property sold, except a buyer who purchases the property or a lender who further encumbers the property, for value and without notice of the seller's rights to a lien.[6]

Consider a sales transaction on terms involving a new 90% first mortgage to be obtained by the buyer to fund their purchase of property. The seller is to carry back an unsecured note for the 10% balance of the purchase price. The lender has received copies of the purchase agreement and escrow instructions which state the seller will not be fully paid in cash and will hold an unsecured note for the balance due on the price when the lender's trust deed is recorded.

The buyer defaults on both the unsecured carryback note and the lender's mortgage. The lender forecloses on the property under its first trust deed.

The seller claims they hold a vendor's lien which is senior to the lender's trust deed since the lender knew when its trust deed was recorded that the seller had not been paid in full and thus did not receive its interest in the property in good faith.

In this example, the lender has a priority position over the carryback seller's unsecured vendor's lien even though the lender did not have a good faith defense against the seller's vendor's lien since the lender knew the seller had not been paid in full when the lender recorded its mortgage.

However, the lender's knowledge of the carryback seller's equitable interest in the property under the vendor's lien law does not destroy the lender's priority position on title when the secured mortgage and the unsecured carryback note are financial conditions agreed to by the seller as stated in the purchase agreement.[7]

Now consider a lender who originates a mortgage on property owned by the borrower — a refinance. The borrower originally acquired the property by

5 CCP §405.24
6 CC §3048
7 **Brock** v. **First South Savings Association in Receivership** (1992) 8 CA4th 661

executing an unsecured carryback note in favor of the seller as part of the price paid for the property. The lender is aware the seller holds an unsecured note that has not yet been paid.

Further, the seller does not waive their vendor's lien interest in the property or agree to subordinate their vendor's lien rights to the lender's trust deed.

Here, the seller's interest has priority over the lender's trust deed when the buyer defaults on the unsecured note held by the seller. The lender knew the seller had not been paid in full and the mortgage originated by the lender was unrelated to the sales transaction which produced the seller's right to a vendor's lien.[8]

Additionally, a vendor's lien is given priority over a **judgment lien** against a buyer since the judgment creditor holding the judgment lien is not a *bona fide encumbrancer.* An abstract of judgment lien is not an encumbrance for value, whether or not the judgment creditor has knowledge of the seller's lien rights in the property.[9]

Waiver of vendor's lien

A seller may *waive* their right to a vendor's lien by their conduct. For instance, a seller holds an unsecured carryback note which they sell and **assign** to an investor.

Here, by the assignment of their unsecured carryback note, the seller waives their vendor's lien right since they are no longer owed money by the buyer. The right to a vendor's lien is **personal** to the seller and cannot be enforced by a person who is not the seller.[10]

Additionally, a seller waives their vendor's lien rights by taking any security, such as stock, other real estate or personal property, to assure payment of the balance due on the purchase price.[11]

Money judgement loses priorty

Consider a seller who seeks a money judgment for the unsecured balance outstanding on the sale of their property without first pursuing foreclosure under their vendor's lien rights. No equity remains in the property sold to justify their pursuing foreclosure of their vendor's lien interest in the property.

Here, the seller does not need to first foreclose on their vendor's lien before obtaining a money judgment on the unsecured note. However, they waive their right to later enforce their vendor's lien since they are no longer owed money on their note as the amount is now owed as a money judgment. Thus, the seller loses their right to priority over abstracts of judgment previously recorded by other creditors.

Also, when the seller does foreclose on their vendor's lien and is awarded a money judgment for a deficiency in the property's value, their recording of an abstract of judgment for the amount of the deficiency attaches as a lien

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8 **McGreevy** v. **Constitutional Life Insurance Company** (1965) 238 CA2d 364

9 **Schut** v. **Doyle** (1959) 168 CA2d 698

10 CC §3047

11 McGreevy, *supra*

on all other real estate owned by the buyer. However, the judgment lien attaching to other properties will be junior to all liens of record, whether they are voluntary trust deed liens or involuntary judgment liens.

Finally, the recording by the buyer of a **declaration of homestead** exemption does not interfere with or have priority over a vendor's lien. The buyer knows of the seller's outstanding unsecured debt they owe the seller on the purchase price and is not allowed to avoid the vendor's lien by a claim of *homestead*.[12]

12 CC §3048

Chapter 22 Summary

A seller who has an unsecured carryback note has the right to a vendor's lien on the property they sold. The lien allows the sellers to foreclose on the property when the buyer defaults for the amount of the purchase price which remains unpaid.

However, unlike a money judgment lien which attaches to all properties owned by the debtor, the vendor's lien only attaches to the property sold, and only when the buyer still owns it.

When the value in the property is insufficient to recover the unsecured balance remaining due on the purchase price as evidenced by the carryback note, the seller may obtain a money judgment for the deficiency.

Vendor's lien rights are not available to sellers for amounts remaining due on the purchase price when legal title to the real estate has not been transferred to the buyer. The seller is entitled to a vendor's lien only when they convey legal title and receive no security for the portion of the purchase price remaining to be paid.

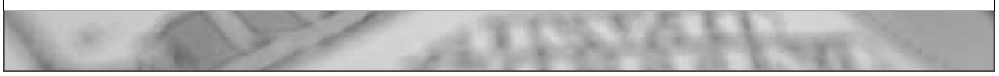
A vendor's lien has priority against all later acquired interests in the property sold, except a buyer who purchases the property or a lender who further encumbers the property, for value and without notice of the seller's rights to a lien. Additionally, a vendor's lien is given priority over a judgment lien against a buyer since the judgment creditor holding the judgment lien is not a bona fide encumbrancer.

A seller may waive their right to a vendor's lien by their conduct. The seller's right to a vendor's lien is waived by taking any security, such as stock, other real estate or personal property, to assure payment of the balance due on the purchase price.

A seller does not need to first foreclose on their vendor's lien before obtaining a money judgment on an unsecured note. However, they waive their right to later enforce their vendor's lien since they are no longer owed money on their note as the amount is now owed as a money judgment.

Chapter 22 Key Terms

Usury and the carryback note



Chapter 23

After reading this chapter, you will be able to:

- distinguish loans from carryback installment sales; and
- understand how a carryback mortgage remains excluded from usury laws on any modification, forbearance or assignment.

Learning Objectives

assignment
balloon payment
forbearance
unconscionable advantage
usury

Key Terms

Modified, assigned and unconscionable rates

The interest rate yield received by a lender on a **real estate loan**, unless exempt, is limited by California's **usury** law to the greater of:

- 10% per year; or
- the rate comprised of the discount rate at the **Federal Reserve Bank of San Francisco (FRBSF)** and a margin figure of 5%.[1]

A non-exempt *real estate loan* is usurious if the note evidencing the loan provides for an interest rate exceeding the ceiling interest rate yield on the day the loan is agreed to by the lender.

usury
A limit on the lender's interest rate yield on nonexempt real estate loans.

However, *usury* laws apply only to a **loan origination** or **forbearance** of lender rights on the default of a money loan. Thus, **credit sales** are not subject to the interest limitations of usury laws.

1 Calif. Constitution Article XV §1

Further, loans exempt from usury limitations on annual yields include real estate loans made or arranged by a licensed real estate broker.[2]

Not subject to usury limitations on interest rate yields

Consider an investor who enters into an agreement for the purchase of income producing real estate. The purchase agreement calls for a down payment with the balance of the price to be evidenced by a **carryback mortgage** in favor of the seller.

The carryback note prepared by escrow based on the terms set by the purchase agreement call for the buyer to make monthly payments of **interest only** on a **straight note**. The principal is due one year after the close of escrow. The interest rate negotiated for the carryback note is 20%.

The buyer defaults on the *carryback mortgage* after making payments for several months. The seller begins foreclosure on the real estate under the trust deed.

The buyer claims the seller cannot foreclose since the interest charged on the note is in excess of the rate allowed by usury laws, rendering the interest provisions in the note void. Thus, the buyer claims no payments are due until the principal is due, and all payments made are to apply only to principal.

forbearance
An agreement that the lender will temporarily reduce monthly mortgage payments for the homeowner at risk of default, without altering the original loan terms.

Can the note carried back by the seller ever, at any rate of interest, be usurious?

No! A carryback debt is the result of a *credit sale* by the seller. Carryback debt is not a *loan* of money or *forbearance* of the right to foreclose on default of a money loan. Thus, a carryback mortgage is not subject to usury limitations on interest rate yields.[3]

Carryback notes modified at usurious rates

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

Consider a property sold to a buyer on terms which includes a carryback mortgage in favor of the seller for a portion of the sales price. The carryback note includes a due date for a **final/balloon payment**.

When the due date for a *final/balloon payment* arrives, the buyer, unable to obtain funds to pay off the carryback mortgage, defaults.

The buyer and seller agree to extend the note's due date for the final payment of principal. In exchange, the buyer agrees to an increase in the note's interest rate, raising the rate above the usury threshold. Thus, the seller's yield on the debt after the modification exceeds the rate ceiling set by usury laws.

The buyer makes all payments due on the modified carryback note, including the final/balloon payment.

The buyer then makes a demand on the seller to return all the interest paid after the modification, claiming the seller's modification of the note was a *forbearance* controlled by usury limitations.

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2 Calif. Const. Art. XV §1

3 **Verbeck** v. **Clymer** (1927) 202 C 557

Is the buyer entitled to recover the interest paid after the modification in the rate of interest due on the carryback debt?

No! The transaction in which the debt was created was a credit sale. As a credit sale, the debt is not a loan and thus not subject to usury laws. Although the terms of the note evidencing the carryback mortgage were modified and a forbearance (such as a cancellation of foreclosure) occurred, the status of a carryback debt is not transformed by a forebearance into a loan. Thus, a modification of the terms for payment — an interest rate increase — does not subject the carryback debt to usury laws since the debt created in a credit sale is not a loan.[4]

Restructuring the carryback debt

Consider a buyer of real estate who acquires property and takes over the seller's existing mortgage evidenced by a note carried back by a **prior owner** of the property.

Later, the buyer defaults on the carryback mortgage. The mortgage holder initiates foreclosure.

A *pre-foreclosure workout* agreement is negotiated between the buyer and the mortgage holder. Under the terms of the agreement, the original carryback note is **cancelled** and the trust deed lien is **reconveyed**.

In exchange for cancelling the note, the buyer signs and delivers a new note and trust deed in favor of the holder of the cancelled carryback note and reconveyed trust deed. The new note is secured by the same property as described in the new trust deed.

The new note is for a greater amount than the principal amount which remained on the carryback debt since the holder of the note was given a bonus for restructuring the terms for payment of the debt, a sum added to the unpaid principal. Also, the interest rate on the new note is increased.

Rollover of the debt

Continuing with this example, the **higher yield** on the new note resulting from the modified note rate and bonus paid to the mortgage holder exceeds the maximum annual average yield allowed over the life of the debt by usury laws.

After paying off the new note, the buyer demands the return of all the interest paid on the new note, claiming it was the result of a forbearance which brought the carryback debt under the protection of usury laws.

Is the mortgage holder entitled to retain the interest bargained for and paid on the note?

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4 **DCM Partners** v. **Smith** (1991) 228 CA3d 729

Yes! The new note evidenced a **restructuring** of the original credit sale debt, and the debt remained secured by the property originally sold. As a **rollover** of the debt created in a credit sale into a new mortgage on the property sold, the debt retained its original characteristics as a carryback debt.

Restructuring the carryback debt with a new note and trust deed did not convert the debt into a loan. Thus, the debt remained exempt from usury laws.[5]

Loan disguised as a carryback

While the modification of a carryback note on a default does not convert the debt into a loan, a loan transaction disguised as a carryback sale is subject to usury laws. In this instance, the documentation for a loan as a carryback transaction is merely a sham, a **masked loan transaction**.

For example, consider a seller of real estate who negotiates with a buyer to **cash out** their equity in the property and assume the existing mortgage. However, the buyer does not have the cash reserves needed to cash out the seller's equity.

The buyer is referred to a lender which is not a licensed real estate broker in California. The buyer contacts the lender directly. The lender agrees to lend the buyer the additional money needed to cash out the seller's equity.

However, the rate of interest demanded by the lender exceeds the maximum yield allowed by usury laws.

Rather than lend the money directly to the buyer, the lender requires the sales transaction be restructured as a carryback sale evidenced by a note and trust deed executed by the buyer in favor of the seller. The note is to be payable on terms dictated by the lender. The lender will acquire the note at an agreed price by **assignment** from the seller concurrent with the close of the sales escrow.

assignment
A transfer to another of rights held by a person. A transfer to another of a person's right under a contract such as a mortgage, lease, purchase agreement or option.

Thus, the buyer will cash out the seller's equity in a two-step transaction consisting of:

- the buyer's down payment funds; and
- the lender's funds structured as payment for the seller's *assignment* of the carryback note to the buyer's lender.

Usury laws avoided?

Concluding our previous example, will the lender's plan to structure its advance of funds as a purchase of a carryback note by an assignment from the seller avoid the interest limitations of usury laws?

No! Although the transaction on its face appears to be a credit sale and an assignment of a carryback note to a trust deed investor, the initial purpose for the involvement of the trust deed investor was to **loan money** to the buyer. As a loan transaction initiated and negotiated by the buyer to obtain

5 **Ghirardo** v. **Antonioli** (1994) 8 C4th 791

purchase-assist funds from a lender without the involvement of a broker to arrange the loan, the transaction is a loan of money and subject to usury law limitations.[6]

Editor's note — One way for a private lender to exempt its loans from the limitation on interest rates imposed by usury laws is to retain a licensed real estate broker to arrange the loan or become licensed as a real estate broker itself, since all loans made or arranged by licensed brokers and secured by real estate are exempt from usury limitations.[7]

The carryback mortgage sold to a lender

Consider a buyer and seller in reverse roles from the previous example, but with the same goal of cashing out the seller on close of the sales escrow. The seller, not the buyer, initiates negotiations to sell the carryback mortgage to a trust deed investor, who is also a non-exempt lender.

The buyer and seller enter into a purchase agreement calling for the buyer to make a down payment and execute a carryback mortgage in favor of the seller for the remainder of the purchase price. Closing is contingent on the seller assigning the mortgage to a trust deed investor.

From the outset of negotiations, the seller intends to immediately sell the carryback mortgage. To assure the mortgage can be sold, the seller (not the buyer in this example) structures the terms of the carryback note for its sale to a trust deed investor. A trust deed investor approves the buyer's credit history before the seller waives the contingency for further approval of the buyer's credit. [See **RPI** Form 150 §8.6]

The yield the trust deed investor is to receive for the funds they advance to acquire the mortgage exceeds the usury limits.

The sales escrow closes concurrent with the trust deed investor funding the purchase of the carryback mortgage by an assignment from the seller.

Later, the buyer claims the mortgage is usurious and they owe no interest to the trust deed investor since the creation and sale of the carryback mortgage was a sham designed to circumvent usury laws.

However, the carryback mortgage evidenced a debt intended by the buyer and seller to arise out of a valid credit sale. The trust deed investor was not brought in by the buyer to make a loan, but was sought out by the seller to purchase the mortgage the seller intended to carryback and resell.

No recharacterization or alteration of the purchase agreement or the sales escrow instructions was required to complete the seller's sale of the carryback mortgage by assignment to the trust deed investor.

6 **Harris** v. **Gallant** (1960) 183 CA2d 94

7 Calif. Const. Art. XV

Thus, the seller may freely *assign their carryback mortgage* to a trust deed investor. The assignment does not transform the carryback debt into a loan or subject the debt to the annual yield limitations of usury laws.[8]

Unconscionable advantage

Although a carryback mortgage and any modification (forbearance) of the terms of an existing carryback note are exempt from usury laws, another judicial limit controls for interest rate charges on carryback debts.

For example, consider a buyer of real estate with a 5% down payment who is only able to obtain financing for 80% of the purchase price. The seller agrees to carry back a second mortgage for the remainder of the purchase price. However, the seller demands an interest rate of 20% per annum to cover their risk of loss from default and foreclosure. Further, the note amortizes the principal in payments over 30 years, but calls for a full payment in five years.

The buyer agrees to the seller's terms for the carryback mortgage since the buyer believes they can obtain the funds necessary to pay off the carryback mortgage prior to the five-year due date.

When the due date arrives, the buyer is unable to obtain the funds necessary to pay off the carryback mortgage. The buyer defaults on the *final/balloon payment* and the seller begin foreclosure proceedings.

Prior to the foreclosure sale, the seller agrees to extend the due date of the mortgage for one year, provided the buyer agrees to increase the interest rate to 200%. The buyer, not wanting to lose their equity in the property after five years of ownership, agrees to the increased interest rate.

Interest payments under the modified carryback mortgage are made for six months, after which the buyer defaults on the mortgage again. As before, the seller begins foreclosure proceedings.

Unconscionable and excessive

unconscionable advantage
When an equity purchase investor or a mortgage holder exploits an element of oppression, helplessness or surprise to exact unreasonably favorable terms from a property owner or tenant.

Continuing our previous example, the buyer now claims they are not liable for the interest since the increased interest rate is usurious. Further, the buyer claims the modified interest rate is voidable as it was the result of an **unconscionable advantage** exercised by the seller when the increased rate was negotiated.

The seller claims the mortgage is not subject to usury laws since it evidences a carryback debt. In regards to the voluntary modification of the annual rate of return, the seller claims the rate is justified based on the risk of loss inherent in a 95% combined **loan-to-value (LTV) ratio** and rapidly rising mortgage rates.

On the first issue, is the seller correct that the note is not subject to a claim of usury?

8 **Boerner** v. **Colwell Company** (1978) 21 C3d 37

Yes! The carryback note evidences a debt owed to the seller which is secured by the property sold, the result of a *credit sale*. Thus, the carryback mortgage, no matter how it is modified, is not subject to usury limitations on interest rates.

However, the seller is incorrect on the second issue of an *unconscionable rate*. The interest rate provision of the note as modified is so unconscionably high as to be shocking to a court. Thus, as an unconscionable annual rate of return on the debt, the excessive rate is not enforceable by the carryback seller.[9]

9 **Carboni** v. **Arrospide** (1991) 2 CA4th 76

Chapter 23 Summary

The interest rate yield received by a lender on a real estate loan, unless exempt, is limited by California's usury law to the greater of:

- 10% per year; or
- the discount rate at the Federal Reserve Bank of San Francisco (FRBSF) plus 5%.

A non-exempt real estate loan is usurious if the note evidencing the loan provides for an interest rate exceeding the ceiling interest rate yield on the day the loan is agreed to by the lender.

Usury laws apply only to a loan origination or forbearance of rights on the default of a money loan. Thus, credit sales, such as carryback debt, are not subject to the interest limitations of usury laws. Loans made or arranged by a licensed real estate broker are also exempt.

The transaction in which the terms of a note evidencing the carryback mortgage are modified or a forbearance occurs does not change to transform the debt into a loan. Thus, a loan modification of the terms for payment does not subject the debt to usury laws since the debt is not a loan.

A new note evidenced a restructuring of the original credit sale debt where the debt remained secured by the property originally sold and retains its original characteristics as a carryback debt does not make the debt a loan, and is not subject to usury laws.

While the modification of a carryback note on a default does not convert the debt into a loan, a loan transaction disguised as a carryback sale is subject to usury laws.

However, a seller assigning their carryback mortgage to a trust deed investor does not transform the carryback debt into a loan subject to usury laws.

Although a carryback mortgage and any modification (forbearance) of the terms of an existing carryback note are exempt from usury laws, an unconscionable annual rate of return on the debt is not enforceable by the carryback seller.

Chapter 23 Key Terms

Chapter 24

Alternative security devices for sellers

Learning Objectives

After reading this chapter, you will be able to:

- identify the proper forms to be used in a sale of real estate to document carryback financing;
- explain how failing to record documentation of a sale does not avoid triggering lender due-on enforcement rights;
- discuss the use of the land sales contract to structure seller financing and the corresponding issues of due-on enforcement and reassessment; and
- identify the consequences of concealing a sale from a mortgage holder.

Key Terms

land sales contract

lease-purchase sale

masked security device

Creative financing vs. creative chaos

The variables for repayment of any debt make up the fundamental aspects of financing, such as:

- the amount of debt owed;
- the interest rate;
- payment schedule; and
- due date.

Two sets of forms are used in a sale of real estate to document the terms of carryback financing which will be junior to any existing mortgage liens:

- a **note and trust deed**, to evidence and secure the balance of the seller's *equity remaining* to be paid following the buyer's down payment; or
- an **all-inclusive note and trust deed (AITD),** to evidence and secure the balance of the *price remaining* to be paid after the buyer makes a down payment. [See Chapter 13]

masked security device
Alternative documentation for a carryback sale, substituted for a note and trust deed in a deceptive attempt to avoid due-on enforcement, Regulation Z, reassessment for property taxes, profit reporting and the buyer's right of reinstatement or redemption on default. [See **RPI** Form 300-1 and 300-2]

All other forms used to document the terms of carryback financing offer not creative financing, but introduce an element of **creative chaos**, both legal and financial. The economic function of all types of documentation of the carryback sale is the same – debt, interest and payment.

Seller financing consists solely of arranging the financing of real estate through the seller's extension of credit to pay a portion of the sales price in the future — an **installment sale**. Arranging financing does not include the creation of alternative documentation to replace the note and trust deed, called **masked security devices**.

Mistaken expectations with alternative documentation

Creating new forms, by using documents designed to serve a different purpose than a trust deed (such as a lease-option) or using forms which have outlived their once useful purpose (such as the obsolete land sales contract), is the primary cause of *creative chaos* and the resulting mistaken expectations.

Documents developed for otherwise legitimate business purposes are occasionally substituted for notes and trust deeds to set up a *smoke screen* in an attempt to avoid:

- a mortgage holder's exercise of its due-on clause;
- reassessment for property tax purposes;
- income tax reporting of profits; and
- the buyer's right of reinstatement or redemption on a default on the debt.

The purpose of this activity is to corrupt the system set up to track conveyancing. All too often, the intended result is actually attained without penalty.

Alternative instruments

Alternative documentation for a carryback sale includes such instruments as:

- land sales contracts, sometimes called **contracts for deed**;
- long-term escrows with interim occupancy agreements;
- unexecuted or open-ended purchase agreements with interim occupancy, sometimes called *lease-purchase agreements*;
- lease-option sales contracts; and
- reverse trust deeds coupled with one of the above.

Masking the obvious sale

During periods of rising interest rates and decreasing sales, when the frequency of lender due-on enforcement also tends to rise, these alternative financing techniques are used to **mask the existence** of a sale in order to avoid due-on enforcement. Similarly, in the masking process, reassessments for an increase in property taxes do not automatically occur.

However, mortgage holders with due-on clauses are allowed to *call* or *recast* a loan on the transfer of any property interest, including:

- a sale;
- a transfer of any possessory interest;
- a further encumbrance; or
- a foreclosure of the property.[1]

All of these activities trigger the due-on clause, whether recorded or not.

Editor's note — Notable exceptions for the marketplace allow leases of three years or less on any property (without an accompanying purchase option), and further encumbrance of owner-occupied, single family residences (SFRs) to escape due-on enforcement.

Since attempts to hide sales from the mortgage holder and county assessor usually involve the use of alternative security devices, inherent financial and legal disadvantages exist from the outset of the transaction.

By changing the intended use of legitimate documents, the legal rights of the parties to the transaction become different from the rights permitted by the use for which the document was originally drafted, called **recharacterization**.

Full benefits of ownership lost

With most alternative security arrangements, the new owner/buyer fails to become the owner of record and often fails to exercise the full benefits of ownership, such as:

- interest/depreciation deductions;
- the right to further encumber the property; and
- property tax exemptions, etc.

Hiding the purchase from the mortgage holder generally includes hiding it from everyone, including the Internal Revenue Service (IRS), Franchise Tax Board (FTB), assessors and creditors.

Other disadvantages exist for owner/buyers who use alternative carryback devices in lieu of a note and trust deed. These negative results include the **failure to record** the documents used and the loss of the benefit extended to recorded documents, as well as the lack of title insurance.

If a carryback transaction is to go **unrecorded, unescrowed and uninsured**, at the very least the proper documents need to be used — a grant deed, trust deed and note — to avoid compounding the failure to record and obtain a title insurance policy by using chaotic documentation.

1 12 Code of Federal Regulations §591.2(b)

Contract for deed: the land sales contract

land sales contract
An agreement infrequently used by a carryback seller in a sale of real property to retain title to the property until all or an agreed part of the purchase price has been paid. Also commonly called a land-contract, conditional sales contract, installment sales contract or real property sales contract.

The **land sales contract** was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by mortgage holders.[2] [See **RPI** Form 168]

The financing arrangement is deceptively simple.

Under a *land sales contract*, a buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. The transaction lacks a formal escrow, title insurance, and the numerous disclosures of property conditions and statutorily mandated seller financing disclosures. [See **RPI** Form 300-1]

Title does not formally pass to the buyer by grant deed until the buyer pays the seller in full.

One might argue the existing mortgage holder of record has no cause to call the loan since the record of ownership of the property does not officially change until the contract is fully performed. However, this argument fails since title is not in issue — property ownership and possession are.

On entering into a land sales contract, an *equitable conversion* of ownership occurs.

From that moment forward, the seller is only entitled to receive money, not a return of the property, except by foreclosure. Thus, the buyer becomes the *equitable owner* of the real estate with the **right of redemption** to pay all sums due the seller and get clear title. No right of reinstatement exists for the buyer under a land sales contract.[3]

However, as straight forward as the land sales contract may sound, it has proven to be an extremely fragile financial and legal affair.

Unequal treatment

Although a land sales contract with a *power-of-sale provision* is accorded the same statutory treatment as a trust deed, courts give unequal treatment to the defaulting buyer under a land sales contract which does not contain a power-of-sale provision.

Most land sales contracts provide no such power of sale. Thus, they need to be **judicially foreclosed** on a default since in essence they are a two-party mortgage.

A defaulting buyer who has built up a substantial equity under a land sales contract has an unconditional right to complete the purchase by paying the entire remaining balance, a *redemption*. However, the buyer has no **right to reinstate** on a default, unless the contract includes terms for a reinstatement or a trustee's power-of-sale provision (which automatically permits the rights of reinstatement and redemption).[4]

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2 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

3 Tucker, *supra*

4 **Petersen** v. **Hartell** (1985) 40 C3d 102

The trend is to regard the land sales contract without a power-of-sale provision as a *mortgage*. A mortgage bears no legal difference from a carryback trust deed, except for the lack of a power-of-sale provision.

A basic land sales contract is an agreement to convey title to the buyer when the buyer **fully satisfies** the dollar amount remaining unpaid on the purchase price.

Also, to fit within the statutory definition of a land sales contract, the agreement to convey title may not call for the transfer of title within one year after the buyer is given possession of the property.[5]

The seller under the land sales contract, recharacterized as a *vendor*, retains legal title to the property **as security** for the buyer's promised payment of the balance of the purchase price. The buyer, recharacterized as a *vendee*, receives possession of the property and automatically becomes the **equitable owner** of the property.

Although the unrecorded land sales contract is often used to mask a sale of real estate, the sale is actually completed when the land sales contract is signed by the parties and delivered to the seller in exchange for the transfer of possession of the property to the buyer. A small down payment to the seller usually accompanies the transaction.

Conveyance escrow

Conveyance of title to the buyer usually occurs years later when a formal sales escrow is opened to complete the seller's performance of the land sales contract. The escrowing of the conveyance under a land sales contract is an event no different in legal and financial effect than the **reconveyance of a trust deed mortgage lien** from title on payment in full.

The **conveyance escrow** is not a traditional "sales escrow" at all as the sale and occupancy by the buyer occurred years before. The *conveyance escrow* is merely the means used to pay off and release the seller's security interest in the property under the land sales contract. Throughout the buyer's occupancy, the seller retained title to the property not as owner, but as the holder of security for the remaining unpaid balance on the credit sale. What escrow ultimately records and the assessor sees is a sale, not the mortgage-burning party it is.

The contentious contract

It is prudent for the buyer and seller to determine and analyze the risks and benefits accompanying their use of an unescrowed, unrecorded and uninsured *land sales contract* before they either:

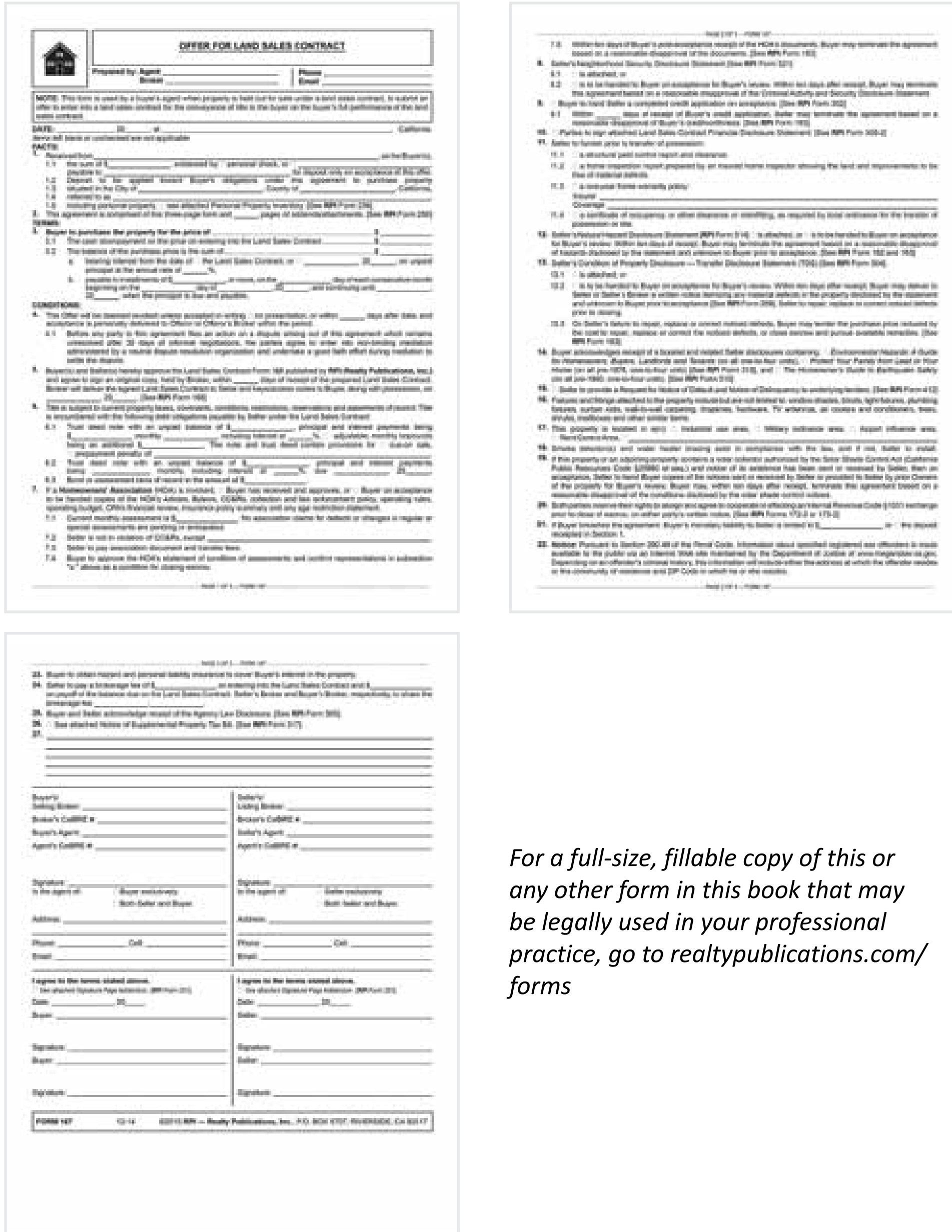
- sign and deliver an offer to purchase on a land sales contract [See Figure 1, **RPI** Form 167]; or
- sign and deliver the land sales contract and exchange down payment funds and possession. [See Figure 2, **RPI** Form 168]

5 Calif. Civil Code §2985

Figure 1

Form 167

Offer for Land Sales Contract


OFFER FOR LAND SALES CONTRACT

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms

Typically, when a land sales contract is used, the formal aspects of an escrowed sale of real estate are imprudently deferred until a "sales escrow" is opened to handle the buyer's payoff and the seller's transfer of title to close out the land sales contract.

The later sales escrow employed to satisfy the land sales contract by final payoff fails to reflect the fact that the actual sale occurred years earlier when the buyer and seller entered into the land sales contract.

The sales escrow, opened to close out the land sales contract transaction, is for the purpose of either:

- a full conveyance and refinancing of the property with a new mortgage holder to provide funds for the payoff of the debt owed to the seller on the land sales contract; or
- a seller "rollover" of the remaining contract debt into a note and trust deed, executed by the buyer and received by the seller on a transfer of the title to the buyer.

Closing costs deferred

All costs of a conventional closing incurred in a formal sales escrow, also called **transactional costs**, are avoided at the time of entering into a land sales contract. A seller and a buyer choosing to use a land sales contract rarely, if ever, escrow the land sales contract transaction, obtain title insurance, local government occupancy or retrofit certificates, or energy reports. They also lose the corresponding benefits of these activities.

Closing costs are deferred until a sales escrow is opened to complete performance of the land sales contract and convey title to the buyer.

Closing costs on a sale include:

- escrow fees;
- recording costs;
- title insurance premiums;
- a beneficiary statement; and
- assumption or loan fees.

Reassessment, supplemental tax bills and income taxes are soon to follow these fees.

The payment of brokerage fees is often in large part deferred, evidenced as a fractional ownership in, or a lien on, or a provision in the land sales contract until the seller is paid in full through the sales escrow.

Due-on-sale and reassessment

Consistent with their rationale for not recording a land sales contract, buyers and sellers do not request a **beneficiary statement** from the mortgage holder or a **waiver** of the mortgage holder's right to call or recast the mortgage on a transfer of equitable ownership. [See **RPI** Form 415]

Thus, sellers and buyers often mistakenly believe an unrecorded sale of real estate (such as a sale on a land sales contract), which is not brought to the attention of the mortgage holder or the county assessor, does not trigger the *due-on clause* or *reassessment* as a sale and change of ownership.

On the contrary, even if the land sales contract document is not recorded, entering into a land sales contract triggers both:

- the **due-on clause** in an existing trust deed as a transfer of an interest; and

- **reassessment** for property tax purposes as a change of ownership.

Whenever the holder of a mortgage containing a due-on clause discovers the mortgaged property has been sold on a land sales contract, the mortgage holder can enforce the due-on clause. Likewise, the county assessor can retroactively reassess on their discovery of the sale (and the tax collector can demand back taxes).

Contract escrows for delayed recording

Escrow companies have contributed to the creative chaos scene in the form of the **contract escrow**.

The *contract escrow* actually involves two escrows.

On the close of the sales escrow, the cash down payment is disbursed to a seller. However, all documents normally recorded, such as a grant deed and a trust deed, are placed in a second "holding" escrow. Nothing is recorded, but the proper documentation has been completed.

The sale of property has been closed for purposes of reassessment, due-on-sale and income tax.

The second contract escrow holds the documents until a written request from the buyer or the seller is received by escrow instructing them to record the grant deed and trust deed.

Since both the seller and the buyer have an insurable interest in the property, two separate policies of **fire and hazard insurance** are frequently obtained — one for the seller and another for the buyer. Alternatively, an agreement is entered into by the buyer and seller giving the buyer an interest in the proceeds of the insurance policy.

The carryback note is often placed on contract collection with the same escrow company.

Unexecuted purchase agreements, leases and extended escrows

Similar in approach to the land sales contract is the transfer of possession to the buyer under an **unexecuted purchase agreement**, as a sales escrow will not be closed for an extended period of time.

Here, a *marketing instrument* is used, such as a regular purchase agreement form. The purchase agreement is turned into a **security device** characteristic of a land sales contract or lease-option. The purchase agreement contains a provision for transfer of possession and buildup of equity by a credit to the purchase price for a portion of the buyer's payments to the seller, called a **lease-purchase sale**.

For example, consider a buyer and seller who sign a standard purchase agreement. [See **RPI** Form 150]

Escrow is opened. A grant deed, a carryback note, a trust deed, and the down payment are deposited into escrow within 30 to 60 days. A preliminary title report may even be ordered. However, the closing and disbursement of funds are delayed until after one to three years of timely performance by the buyer.

lease-purchase sale
A sales transaction characterized by a purchase agreement containing a provision for the present transfer of possession on a lease and buildup of equity in ownership by the tenant over the term of the lease before closing the sale by crediting the purchase price with a portion of the buyer's lease payments.

During the extended escrow period, payments are made by the buyer to the seller which include credit of a portion of the payment toward the down payment (or price) called for in the purchase agreement. Often, the buyer's payments are sent to the same escrow company that received the down payment and documents. In turn, the escrow forwards the funds on to the seller, the mortgage holder or a portion to both.

Since the buyer wants to take possession of the property prior to the close of escrow, they enter into an interim occupancy (lease) agreement with the seller. Neither the lease nor the escrow will extend beyond three years to avoid triggering any due-on clauses.

If the seller enters into a lease for more than *three years* or applies payments toward the purchase price, the transfer of possession will qualify as a sale, triggering reassessment, profit tax reporting, the mortgage holder's right to accelerate the loan, etc.[6]

For the buyer to protect any increase in the property's value which occurs by the end of the occupancy period, the buyer needs to:

- timely close the long-term escrow;
- renew or extend the lease; or
- find a buyer who will purchase their position.

The lease-option sale

Buyers and sellers of real estate need to understand that a sale structured as a **lease-option** is still a sale. The form used to structure the sale does not change a buyer's or seller's rights and obligations under mortgage and contract law.

Moreover, a seller seeking to disguise a sale as a lease-option transaction creates risks that are eliminated by more conventional wraparound formats, like the *all-inclusive trust deed (AITD).*

A sale documented as a lease and option to purchase typically lacks a power-of-sale provision— the seller's best remedy to recover the property (title and possession) if the buyer defaults. [See Figure 2]

The lease-option sale usually is not documented through an escrow, nor is there delivery of a grant deed or a note and trust deed.

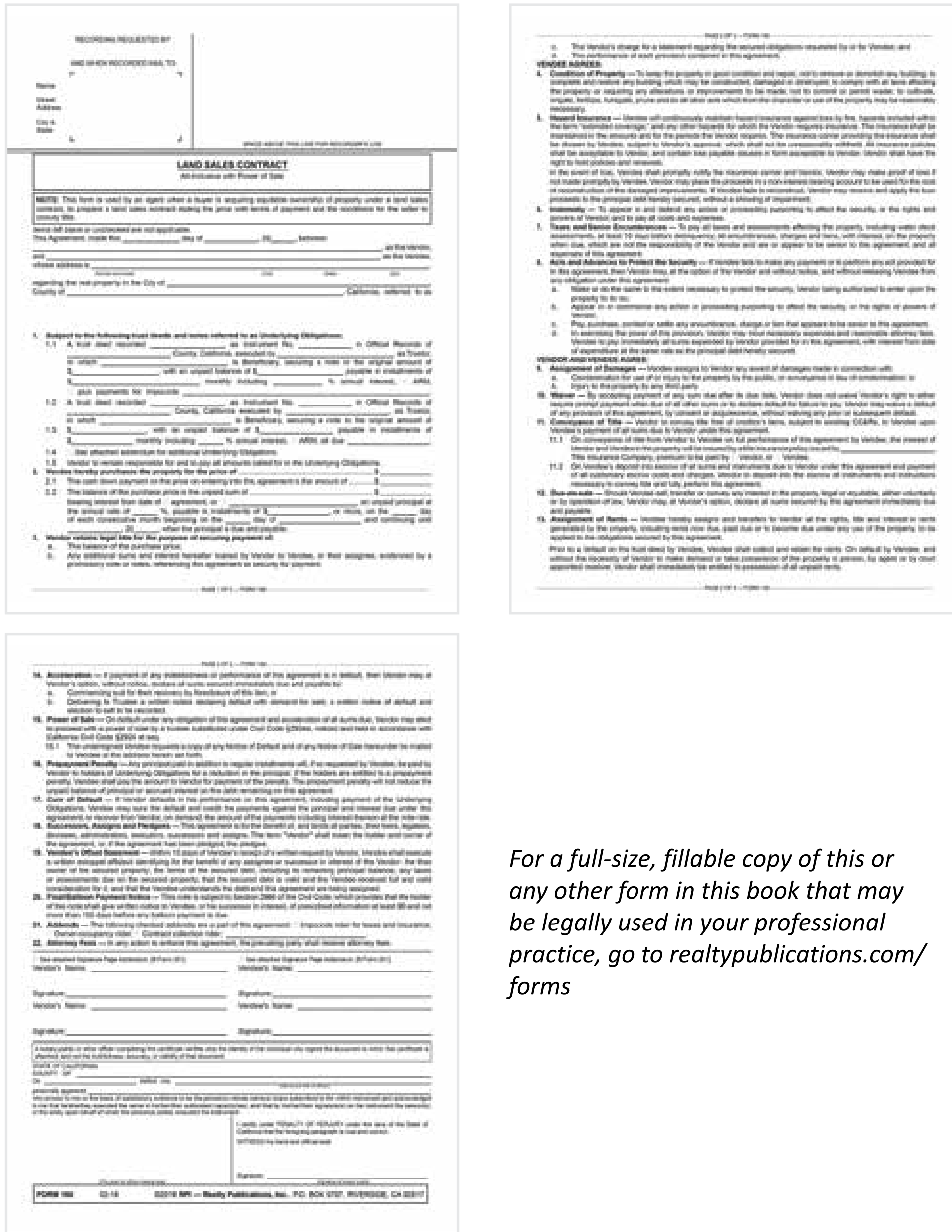
Instead, the buyer will lease the property and hold an option to purchase the property at a *predetermined price*, not a price based on market value at the time of exercising the option. Thus, any increase in value accrues to the buyer, not the seller.

6 12 CFR §591.2(b)

Figure 2

Form 168

Land Sales Contract



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The down payment, labeled **option money**, is applied toward the purchase price of the property if the option is exercised. Similarly, a portion of the monthly payment, called **rent**, will apply as principal paid toward the price on exercise of the option prior to its expiration. Of course, the expiration of the option is the legal equivalent of a due date for payment of the balance of the purchase price. [See Figure 3, **RPI** Form 163]

However, when a buyer as tenant receives credit toward the purchase price on payment of their option money or rent, the lease-option is *recharacterized* as a land sales contract or mortgage.

Also, a carryback sale structured as a lease-option typically fails to include a trustee's power- of-sale provision. Thus, the seller is prohibited from rapidly foreclosing by a trustee's sale to eliminate the equity the buyer has paid for and built-up in the property.

Economic characteristics of a credit sale

Except for the absence of documentation in the form of a grant deed, note and trust deed, the terms of the lease-option sale have all the economic characteristics of a **credit sale**. Under a lease-option sale, there is:

- an agreed-to price;
- a down payment;
- monthly rent payments which apply in whole or in part toward principal (the balance being interest); and
- a final/balloon payment for the balance of the unpaid purchase price.

When a buyer in possession of property under an agreement with the seller receives credit toward the purchase price for a portion or all of their payments to the seller, the buyer has built up and established equity in the property. Thus, the buyer has an **ownership interest** in the property which carries with it the *right of redemption* to pay off the seller and get clear title. The buyer's redemption rights can only be terminated by a judicial or nonjudicial foreclosure, or a deed-in-lieu of foreclosure. Either way, the seller (the mortgage holder in this arrangement) will likely be called on to pay "key money" to get possession of the property.

A lease-option agreement structured on terms economically consistent with a credit sale (a down payment, a credit of payments toward the price or both) is neither a lease between a tenant and a landlord nor an option to buy. The lease-option sales agreement is a **disguised security device** for credit financing of a sale arranged by a buyer and a carryback seller.[7]

An actual lease coupled with a separate option to buy is the antithesis of seller financing. A borrower's debt obligations and a mortgage holder's foreclosure rights are diametrically opposed to a tenant's leasehold obligations and the eviction rights of a landlord.

Also, all lease-options trigger due-on provisions in mortgages which encumber property.

Tax aspects

Tax-wise, lease-option sales are recharacterized by the IRS, the state FTB and the county assessor as carryback financing or land sales contracts.

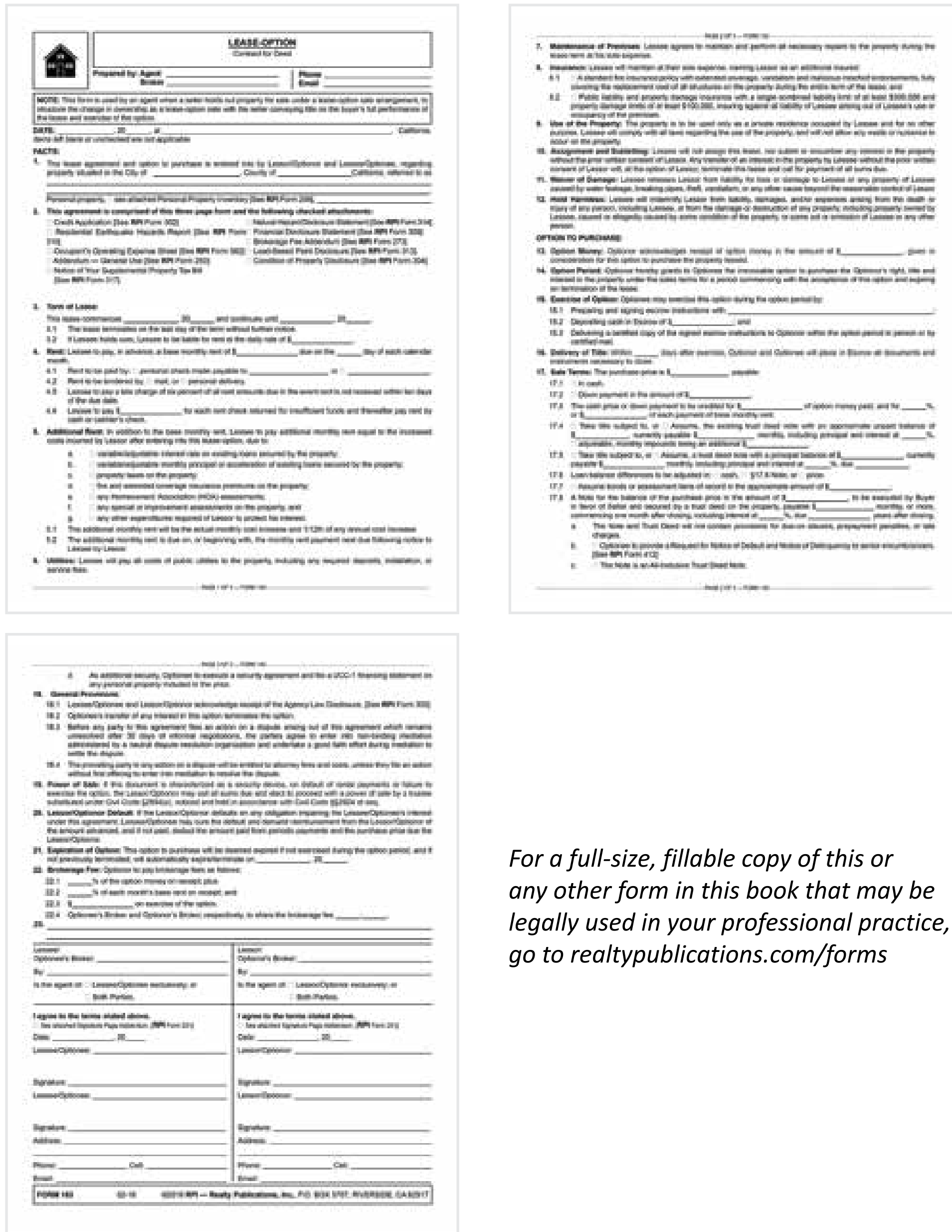
One reason sellers conceal property sales behind the format of a lease-option is to avoid added tax burdens on a change in ownership. Under an actual option agreement, any option money received by the seller is reported as either **profit or income** when the option is exercised or expires, or the property is sold subject to the option. [See Chapter 26]

7 **Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798

Figure 3

Form 163

Lease-Option



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The seller, disguised as a landlord, might also deduct the amount of the property's annual depreciation to reduce income taxes, until the IRS recharacterizes the lease-option as a sale and disallows the deductions.

Buyers are motivated to structure a sale as an unrecorded lease-option to evade additional taxes due on property reassessment by the county. However, the use of a lease-option to mask a sale has property tax consequences, since the economic characteristics of the transaction constitute a change of ownership, triggering retroactive reassessment when later discovered.

Reverse trust deed

The **reverse trust deed** is occasionally used to provide recorded protection for a buyer's investment in an otherwise unrecorded transfer, such as one involving the two-step contract escrow.

As the name suggests, the economic roles of the buyer and seller in the transaction are reversed by recharacterization of events.

Under a *reverse trust deed*, escrow is instructed to document the amount of the down payment on the property as a loan made to the seller.

The seller, disguised as an owner borrowing money, signs a note for the amount of the down payment and a trust deed in favor of the buyer. The trust deed appears as the buyer's lien on the very property the buyer is acquiring, hence its name: reverse trust deed.

When escrow closes on the sale, the buyer's reverse trust deed is recorded naming the buyer as the beneficiary. The seller receives the *net proceeds* from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

Hold until recording is requested

All other documents regarding the buyer's *actual* purchase of the property — the executed grant deed and any carryback notes or trust deeds — are left unrecorded and placed into a **contract** or **holding escrow**. The escrow agent is instructed to hold these documents (together with the note and a request for a reconveyance of the reverse trust deed) until the buyer or seller requests they be recorded.

As a result, the record title indicates the seller merely equity-financed the property. Neither the mortgage holder nor the tax assessor is alerted to the transfer as long as the grant deed remains unrecorded and undisclosed. However, both the mortgage holder's due-on clause and the assessor's right to reassess have been triggered.

The reverse trust deed takes the place of the *Memorandum of Agreement* recorded in some contract escrow arrangements.

Despite its duplicitous nature, the reverse trust deed presents a degree of financial protection to the buyer. When recorded, it prevents the seller from defeating the buyer's down payment by further encumbering or deeding out the property to a bona fide purchaser (BFP).[8]

If the seller interferes with the buyer's unrecorded grant deed interest, the buyer can foreclose on the trust deed and wipe out the seller's position.

8 **Miller** v. **Cote** (1982) 127 CA3d 888

Economic and legal flaws

The reverse trust deed is not perfect and has several potentially fatal flaws, both economic and legal.

Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect their equity (due to the historical 2% annual rate of inflation as a monetary policy of the Federal Reserve and cyclical asset inflation).

If the buyer needs to foreclose on the property to recover the amount of their down payment, the buyer will only become the legal owner of the property if they are the successful bidder at a trustee's sale.

Further, the buyer runs the risk of being *overbid* by other bidders who appear at the sale. At a minimum, the buyer as the foreclosing beneficiary of the trust deed will only get back the amount of their original down payment, plus interest.

Legally, the reverse trust deed is even more disenchanting than lost inflation or appreciation. Even if the buyer could bid high enough at the trustee's sale to acquire title to the property, they still stand to lose it if the senior mortgage holder calls the loan, and if unpaid, forecloses.

If the property is an owner-occupied, one-to-four unit residential property, the owner (meaning the seller, not the buyer) can further encumber and avoid a call under the existing mortgage holder's due-on clause only if they **continue to occupy** the property.[9]

Thus, the very purpose for using a reverse trust deed (to transfer possession without the risk of the due-on-sale/reassessment) renders it *legally useless*, except to foreclose on the property. The reverse trust deed does not avoid a call or the recasting of the existing financing or a reassessment when the transaction is discovered by the mortgage holder or the county assessor.

Reverse trust deed tax liabilities

Tax-wise, a reverse trust deed transaction, unless reported as a sale, exposes the seller to liability for **tax evasion** for deliberately restructuring a sale to appear as a non-taxable event (a loan) — unless it is actually reported as a sale in the year of the transaction.

The substance and function of the transaction (the sale of the property) supersedes its recorded form (the trust deed loan).

Also, concealing the sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for their failure to report profit to the IRS and FTB.

When the grant deed is eventually recorded, its date prepared and notarized will probably alert the assessor to the unrecorded transfer of the property, which occurred a few years earlier, triggering retroactive assessment and the mailing of tax bills.

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9 12 CFR §591.5(b)(1)(i)

Filing the IRS 1099-S

When a formal sales escrow is not used to handle documents and funds on a sale, the person arranging the sale, generally the broker, is required to report the transaction to the IRS on a **1099-S form**.[10]

The IRS recognizes the sale date to be the earlier of the dates on which:

- title is transferred; or
- the economic benefits and burdens of ownership shift from the seller to the buyer.[11]

Typically, reporting the sale to the IRS with a 1099-S form is incorrectly deferred until the title is conveyed to the buyer through escrow on payoff of the land sales contract, lease-option or other masked security device or off-record handling. Here again, escrow improperly collaborates with the seller, buyer and broker to prevent discovery of the previously masked sale by all persons or agencies, even when escrow closes and reports the closing as the date of the sale.

10 Revenue Regulations §1.6045-4(a)

11 Rev. Reg. §1.6045-4(h)(2)(ii)

Chapter 24 Summary

Two sets of forms are used in a sale of real estate to document the terms of any carryback financing which will be junior to any existing mortgage liens:

- a note and trust deed; or
- an all-inclusive note and trust deed (AITD).

All other forms used for documenting the terms of carryback financing offer not creative financing, but introduce an element of creative chaos, both legal and financial.

During periods of rising interest rates, alternative financing techniques share a common strategy of masking the existence of a sale in order to avoid due-on enforcement.

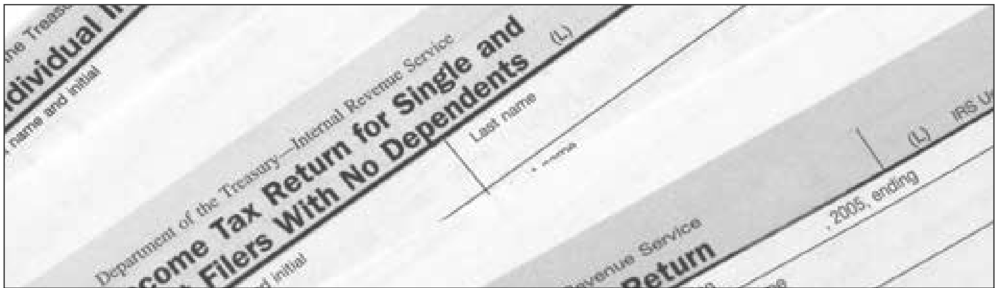
However, mortgage holders with due-on clauses are allowed to call or recast a loan on the transfer of any property interest, including a sale, a transfer of any possessory interest, a further encumbrance or a foreclosure of the property, whether recorded or not.

The land sales contract was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by mortgage holders. However, entering into a land sales contract triggers both the due-on clause in an existing trust deed as a transfer of an interest and reassessment as a change of ownership, even if the land sales contract document is not recorded.

Concealing a sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for their failure to report profit to the IRS and FTB.

Chapter 24 Key Terms

Chapter
25



Interest reporting on a carryback note

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between reportable interest income and profits in payments received by the seller on a carryback note;
- calculate the seller's annual tax reporting of interest income from a carryback note at no less than a minimum interest rate by imputing interest as an allocation from principal; and
- understand the process of converting principal to interest using an Applicable Federal Rate (AFR).

Key Terms

Applicable Federal Rate (AFR)

cost basis

imputed interest rate

portfolio category income

Charge or impute at the note's own AFR

Consider a seller of investment real estate who extends carryback financing, also called an **installment sale**, to a buyer for a portion of the property's sales price.

In addition to stating the principal amount owed, the carryback note sets forth:

- the interest rate charged by the seller;
- the monthly installment payments of principal and interest; and
- the due date for the **final/balloon payment**.

portfolio category income
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

Taxwise, the **interest income** portion of each installment payment is reported by the seller as **portfolio category income**. The *interest income* is then offset by any losses in the operation or sale of portfolio assets, such as:

- land holdings;
- ground leases;
- income property subject to a management-free, net lease agreement;
- mortgages; or
- stocks and bonds.

Any remaining interest earnings in the portfolio income category are reported and, unless offset by losses from the business or rental income categories and personal deductions, taxed at ordinary income rates. Ordinary income tax rates range from a floor of 10% to a ceiling of 39.6% (in 2016).

cost basis
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting and recovery of capital.

When the seller's remaining **cost basis** in the property is greater in amount than the mortgage encumbering the property, the **principal amount** of the carryback note represents an allocation of:

- part of the **basis**; and
- a portion of the **profit** taken on the sale.

The *cost basis* portion of each payment of principal is a **return of capital** and thus is not taxed. Conversely, the profit portion of the principal is comprised of *gains* to be reported within the **property's income category** (trade/business, rental/passive, portfolio or personal residence) and is taxed, if not offset by other losses.

The *profits* on the sale of income-producing property comprise:

- *unrecaptured depreciation gains;* and
- *long-term capital gains*.

These gains are taxed at a ceiling rate of 25% for unrecaptured depreciation gains and 15% for long-term capital gains, unless offset by:

- capital or operating losses on other properties owned by the seller within the same income category;
- allowable losses spilled over from other income categories; or
- itemized deductions.

The dynamics of planning

The 164% spread that exists between the long-term capital gain tax (15%) and the maximum tax on interest income (39.6%) is the dynamic which makes tax planning interesting to brokers, attorneys and accountants.

Sellers can reduce the overall amount of their taxes on an *installment sale*, while still receiving the same total amount of dollars over the life of the installment sale, by:

- increasing the purchase price of the property sold (thus increasing profits which are taxed at a 15% rate); and

- decreasing the interest rate charged on a carryback note (thus reducing ordinary income which is taxed at a 164% higher rate than gains).

To combat this shift in earnings from interest income to profits on installment sales, which reduces the overall tax on the entire transaction, the federal government set a floor rate for **minimum interest reporting** on carryback notes. Minimum interest rates limit the extent to which taxes can be reduced, properly called **tax avoidance**.

imputed interest rate
The applicable federal rate (AFR) set by the Internal Revenue Service (IRS) for carryback sellers to impute and report as minimum interest income a portion of principal when the note rate on a carryback debt is a lesser rate.

Conceptually, all sums received by the seller on the carryback note, whether labeled as principal or interest, are subject to a *reallocation of principal to interest* under **imputed interest** reporting rules.

The *rules for imputing interest* only apply to the seller. The buyer reports the principal and the interest as agreed in the carryback note, and the terms of the note remain unaltered by any imputing reported by the seller.

Reallocation of principal to interest

Carryback financing arrangements are subject to the minimum imputed interest rate reporting rules if the terms of the note call for any installment payments to be made for more than six months from the date the transaction closes.

Every debt that is the result of an extension of credit on a sale, such as a note carried back by a seller, has an **Applicable Federal Rate (AFR)** of interest. The note's *AFR* sets the minimum rate of interest the seller will report over the life of the carryback note. The rate of interest reported is fixed and does not vary during the life of the note, unless the terms of the note are modified.

Applicable Federal Rate (AFR)
Rates set by the Internal Revenue Service for carryback sellers to impute and report income at the minimum interest when the note rate on the carryback debt is a lesser rate.

Each carryback debt, regardless of the type of security device employed, has its own AFR. These financing arrangements include:

- a trust deed note;
- a land sales contract;
- a lease-option sale; or
- a lease-purchase agreement.

These security devices used by the seller include the terms for payment of the installment debt owed the seller for the unpaid portion of the purchase price.

Any carryback debt negotiated at an interest rate lower than the note's AFR triggers the reporting of a portion of the note's principal balance as interest. AFR reporting entails an allocation and conversion of principal to interest by the taxpayer, called **imputing**.[1]

Taxwise, *imputing* decreases the amount of principal reported on the carryback note. In effect, imputing also reduces the sales price the seller reports for the property sold. Likewise, the **profit** which would have been reported without imputing is decreased. Further, the interest income is increased by the amount of principal allocated to interest.

1 26 United States Code §1274(b)

The financial result of this allocation of principal to interest is a shift of profits to interest income. Further, this results in an overall *increase* in the amount of taxes the seller will pay on the transaction during the life of the carryback mortgage.

The buyer is completely unaffected by the imputing and the seller's income tax reporting, and simply reports the principal and the interest as agreed in the carryback note.

Applicable Federal Rates

Figures for the AFRs are set monthly by the **Internal Revenue Service (IRS).** AFR figures are loosely based on the rates of return (yield) on Treasury notes (T-notes) and bills (T-bills) issued by the government.

The percentage figure set as the AFR for a particular carryback note is based on three factors from the installment sales transaction, including:

- the **acceptance date** of the purchase agreement;
- the **term of the note**; and
- the note's periodic **payment schedule**.

The first step towards identifying the proper AFR for a note is to locate the AFRs for the **month of acceptance** of the purchase agreement or counteroffer, lease-option or land sales contract. Alternatively, the AFR figure may be selected from the AFRs for either of the two months before the date the purchase agreement is accepted.[2]

The IRS sets 12 fixed-rate AFRs each month. Thus, based on the **note's due date**, the fixed rates are broken down into **three AFR categories**:

- short-;
- medium-; and
- long-term.

Periodic payment schedules

Further, each category contains four rates, classified as monthly, quarterly, semi-annual and annual **periodic payment schedules**, one of which is selected based on the payment schedule in the carryback note. [See Figure 1]

The second step towards identifying the proper AFR for a note is to select the AFR category in which the note belongs, based on the **term of the note**. The selection of a category is set by the number of years from the closing of the sale to the due date of the note's final payment.

The categories are divided as follows:

- notes with due dates of **three years or less** fall into the **short-term** AFR category;
- notes due between **three and nine years** fall into the **mid-term** AFR category; and

2 26 USC §1274(d)(2)

Figure 1

Example Applicable Federal Rates

March 2016

Short term, not over 3 years:	AFR
Monthly	0.65%
Quarterly	0.65%
Semi-annual	0.65%
Annual	0.65%
Medium term, between 3 and 9 years:	**AFR**
Monthly	1.47%
Quarterly	1.47%
Semi-annual	1.47%
Annual	1.48%
Long term, over 9 years:	**AFR**
Monthly	2.31%
Quarterly	2.31%
Semi-annual	2.32%
Annual	2.33%

- notes due in **over nine years** fall into the **long-term** AFR category.[3]

Option periods to renew or extend the note's due date are included when figuring the length of the note's term and selecting the correct AFR category.[4]

The last step towards identifying the proper AFR for a note is to select the rate within the due date category that matches the note's periodic **payment schedule** (monthly, quarterly, etc.).

9% ceiling up to threshold amount

For all carryback sales entered into in 2016 in an amount no greater than $5,664,800, called the **interest threshold**, the minimum reportable interest rate is the lesser of 9% or the note's AFR.[5]

3 26 USC §1274(d)(1)(A)
4 26 USC §1274(d)(3)
5 26 USC §1274A(b); IRS Revenue Ruling 2015-24

Thus, 9% compounded semi-annually is the **maximum rate** for imputing carryback notes with a principal balance at or below the threshold amount, even though the AFR may exceed 9% (as it did in the early 1980s and will likely occur again by the 2030s).[6]

The threshold amount for applying the 9% ceiling is **adjusted for inflation** each year by the IRS, starting from a base amount of $2,933,200 in 1990.[7]

A carryback note with a principal amount greater than the *interest threshold* reports interest at or above the note's AFR on the entire amount on the note. Reporting is without regard to the ceiling of 9% and not just on the amount exceeding the threshold. In summary, if the note rate is less than the note's AFR, the principal amount of the note (for reporting purposes only) is reduced to conform to the amortization schedule, due date and the note's AFR in the process of *imputing*.

All carryback notes that are part of the same transaction or a series of **related transactions** are considered to have occurred in one sale. The amounts to be paid in principal and interest over the life of all carryback notes in related sales transactions are totaled to determine whether the 9% threshold ceiling or the AFR restrictions apply.[8]

Re-amortize and report

The IRS, to avoid economic distortion in private transactions, injects an equalizer in the form of a minimum annual **rate of interest** the seller may report on a carryback note.

This floor rate for reporting interest income neutralizes the seller's incentive to effectively raise the price a buyer will pay in exchange for reducing the interest charges on the carryback note. Thus, the minimum reportable interest rate implicitly removes an incentive to artificially increase the sales price of property to exceed its market value.

Consider a seller who agrees to carry a note for $100,000 at an interest rate of 7%, monthly payments of $665.30 with a $94,797.06 *final/balloon payment* due in five years. Based on the month the purchase agreement is entered into, the carryback note's medium-term due date and the monthly principal and interest payment schedule, the fixed AFR which controls for the entire life of the note is 8%, a higher rate than the 7% note rate. [See Figure 2]

Over the life of the note, the seller is scheduled to receive a total stream of principal and interest payments equal to $134,049.76 — $100,000 in principal and just over $34,000 in interest under the terms of the 7% note.

Each year, the seller will receive payments of principal and interest totaling $7,983.60. This amount is first applied to and reported as interest at no less than the note's AFR. The amount of the remaining payment is then deducted from the note's principal balance.

6 26 USC §1274; Rev. Rul. 2015-24
7 26 USC §1274A(d)(2)
8 26 USC §1274A(d)(1)

Figure 2

Re-amortization of imputed interest

- ✓ $100,000 note at 7% annual interest rate, AFR is 8%
- ✓ $665.30 monthly payments
- ✓ five-year due date
- ✓ Total payments collected equal $134,049.76; $665.30 x 59 months plus $94,797.06 final payment

Principal reduction

Term	7% note balance	8% AFR balance
origination	$100,000	$95,994
end of year 1	$98,984	$95,679
year 2	$98,984	$95,338
year 3	$96,727	$94,968
year 4	$95,475	$94,568
Final payoff	**$94,797.06**	**$94,797.06**

The principal received is further broken down into basis and profit on the profit-to-equity ratio for installment sale reporting of profit taxable from year to year.[9]

Taxwise, the interest rate the buyer is charged is less than the AFR. Thus, interest income is imputed (from principal) and reported by the seller as portfolio income at the AFR figure.

To *calculate the interest income* reported to the IRS, the seller re-amortizes the note (based on the amount of the scheduled installments, the final/ balloon payment amount and the number of months until due) at the note's AFR of 8%. These figures will set the amount imputed as reportable interest, and in turn, reduce the principal amount reported on the note.

Greater portion of each payment reported as interest income

Continuing our previous example, to calculate the note's AFR principal balance on origination for tax reporting, the seller first needs to calculate the principal amount to be received as the final/balloon payment by subtracting one month's interest at the AFR.

1. Interest = $94,797 final payment x .08/12 = $632

9 26 USC §453

2. $94,797 - $632 = $94,164 principal amount in the final/balloon payment

Next, the number of years it will take to pay off the principal amount of the final principal payment needs to be calculated using a financial calculator.

3. Principal balance (in final payment) = $94,164; monthly payment = $665.30; annual AFR interest = 8%

4. Resulting term = 36 years to fully amortize

Next, add the number of years running from origination to the date of the final/balloon payment to the AFR amortization period determined for the payoff amount. The total years for amortization is used to calculate the AFR principal balance at origination, or present value (PV).

5. 36 years + 5 years = 41 years, the amortization of AFR principal at the AFR interest figure

Next, using a *financial calculator*, calculate the AFR balance at origination, or PV, using the recalculated AFR amortization period, the scheduled monthly payment and the AFR interest figure.

6. Term = 41 years; monthly payment = $665.30; annual interest = 8%

7. Resulting AFR balance at origination = $95,994

Using an amortization table or financial calculator, the AFR balances at the end of each year may now be determined for each year up to the final/balloon payment.

This re-analysis of the principal and interest in the note's stream of scheduled installments and payoff amounts at the imputed interest rate **reduces the profit** by reducing the original principal amount of the note and the principal amount contained in each payment. Conversely, a larger portion of each payment than agreed to in the note executed by the buyer is reported as interest income. [See Figure 2]

Commingling interest and profit

Profits reported on the sale of real estate are taxed at rates ranging from 10% to 25% for various types of **gains** on real estate sales.

Ordinary income is taxed at higher rates than profits, ranging from 10% up to 39.6%, which sets the rates for taxes paid on interest income.

The objective of imputed interest reporting is to prevent carryback sellers from structuring the price and terms of payment to convert interest income into profit (**gains**) and achieve up to a 60% reduction in taxes on the amount converted to profits over the life of the mortgage.

For example, consider a carryback seller of rental property who compensates for their increased sales price by negotiating a reduced interest rate on their carryback mortgage, resulting in a zero-sum difference in the amount of dollars they will receive over the life of the mortgage. The remaining rentals they own are highly leveraged and produce annual operating losses.

The interest income will not directly offset the rental operating losses (since it is portfolio category income, not passive rental category income). However, if the seller is classified as being in a real estate-related business, they can annually offset the interest income by any rental operating losses.[10]

Taxwise, the high sales price/low interest rate generates enlarged profits as principal payments are received from year to year on the mortgage. Thus, the large annual reportable operating losses from the seller's highly leveraged rental properties will annually offset the enlarged profit from the installment sale of a rental which will be reported each year in the passive income category.

Applicable Federal Rates

Continuing our previous example, unless the seller can *write off* the operating losses as resulting from a real estate-related business, the losses will not offset interest income on the carryback note since interest is reported in a separate income category.

The seller will use their annual reportable rental operating losses to shelter their artificial profit received annually on the installment sale of the rental property at an above market price.

The monthly payments received by the seller equal the same amount they would receive in monthly payments on a lesser purchase price with a higher interest rate.

Here, compulsory reporting of imputed interest at minimum rates prevents sellers who are not in a real estate-related business from commingling *investment category interest income* with *rental category operating losses* to offset one another and neutralize taxes.[11]

Interestingly, no reporting rules exist to govern the opposite process by which the seller reduces the purchase price and, by the terms of the carryback note, converts profit into increased interest earnings. This process increases portfolio category income, and may be performed in order to, for example, eat up losses carried forward on stock sales and carrying costs of land ownership.

Conversion into investment category interest income

Consider a "land-poor" seller who has built up substantial investment/portfolio category losses carrying their property. The seller sells their rental category property (with a $1,000,000 fair market value) in the passive income category for $750,000 to an investor with a $100,000 down payment.

The seller carries back the balance in an **all-inclusive trust deed (AITD)** for $650,000 at 15% — significantly above current market interest rates — with

10 26 USC §469(c)(7)
11 26 USC §469(c), (e)

a seven-year due date. To ensure their high yield for seven years on the note will effectively recover the dollar amount of the $250,000 price reduction, the seller includes a *lock-in clause* in the note which bars prepayment for seven years.

In case the note is legally payable at any time during the seven-year period, a stiff prepayment penalty of 30% on unscheduled principal payments is included to cover the shortfall in total receipts from the sale (interest for seven years) due to an early payoff.

Here, the seller has effectively converted $250,000 of their profit on the sale of rental property into investment category interest income on the carryback mortgage. A portion of their actual rental profit (converted to interest) is now sheltered by their accumulated investment/portfolio losses carried forward from prior years due to land ownership expenses and resale losses (or stock/bond market losses).

Threshold for accrual reporting

If the principal amount of a note carried back in 2016 is more than $5,664,800, labeled the **accrual threshold**, the seller needs to report interest income each year *as the interest accrues* without regard for when payments on the note are received.[12]

For example, consider a carryback mortgage with a principal amount of $10,000,000 calling for a **graduated interest rate** of:

- 5% the first year;
- 6% the second;
- 7% the third;
- 8% the fourth;
- 9% the fifth; and
- 10% in years six through eight with a final/balloon payment due on the eighth anniversary of closing.

The amortization period for the payments is 30 years, with principal and interest payable monthly. Each year the amount of the payment increases as the note is re-amortized at that year's graduated rate for the remainder of the amortization period.

Additional interest income

To determine if additional interest income will be imputed, the amount of the **average annual interest** earned during the eight-year term of the note needs to first be established. To do so, interest earned on the accrual basis needs to be calculated as a constant (average) annual yield over the eight-year term, taking into account all interest agreed to be paid on the note in the future.

The average rate of interest over the eight-year period is 8.12%. However, the average interest rate charged is not equivalent to interest paid, called the

12 Rev. Rul. 2015-24

yield. The rate of interest is constant over the years of the note while the *amount* of interest paid is reduced each year as the principal balance declines due to amortization. As a result of amortization, the average yield (or interest paid) is 7.75% over the eight-year life of the note.

Accrual-threshold notes, such as the $10,000,000 note, are controlled by **accrual reporting**. Thus, the carryback seller reports interest annually at the note's constant *average yield* (in this case 7.75%) over the full term of the note.

In the graduated payment example, the seller reports more interest income than they actually receive in the early years of the note, and less interest income than they actually receive in the later years under the terms of the note.

Additionally, if the average yield on the accrual-reporting note is less than the note's AFR, the seller needs to report interest at the AFR each year.

The straight note

The fundamental difference between annual accrual reporting and cash reporting is best demonstrated by considering a carryback note with principal and interest due in one installment payable after the year of sale, called a **straight note** or **sleeper mortgage**.

Consider a buyer of an investment property. The seller carries back a mortgage for $1,000,000 at 5% interest compounded annually, with principal and interest due in two years. The note's short-term AFR is 7%, compounded semi-annually.

In this example, the seller is entitled to report their profit and interest income from the *straight note* on the **cash method** when they receive the principal. The straight note does not exceed the threshold amount which would require accrual accounting rather than cash accounting. A statement is filed with the seller's tax return in the year of the sale which states that no interest will be reported until the mortgage is paid in full.[13]

The seller receives $1,102,500 of principal and interest in a final/balloon payment on the due date of the straight note. However, rather than reporting the 5% interest income of $102,500 as stated in the note, the seller is required to report the interest at the note's AFR, 7% compounded semi-annually.

Thus, they will report $147,523 (rather than $102,500) as interest income. The remaining $954,977 ($1,102,500 - $147,523) of the payment received (rather than $1,000,000) is AFR principal. The principal represents an allocation between profit and a return of capital in amounts based on the equity-to-profit ratio for the original installment sale transaction.

13 26 Code Federal Regulations §1.1274A-1

The sleeper mortgage

Now consider an investment property purchased with a carryback *sleeper mortgage* for $10,000,000, a principal amount on the note that exceeds the accrual threshold and requires annual (accrual) reporting of interest.

The $10,000,000 note calls for 5% interest, compounded annually, with a two-year due date for the payment of all principal and interest totaling $11,025,000. The note's short-term AFR is 7%, compounded semi-annually.

The principal amount of the note is first recomputed to impute interest at the note's AFR. Once the principal amount is recomputed using the total payment received and the AFR, the seller's reportable principal in the note is no longer $10,000,000, but slightly over $9,600,000 (using the formula x = $11,025,000 $\div$ 1.035^4).

Editor's note – Here, since the note's AFR is compounded at 7% semi-annually, the AFR is calculated as 3.5% every six months, compounded four times over the two-year term.

Thus, like cash reporting, accrual reporting includes additional interest income of approximately $400,000 **imputed as interest** over the two year period, which reduces the note's principal amount (and profit on the sale).

However, unlike cash reporting, accrual reporting requires interest to be reported annually at the note's AFR, as it **accrues unpaid**.

As a result, nearly $700,000 (interest compounded semi-annually at 7% on recomputed principal) is reported as portfolio category interest income in the first year, even though the seller receives no payment with which to pay the taxes on the accrued interest income.

Special imputed interest rates and exemptions

Interest on **sale-leaseback financing** arrangements is imputed at 110% of the note's AFR.[14]

Carryback notes created on the sale of land between **family members** will impute interest at a ceiling rate of no more than 6%, compounded semi-annually, unless the total sales price of all transactions between the same two family members in the same year exceeds $500,000 (the threshold which triggers imputed interest reporting at the note's AFR).[15]

Carryback notes with a due date of six months or less are exempt from imputed interest reporting.[16]

A carryback note assumed by a buyer does not receive a new AFR at the time of assumption, unless the terms of the note are modified.[17]

14 26 USC §1274(e)
15 26 USC §483(e)
16 26 USC §1274(c)(1)(B)
17 26 USC §1274(c)(4)

Chapter 25 Summary

A seller of investment real estate who extends credit to a buyer for a portion of the property's sales price reports earnings for tax purposes. The interest income portion of each installment payment is reported as portfolio category income. Any remaining interest earnings in the portfolio income category are reported and taxed at ordinary income rates, unless offset by losses and personal deductions.

The cost basis portion of each payment of principal is a return of capital and is not taxed. Conversely, the profit portion of the principal is comprised of gains to be reported within the property's income category and is taxed, if not offset by other losses.

All sums received by the seller on the carryback note, whether labeled as principal or interest, are subject to a reallocation of principal to interest under imputed interest reporting rules.

Every debt that is the result of an extension of credit on a sale has an Applicable Federal Rate (AFR) of interest. The note's AFR sets the minimum rate of interest the seller will report over the life of the carryback note.

AFR reporting entails an allocation and conversion of principal to interest by the taxpayer, called imputing. The IRS injects an equalizer in the form of a minimum annual rate of interest the seller will report on a carryback note. When the interest rate the buyer is charged is less than the AFR, the seller needs to recalculate the interest income reported to the IRS by re-amortizing the note.

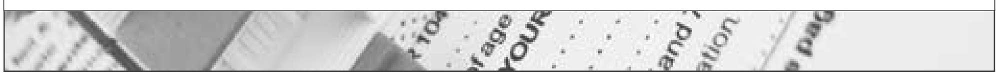
This re-analysis of the principal and interest in the note's stream of scheduled installments and payoff amounts at the imputed interest rate reduces the profit by reducing the original principal amount of the note and the principal amount contained in each payment. Conversely, a larger portion of each payment than agreed to in the note executed by the buyer is reported as interest income.

Chapter 25 Key Terms

Notes:

Chapter 26

Seller financing diminishes tax impact



Learning Objectives

After reading this chapter, you will be able to:

- understand how profit reporting for income tax purposes is deferred under an installment sale;
- calculate and apply the profit-to-equity ratio when reporting profit on a carryback sale; and
- maximize a carryback seller's tax deferral benefits by avoiding debt relief.

Key Terms

all-inclusive trust deed (AITD) note

balloon payment

cost basis

dealer property

due-on clause

passive category income

pledge

portfolio category income

stepped-up basis

Installment sale defers profit reporting

Consider a seller who lists their income-producing property for sale with a real estate agent. The listing price for the property is $1,500,000 and it is free of encumbrances. The seller's **cost basis** in the property is $100,000.

As a result of counseling, the seller's agent discovers the seller's goal is to convert their ownership of the real estate into a relatively management-free, interest-bearing investment. The seller is an experienced investor and is not inclined to turn their real estate over to a trustee or exchange it for an unsecured annuity.

Consistent with their management-free investment goals, the seller agrees with their agent to carry back an interest-bearing installment note to provide financing for a buyer of the property. The monthly payments on the carryback note include interest which will provide the seller with an income, replacing the **net operating income (NOI)** they currently rely on from the property.

The seller's agent locates a buyer for the property who submits a full-price offer consisting of:

- a 20% down payment; and
- a carryback mortgage in favor of the seller for the remaining 80% of the purchase price.

Terms of the installment sale

Continuing our previous example, the buyer will tender a $300,000 down payment in cash and execute a note for the balance of the price, secured by a trust deed on the property. The transaction will close prior to the end of the year. The first installment of the carryback mortgage will be paid in the year following the year of the sale.

The terms of the carryback mortgage include:

- $1,200,000 in principal;
- 7% fixed interest rate;
- monthly payments of $7,983.63 on a 30-year amortization schedule; and
- a 10-year due date for a **final/balloon payment** of $1,037,732.25.

balloon payment
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/ balloon payment. [See **RPI** Form 418-3 and 419]

Editor's note – The final/balloon payment discussed in this example is for a business carryback mortgage. In contrast, the inclusion of a final/balloon payment on a consumer carryback mortgage is subject to restrictions set by Regulation Z (Reg Z) when the seller carries back greater than five consumer mortgages in a calender year.

cost basis
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting and recovery of capital.

The seller's agent reviews an estimate of the seller's net proceeds obtainable on a sale of the property with the seller, noting the **net sales price** after payment of around $100,000 in closing costs will be approximately $1,400,000. Then, taking the seller's *cost basis* of $100,000 into account, the seller's agent calculates the profit on the sale will be approximately $1,300,000. [See **RPI** Form 310]

When will the seller pay income taxes on the $1,300,000 in profit taken on the sale of their property?

Tax bite deferred

Continuing our previous example, the seller will automatically report the sale as an **installment sale** on their income tax return.

Installment reporting *defers payment* of pro rata amounts of profit taxes to later years when installments on the carryback mortgage are received by the seller. The portion of each installment which is principal contains a pro rata share of the profit received on the sale. It is this receipt of sales profit via the principal and interest payments that is reported each year.[1]

Deferring the tax on profit

For a seller of real estate, profit is the portion of the *net sales price* remaining after deducting the seller's remaining capital investment (*cost basis*) in the property. The formula is:

net price - basis = profit

However, a developer's **dealer property**, such as vacant lots or homes sold by a developer or speculator as part of a fix and flip operation, generates ordinary income, not profit.[2]

dealer property
Real estate held for sale to customers in the ordinary course of an owner's trade or business, where the earnings on the sales of the properties are taxed as business inventory at ordinary income rates.

When a sale of real estate generates profit, called **gain** by the Internal Revenue Service (IRS), *all profit* taken on the sale is reported in the year of sale, unless the profit is:

- *excluded*, which occurs when the sale of property qualifies as a principal residence for the Internal Revenue Code (IRC) §121 $250,000 profit exclusion per individual homeowner;
- *exempt*, which occurs on the sale of business or investment property when the net sales proceeds are used to acquire identified replacement property in an IRC §1031 reinvestment plan, or to replace property taken by the government through eminent domain; or
- *deferred*, which occurs when the profit on a sale is allocated to a note carried back on the sale and reported under the IRC §453 installment method.

Editor's note – 26 United States Code (26 USC) is the Internal Revenue Code (IRC).

Exclusion on a converted principal residence

When the sale of a property qualifies as the seller's principal residence, profit on the sale may be excluded from taxation. For a residential income property that was once used as the investor's primary residence, the sale may still qualify for the exclusion.

For **federal income tax purposes**, a homeowner can exclude up to $250,000 of the gain (up to $500,000 for a married couple) on the sale of the property used as their principal residence if they:

- owned the property for at least two years;
- occupied the property as their *principal residence* for at least two of the past five years; and
- did not exclude any gain from the sale of another property during the two-year period ending on the date of the sale.[3]

1 26 United States Code §453
2 26 USC §§64, 1231(b)(1)(A-B)
3 26 USC §121

If the owner sells the property within three years of converting it to a rental, they may still qualify for the principal residence profit exclusion.

When an owner sells a rental property they previously occupied as their primary residence, the basis used to calculate a gain is different from the basis used for determining a loss on the sale. Furthermore, the date the property's use was converted from principal residence to rental property is the commencement of the owner's depreciation of their cost basis as allowed for tax purposes.

The basis used for calculating a gain is determined by taking the cost basis (original purchase price + capital improvements – any casualty loss) less any post-conversion depreciation taken.

The adjusted basis for determining a loss is calculated using the lesser of:

- the cost basis on the date of conversion; or
- the fair market value (FMV) on the date of conversion.

Thus, the rule for calculating the adjusted basis prohibits a tax loss from a decline in value that occurs prior to the conversion date.[4]

Applying the profit-to-equity ratio

Before reporting the profit realized on a sale, the profit taken is allocated and attributed to part or all of the net cash proceeds and the principal of the carryback note received from the sale.

To accomplish the allocation, a ratio is first established between the profit on the sale and the *net sale proceeds* the seller receives (such as cash and a carryback note).

The ratio is set as the percentage of the net sales proceeds to be allocated to represent profit on the sale, called the **contract ratio** by the IRS or, more generically, the **profit-to-equity ratio**. Thus, whatever percent of the net equity is profit sets the profit-to-equity ratio applied to the cash and carryback note received from the sale.

Continuing with our introductory example, the net proceeds from the seller's equity in the property are $1,400,000. The net sales proceeds calculated become the sales price ($1,500,000) minus any *debt relief* ($0) minus closing costs ($100,000).

Thus, the *profit-to-equity ratio*, also called the **contract ratio**, of the $1,400,000 net sales proceeds represented by the $1,300,000 in profit is 0.9286 (93% for our purposes).

Accordingly, 93% of the net cash proceeds received on closing ($200,000) is reported and taxed as profit ($186,000) in the year of the sale. In future years, 93% of the principal in each installment received on the carryback mortgage is similarly reported as taxable profit.

4 Internal Revenue Service Publication 551

Thus, $14,000 of the cash proceeds from the down payment represents the seller's recovery of a portion of their remaining cost basis in the property. A return of capital is not taxable profit – it is a return of remaining invested capital and never taxed.

Each monthly installment on the seller's $1,200,000 carryback mortgage is $7,983.63.

During the year following the year of sale, the 12 installments received by the seller will include $12,189.71 in principal plus $83,613.85 in interest. Additional interest is also paid to the seller to cover any interest that accrued unpaid in the year of the sale (which may have been prepaid in the year of sale through escrow).

Portfolio category income reporting

Continuing our previous example, the seller will report all the interest received as **portfolio category income** without regard for whether the profit in the related principal payment is classified as:

- **business category income;** or
- **passive category income** (profit).

For profit reporting, the profit-to-equity ratio of 93% is applied to the principal in each installment received on the mortgage. Thus, the carryback seller's reportable profit in the first year (following the year of sale) is $11,336.43 — the $12,189.71 in principal payments the seller will receive multiplied by the profit-to-equity ratio of 93%.

The 7% remainder of the principal they will receive ($853.28) is untaxed since it represents a partial return of the seller's original capital investment (remaining cost basis).

Ten years after closing, the *final/balloon payment* will be received by the seller. Again, the profit-to-equity ratio of 93% will be applied to the final/balloon payment of $1,037,732.25. The profit reported by the carryback seller when the final/balloon payment is received will be $965,090.99 — 93% of the principal in the final/balloon payment.

Since the seller acquired the property as a depreciable long-term investment (**capital asset**) and actually held the property for at least one reporting period, the profit taken by the seller consists of two types of gains:

- **unrecaptured gain** in the amount of all depreciation taken during the seller's ownership (and taxed at a 25% rate in 2016); and
- **long-term gain** in the amount of all remaining inflation-appreciation profit (and taxed at 15%-20% rates in 2016).

portfolio category income
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

passive category income
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

The goals of an installment sale

While a carryback seller will pay a profit tax on all of the profit from a buyer's down payment, principal installments and final/balloon payment, the seller achieves two financial goals on the installment sale of their real estate:

- the *highest sales price* possible by providing the buyer with financing to facilitate the sale at the price sought by the seller; and
- the *maximum annual income* by earning interest on the principal in the carryback note, principal which includes unpaid and deferred profit taxes on 85% of the sales price.

When the seller carries back a **straight note** calling for the entire principal to be paid in a final/balloon payment after the year of sale, the sale is also reported as an *installment sale*. Here, the one installment is scheduled to be received after the year of the sale.[5]

However, a *straight note* due in the year of the sale, but paid delinquently, does not qualify the transaction for installment sale reporting.

The seller may structure payments on the carryback mortgage so they receive all or most of their principal (and thus profit) in a designated later year (or in any year on demand), if they anticipate taking a substantial loss in that later year which will offset reportable profit on the principal in their carryback mortgage. Buyers with cash reserves can accommodate these arrangements.

Debt relief, profit and taxes

Consider a seller who lists their income-producing property for sale. The seller recently refinanced the property, encumbering it with a $480,000 mortgage.

The seller is willing to accept the following sales terms for the property:

- a purchase price of $800,000;
- a 20% down payment of $160,000;
- an assumption of the existing $480,000 mortgage by a buyer; and
- a carryback mortgage for the balance of the seller's equity of $160,000.

In a discussion with the seller about profit on the sale, the seller's agent determines the seller's remaining cost basis in the property is $50,000, the improvements having been fully depreciated since the seller's purchase of the property many years ago.

On a sale of the property for $800,000, the net sales price will be approximately $720,000 after deducting all transactional costs.

The net sales price, besides representing the seller's debt and equity, is a return of their $50,000 remaining cost basis and a $670,000 profit on the sale. The profit is a result of:

- depreciation deductions (*unrecaptured gain*); and
- an increase in the property's dollar value due to inflation and local appreciation (*long-term gain*) during the seller's years of ownership.

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5 26 USC §453(b)(1)

All of the profit on the sale, unless deferred, exempt or excluded from taxation, is to be taxed in the year of sale as either:

- unrecaptured gain (depreciation) at a rate of 25%; or
- as a long-term capital gain (increased value) at the current rates of 15-20%.

Editor's note – If the carryback seller's AGI exceeds $200,000 ($250,000 for joint filers), a net investment income tax of 3.8% is also imposed on the interest income received on the trust deed. Howeer, if the seller's AGI is solely derived from salary or wages, it is not subject to the 3.8% tax. For example, if the seller had an AGI of $5,000 over the threshold amount, but $0 in net investment income, the lesser of the two amounts ($0) would result in a $0 net investment income tax.

The federal income tax bill will require around $140,000 be paid from the net proceeds of the sale plus California state tax, all totaling nearly 28% of the net sale proceeds.

Although the seller does not want to remain responsible for payments on the existing mortgage, the seller's agent explains to the seller how an assumption or refinancing of their existing mortgage by the buyer on an installment sale produces an adverse tax consequence for the seller.

Existing financing and profit

The calculation of profit on a sale is unaffected by the existence or nonexistence of *mortgage debt*. Debt encumbering a property plays no role in calculating the profit on a sale.

However, the assumption or refinancing of an existing debt by a buyer in a carryback sales transaction plays a significant role in setting the percentage of the down payment and principal in the carryback note which will be reported as profit and taxed each year as payments are received. The *percentage* is the portion of the seller's net proceeds from the sale — cash and seller financing — which is profit on the sale, the profit-to-equity ratio.

Tax-wise, the seller's goal in an installment sale is to structure the net sales proceeds to produce the lowest profit-to-equity ratio possible.

The lowest percentage possible in any sale is achieved when the *net sales price* and the *net sales proceeds* are the same, as in our opening scenario for this chapter. This percentage occurs naturally when the property is free of debt and unencumbered by liens. Thus, there is no debt relief on the installment sale.

Maximum tax deferral benefits

For the seller to receive the maximum tax deferral benefits available on an installment sale, no debt relief may occur. To entirely avoid debt relief when the property sold is encumbered by a trust deed, the seller needs to *remain responsible* for the trust deed debt after closing the sale.

Here, an **all-inclusive trust deed (AITD) note** carryback or land sales contract accomplishes this debt relief avoidance as an installment sale of property since the buyer does not assume or refinance the seller's existing mortgage. [See **RPI** Form 167 and 168; see Chapter 13]

all-inclusive trust deed (AITD) note
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

With an *AITD*, the principal amount of the carryback note is the balance due on the *purchase price* after deducting the buyer's down payment. The principal amount of the carryback note is not the balance of the seller's equity remaining to be paid after deducting the down payment (as occurs with a regular carryback note and the assumption or refinance of the existing mortgage by the buyer).

For example, the greater the amount of the debt assumed (or paid off on the sale) by the buyer, the smaller the seller's net sales proceeds. The profit on the sale does not vary, regardless of how the sale is financed. Thus, the smaller the seller's net proceeds on the sale (cash and carryback note), the higher the percentage of the net sales proceeds attributable to profit.

When the amount of the mortgage debt assumed or refinanced by the buyer exceeds the seller's remaining cost basis, the amount of the seller's profit will be greater in amount than the seller's net sales proceeds, a situation called **mortgage over basis**. Thus, all principal received on closing the transaction or by installment payments will be profit, and the profit-to-equity ratio will top out the note as 100% profit.[6]

Existing mortgage assumption by the buyer

In our previous mortgage assumption example, 100% of the net proceeds from the down payment and the entire principal in the seller's $160,000 carryback note will be profit, taxable in the years the principal amounts are received by the seller. As always, the tax is deferred only on that portion of the $670,000 profit allocated to the principal in the carryback note ($160,000). On a buyer's assumption of a mortgage, the amount of the carryback note is a small portion of the total sales price.

The remaining $510,000 ($670,000 - $160,000) in profit not allocated to the carryback note is taxed in the year of sale. Thus, the 25% and 15% profit tax due to the IRS on gains (unrecaptured and long-term) in the year the property is sold (2014 in this example) will be around $105,000 (plus state taxes).

However, the seller's cash sales proceeds are only $80,000, the $160,000 down payment minus the $80,000 in closing costs.

If the carryback seller allows a buyer to assume the existing mortgage, the immediate financial result will be disastrous. In this instance, taxes will greatly exceed the seller's cash proceeds. The seller's only relief on an assumption and carryback sale will come from any substantial losses they may incur from other business or investment sources which will offset these profits, and thus reduce their tax liability.

A far more prudent approach exists.

6 26 Code of Federal Regulations §15A.453-1(b)(2)(iii)

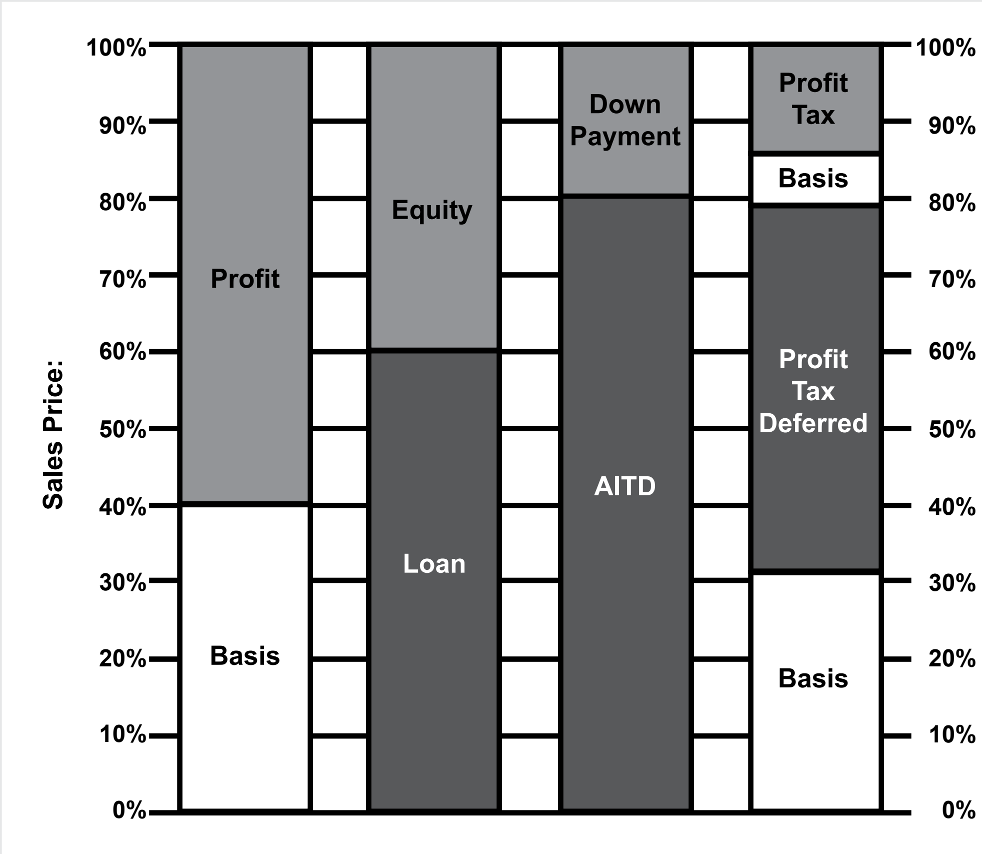

Figure 1

AITD/Mortgage-Over-Basis

The savvy seller, on the instruction of their agent, will want to structure any carryback mortgage on the sale of encumbered property as an *AITD* for the amount of the *balance of the purchase price*, not just the amount of equity remaining unpaid after the down payment and assumption of the existing mortgage. [See Chapter 13]

With an AITD, the total amount of the cash down payment and AITD will equal the *net sales price*, making the AITD a substantial 80% portion of the sales price. The resulting profit-to-equity ratio will be the lowest percentage figure available for allocation of profit between the cash proceeds and the carryback mortgage.

The all-inclusive trust deed

A broker needs to be able to explain to a seller of encumbered property how the carryback AITD, also called a **wraparound security device**, will:

- reduce the amount of profit allocated to the down payment (and thus reduce the seller's profit taxes in the year of sale); and
- increase the amount of profit allocated to the carryback note (and thus defer to future years the payment of taxes on *all profit* not allocated to the down payment). [See Figure 1]

A necessary arrangement for the seller on the sale of encumbered property is to *retain responsibility* for all future payments on the underlying mortgage in order to avoid debt relief.

To retain responsibility for the underlying mortgage, the seller carries back an AITD for the balance of the purchase price remaining unpaid after the down payment, not a regular note for the balance of their equity after the down payment. Thus, the seller will continue to make payments on the existing mortgage to the mortgage holder, not the buyer.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

A seller who remains responsible for a wrapped mortgage containing a **due-on clause** needs to obtain the *mortgage holder's consent* to the carryback sale, called a **reverse assumption**, since the buyer will not assume the mortgage.

The seller may be required to pay an *exaction* (points and interest rate modification) to induce the mortgage holder to waive the *due-on clause* and consent to the transfer of title and further encumbrance with the AITD.

Other types of *wraparound financing devices* produce the same tax results as an AITD, such as:

- land sales contracts [See **RPI** Form 168];
- contracts for deed;
- lease-option sales [See **RPI** Form 163]; and
- lease-purchase sales agreements.

These alternative financing devices also trigger the due-on clause in any trust deed of record, as does any carryback note secured by a trust deed on a mortgaged property. They also trigger reassessment for property taxes.

The profit allocated to the AITD will be sheltered from the payment of profit tax until the seller:

- receives payments of principal on the AITD;
- hypothecates the all-inclusive note (to be discussed below) [See **RPI** Form 242]; or
- shifts the responsibility for payment of the underlying wrapped mortgage to the buyer.[7]

Structuring the carryback sale as an AITD

Continuing with our previous example, the seller's **net sales proceeds** of $720,000 (cash plus the AITD carryback) are the same as the seller's **net sales price** when the seller remains responsible for the underlying mortgage in the AITD carryback.

Since the profit on the sale is $670,000 and the net sales proceeds are $720,000, the profit-to-equity ratio will be 93%, the lowest percentage available on the transaction.

In the year of sale, the seller will net $80,000 from the down payment, of which 93% ($74,400) is reportable as profit. All other profit has been allocated to the principal amount of the all-inclusive note. Thus, taxes on all profit not allocated to the down payment are deferred to later years.

7 **Professional Equities, Inc.** v. **Commissioner** (1987) 89 TC 165

The 25% tax on gains from unrecaptured depreciation represented by the $74,400 profit allocated to the down payment is around $18,600. The use of the AITD avoids the $105,000 in taxes the seller would otherwise have incurred in the year of sale had the buyer assumed or refinanced the seller's existing mortgage.

Structuring the carryback sale as an AITD allows the seller to receive **after-tax sales proceeds** of $61,400 from the $80,000 net down payment.

In conclusion, the 93% profit-to-equity ratio will be applied to the principal received in the AITD payments and on the final payoff. The profit-to-equity ratio sets the amount of the profit in the principal on the note which will be taxed when the principal is paid.

AITD later modified to take the profit

Consider a seller who carried back an AITD on the sale of rental property in a prior tax year. Profit from the sale was allocated to the all-inclusive note, reported and taxed on the installment method.

In the current tax year, the seller sustains either a substantial trade or business loss, or an operating or capital loss in the rental (passive) income category. A portfolio loss on stocks or bonds does not offset the profit taken on a rental property in the *passive category income*, except for $3,000 annually.[8]

The seller takes no profits this year to offset their loss. The losses, whether business or rental, are of no further tax benefit after the current year since the seller is treated as being in a real estate-related business.

Engineer the reporting of taxes

Continuing with our previous example, the seller may shift a portion of the profit from the all-inclusive note into the current year by *negotiating a modification* of the AITD with the buyer. With a modification, the seller may arrange to report a substantial portion of the installment profit in the current year by:

- *shifting responsibility* for the wrapped mortgage to the buyer by allowing them to assume or refinance the wrapped mortgage;
- *reducing the principal balance* in the all-inclusive note by the amount of the mortgage assumed or refinanced by the buyer; or
- *pledging the all-inclusive note as collateral* for a loan of an amount equal to their losses.

The percentage of profit in the principal of the all-inclusive note, as set by the profit-to-equity ratio, is applied to the principal reduction on the all-inclusive note — a reduction equal in amount to the mortgage assumed or refinanced, or the pledge of the note — to determine the amount of profit to be reported due to the debt relief.

Thus, on incurring debt relief by renegotiating the terms of the all-inclusive note and converting it to a regular note, the carryback seller is able to engineer

8 IRS Pub. 17

Broker Considerations

When assisting a carryback seller, the broker needs to be aware of other tax factors, including:

- *the $5 million carryback threshold rule — a seller who carries back more than $5 million during an individual tax year will incur an interest charge on the amount of the deferred tax [26 USC §453A];*
- *accrual accounting threshold — if the carryback amount in 2016 is $4,046,300 or more, the seller is to use the accrual method of accounting, reporting interest income as it accrues, whether or not payment of interest is actually received [26 USC §1274A(c)(2)(A); IRS Revenue Ruling 2015-24]; and*
- *minimum interest reporting — if the carryback amount in 2016 is up to $5,664,800, the interest rate charged is the lesser of the* ***Applicable Federal Rate (AFR)*** *or 9%. [26 USC §1274A(b); Rev. Rul. 2015-24]*

If the interest charged on the carryback note is lower than the AFR, the seller is required to report interest at the AFR rate, called ***imputing****, allocating principal to interest for reporting purposes only.*

the time for reporting a substantial amount of the profit in their carryback. As a result, the tax on the profit is avoided by the offset provided by the losses from business or rental category operations and sales in the year the AITD is modified.

Pledging carrybacks

A seller who **pledges** their carryback note as collateral for a loan, also called **hypothecation**, triggers the reporting of a portion of the profit which was allocated to principal in an amount equal to the amount borrowed.

pledge
To offer an asset (such as an existing carryback note) as collateral or security for another, unrelated debt. Also known as hypothecation. [See **RPI** Form 242]

The borrowing and pledging may also be timed to occur in a tax year when a loss on a business or rental activity has occurred, thus offsetting one another. [See **RPI** Form 242]

When a seller *pledges* a carryback note, the loan proceeds are considered to be equivalent to the payment of principal on the note. Thus, profit allocated to the principal is reported and taxed in an amount equal to the loan amount in the year of the pledge.[9]

The percentage under the profit-to-equity ratio, used to allocate profit to the carryback note, is applied to the amount of the loan proceeds to determine the amount of profit to be taxed due to the pledge.[10]

Prepayment penalties

On the prepayment of a carryback mortgage, the principal paid to satisfy the note includes profit which is reported and taxed in the year of the *premature payoff*.[11]

9 26 USC §453A(d)(1)
10 26 USC §453A(d)(2)
11 26 USC §453(c)

To assure a seller they will retain their tax advantages of an installment sale until the final/balloon payment becomes due, the seller's agent will suggest their client include a *prepayment penalty* clause in the carryback mortgage.

Statutory limits exist for prepayment penalties on carryback mortgages secured by owner-occupied, one-to-four unit residential properties. Additionally, all consumer carryback mortgages which contain a prepayment penalty are required to meet **qualified mortgage (QM)** parameters under the federal **ability-to-repay (ATR)** rules.[12]

For all other types of property, a prepayment penalty clause may be structured to compensate the seller for the entire amount of the projected profit tax they would prematurely incur due to the prepayment of principal on the note.

The prepayment penalty needs to be *reasonably related* to the actual expenditures likely to be made for the payment of profit taxes on a buyer's early payoff, including:

- *profit taxes*, based on current or reasonably anticipated rates; and
- *maintaining a portfolio yield* during the lag time after early payoff and before the funds are reinvested.

Election out

A seller may elect out of installment sale reporting by voluntarily reporting the profit as taxable in the year of the sale.[13]

Reporting all the profit on a carryback sale as taxable in the year the property was sold (and escrow was closed) may be advantageous to a seller who has an equivalent offsetting loss during the year of sale.

These offsetting losses include:

- *trade* or *business loss*, on a real estate brokerage, speculator fix and flip programs or a development business;
- *rental operating loss*, directly offset by the profit on a carryback sale of a rental property;
- *rental operating losses* which reduce the seller's adjusted gross income (AGI) if they are in a *real-estate-related business* activity;
- *capital loss* on the sale of a rental or passive business investment; or
- *capital loss* carried forward or from the sale of investment/portfolio category assets (stocks and bonds) when the installment sale is of an investment/portfolio category property, such as the sale of land held for profit on resale, a second home or a triple-net leased, management-free rental property.

12 Calif. Civil Code §2954.9; 12 CFR §1026.43

13 26 USC §453(a), (d)(1)

California Franchise Tax Board installment sales rules

Unlike the federal withholding scheme, California requires the buyer, through escrow, to withhold 3 1/3% of the sales price from the seller's proceeds on all sales, unless the transaction is excluded from withholding.

Excluded transactions include sales by:

- all California-based entities: and
- any individual who certifies that the transaction qualifies for an exclusion from withholding for the Franchise Tax Board (FTB).

For individual sellers entering into an installment sale of their property, the transaction is either:

- *qualified* from withholding by the individual seller certifying they are excluded; or
- *not qualified* and subject to the mandatory withholding of the entire 3 1/3% of the price from the down payment, unless the buyer agrees to withhold the 3 1/3% from each installment of principal paid on the price. [See Franchise Tax Board Form 593-I]

If the buyer refuses to withhold and forward 3 1/3% of the principal in each periodic payment to FTB, the carryback note may call for installments of interest-only payments and avoid amortization of the principal.

Thus, only the final/balloon payment may contain a payment of principal. In this fashion, the buyer's agreement to withhold principal is limited to the final payoff. Then, the buyer is only responsible for one filing with the FTB, besides the original filing by escrow which withheld 3 1/3% of the cash proceeds from the down payment, not 3 1/3% of the sales price.

Exclusion from California FTB withholding

However, the sale may *qualify for exclusion* from California FTB withholding. If the sale is excluded, the issue of buyer cooperation to withhold on every payment of principal is eliminated.

The seller's transaction is excluded from FTB withholding on both the down payment and the dollar amount of a carryback note, if:

- the property is the seller's *principal residence*;
- the sale is declared by the seller to be a *IRC §1031 reinvestment transaction* (with the carryback note being payable to the buyer's trustee for ultimate assignment as consideration for the purchase of a replacement property);
- the property is *sold at a loss* if the purchase price is less than the remaining cost basis; or
- the property is sold for a *price of $100,000* or less.

Miscellaneous installment rules

A carryback note needs to qualify for installment sale reporting at the time escrow closes.

Consider a carryback note with a due date in the same year as the sale. The seller may not restructure the carryback transaction *after escrow closes* in an attempt to qualify the sale as an installment sale by extending the due date on the carryback note to a date beyond the year of the sale.[14]

However, the seller may later modify the terms a carryback note they have reported as an installment sale by:

- extending its due date;
- subordinating the carryback mortgage to a new mortgage; or
- accepting substitute security from the buyer.

For builders, developers and speculators who sell their *dealer property* on a credit sale, installment sale reporting is not available (with exceptions). Their earnings from the sale of inventory are classified as trade/business income, not profit taken on the sale of a capital asset or property used to house and conduct an ongoing trade or business operation.[15]

However, the dealer property exclusion does not apply to the installment sale of farms, vacant residential lots and short-term timeshares, even though they may be classified as dealer property.[16]

No stepped-up basis on death

Consider a wife who, on her husband's death, becomes the owner of her husband's one-half interest in a carryback note they jointly held from an installment sale in a prior tax year. The carryback note has been reported and taxed on the installment method. Thus, the principal of the note contains untaxed profit.

The wife seeks a **stepped-up basis** on the entire note to its market value on the date of her husband's death since the note is a community property asset which she received upon her husband's death.

stepped-up basis
The setting of an asset's cost basis to fair market value for income tax purposes when transferred by death of the owner.

In this scenario, the carryback note held in community property and received by the wife on her husband's death does not qualify for a *step-up in basis*. The note at the time of death contained profit which had been *realized* on a prior sale and was yet to be taxed as *recognized*.[17]

14 26 CFR §15a.453-1(b)
15 26 USC §§453(b)(2)(A), (l)
16 26 USC §453(l)(2)]
17 26 USC §§453(e)(6)(C), 691(a)(4)

Chapter 26 Summary

Installment reporting defers payment of pro rata amounts of profit taxes to later years when installments on a carryback mortgage are received.

Before a seller reports the profit realized on a sale, the profit taken is allocated and attributed to part or all of the net cash proceeds and the principal of the carryback note received from the sale. The ratio is set as the percentage of the net sales proceeds to be allocated to represent profit on the sale.

A straight note carried back by a seller calling for the entire principal to be paid in a final/balloon payment after the year of sale is also reported as an installment sale.

Debt encumbering a property plays no role in calculating the profit on a sale. However, the assumption or refinancing of an existing debt by a buyer in a carryback sales transaction affects the percentage of the down payment and principal in the carryback note which will be reported as profit.

For the seller to receive the maximum tax deferral benefits available on an installment sale, no debt relief may occur.

An all-inclusive trust deed (AITD) note carryback or land sales contract avoids debt relief as an installment sale of property since the buyer does not assume or refinance the seller's existing mortgage.

A seller who pledges their carryback note as collateral for a loan, called hypothecation, triggers the reporting of a portion of the profit which was allocated to principal in an amount equal to the amount borrowed.

Chapter 26 Key Terms

Glossary

#

5/1 ARM **180**
A common type of adjustable rate mortgage with an introductory fixed rate period of five years followed by an annually-adjusted interest rate for the life of the mortgage.

A

abstract of judgment **249**
A condensed written summary of the essential holdings of a court judgment.

acceleration **83, 112, 120**
A demand for immediate payment of all amounts remaining unpaid on a loan or extension of credit by a mortgage lender or carryback seller.

accrual note **83**
An installment note calling for payments to be credited first to accrued interest with the remainder to principal. [See **RPI** Form 420]

add-on note **83**
A note in which interest is charged on the original loan amount for the entire term of the loan, then added to the original loan amount to set the total amount of principal and interest to be paid over the life of the note, payable in equal monthly installments.

adhesion contract **104**
An agreement in which one party has dramatically superior bargaining strength, forcing the weaker party to either accept or reject all the agreement's stated terms, a dynamic present to some degree in all lender/borrower relationships.

adjustment interval **180**
The predetermined period of time after which the interest rate and payment amount on an adjustable rate mortgage (ARM) or other variable rate mortgage is recast.

adjustable rate mortgage (ARM) **68**
A variable interest rate note, often starting out with an introductory teaser rate, only to reset at a much higher rate in a few months or years based on a particular index. [See **RPI** Form 320-1]

alienation clause **111**
A trust deed clause limiting the rights of the owner of the mortgaged property to freely transfer their interest in the property by sale, lease or further encumbrance.

allonge **79**
An attachment to a note occurring between preparation of the note and closing the transaction providing information necessary to update entries on the note at the time it becomes effective. [See **RPI** Form 250]

all-inclusive trust deed (AITD) note **5, 70, 135, 144, 158, 169, 228, 300**
A note entered into by the buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment. Also referred to as a wraparound mortgage or overriding mortgage. [See **RPI** Form 421]

affirmative duty **28**
An agent's obligation to voluntarily undertake an advisory activity when in a fiduciary relationship.

anti-deficiency **205, 218**
A limitation placed on a mortgage holder barring recovery of losses on a default resulting when the mortgaged property's value is insufficient to satisfy a nonrecourse mortgage debt, and a recourse mortgage debt if nonjudicially foreclosed.

anti-deficiency law **248**
California legislation limiting a mortgage holder's ability to recover losses on a default when the mortgaged property's value is insufficient to satisfy the mortgage debt.

Applicable Federal Rate (AFR) **69, 281**
Rates set by the Internal Revenue Service for carryback sellers to impute and report income at the minimum interest when the note rate on the carryback debt is a lesser rate.

assignment **258**
A transfer to another of rights held by a person. A transfer to another of a person's right under a contract such as a mortgage, lease, purchase agreement or option.

assumption **201**
A promise to pay the debt of another, typically a mortgage, given by a buyer of property.

B

balloon payment **55, 95, 161, 256, 294**
Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment. [See **RPI** Form 418-3 and 419]

beneficiary **49**
One entitled to the benefits of properties held in a trust or estate, with title vested in a trustee or executor.

beneficiary statement **154**
A document issued by a mortgage holder on request noting future payment schedules, interest rates and balances on a mortgage assumed by a buyer. [See **RPI** Form 415]

blanket mortgage **154, 218, 232**
A mortgage which is secured by two or more parcels of real property. [See **RPI** Form 450]

bridge loan **232**
A short-term mortgage arranged for a buyer to fund the purchase of a property but encumbering other real estate owned by the buyer, pending the arrangement of long-term financing or the sale of the other real estate as the source of funds for its repayment.

business mortgage **91**
A debt incurred for other than personal, family or household (consumer) purposes and secured by any type of real estate.

C

call **171**
A lender's demand for the balance of the loan to be immediately paid in full. [See **RPI** From 418-3]

call provision **97**
A provision in a note giving the mortgage holder the right to demand full payment at any time or after a specified time or event, also called an acceleration clause. [See **RPI** From 418-3]

carryback mortgage **56**
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

carryover provision **184**
An adjustable rate note provision allowing the lender to apply any margin exceeding a periodic rate cap on a given adjustment to the next scheduled rate adjustment.

collateral assignment **220**
An agreement providing additional, cumulative and concurrent security for a debt, in the form of personal property, to additionally secure the property owner's performance under the debt. [See **RPI** Form 437 and 446]

compounding **164**
The adding of accrued and unpaid interest to principal which thereafter accrues interest as principal at the note rate.

compounding on default **90**
An interest provision triggered by a delinquency in a payment causing interest to accrue on the amount of interest contained in the delinquent installment at the note rate until the delinquent payment is paid, a type of late charge. [See **RPI** Form 418-1]

conforming loan **91**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac, excluding FHA/VA or other government-insured mortgages.

consumer mortgage **76, 90**
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

cost basis **280, 294**
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting and recovery of capital.

cross-collateralization **218, 232, 237**
The use of one trust deed to describe multiple parcels of real estate or a UCC-1 financing statement encumbering personal property together with a trust deed as additional security for payment of a debt. [See **RPI** Form 436]

D

dealer property **295**
Real estate held for sale to customers in the ordinary course of an owner's trade or business, where the earnings on the sales of the properties are taxed as business inventory at ordinary income rates.

debt service **39**
The amount of principal and interest paid on a debt periodically, also referred to as the loan payment amount.

deed-in-lieu of foreclosure **241**
A deed to real property accepted by a lender from a defaulting borrower to avoid the necessity of foreclosure proceedings by the lender. [See **RPI** Form 406]

deficiency **56**
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

dragnet clause ....
A provision in a trust deed that purports to use the mortgaged real estate as security for all debts 104between the parties to the security agreement.

due-on clause .... **104 , 118, 134, 152, 168, 232, 302**
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

E

effective yield **158**
The actual rate of interest received by the mortgage holder as a result of leveraging, discounts and 110bonuses, distinct from the interest rate charged on the mortgage, also known as the effective rate of return.

eminent domain **110**
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

exculpatory clause 78, 99, 231
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower. [See **RPI** Form 418-5]

F

forbearance..................256
An agreement that the lender will temporarily reduce monthly mortgage payments for the homeowner at risk of default, without altering the original loan terms.

fully-indexed rate 182
For adjustable-rate notes, the index figure at the time of application plus the gross margin stated in the note.

further-approval contingency 21,32, 236
A provision in an agreement calling for the further approval of an event or activity by the seller, buyer or third party as a condition for further performance or the cancellation of the transaction by a person benefitting from the provision. [See **RPI** Form 185 §9 and 279 §2]

G

Garn-St. Germain Federal Depository Institutions Act of 1982 120
Federal legislation which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

grace period 82
The time period following the due date for a payment during which payment received by the lender or landlord is not delinquent and a late charge is not due. [See **RPI** Form 550 §4.3 and 552 §4.7]

graduated payment mortgage 67, 165
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

guarantee agreement ....
An agreement to be obligated to pay the debt or perform on a contract of another person if that person defaults or does not perform. [See **RPI** Form 439]

guarantor..................237
A person who agrees to pay a money obligation owed by another to a mortgage holder or a landlord under a lease agreement on a default in the obligation and demand for the sums remaining unpaid. [See **RPI** Form 439 and 553-1]

H

hypothecate..................58, 78, 227
To pledge a thing as security without the necessity of giving up possession of it. To mortgage a property. [See **RPI** Form 242]

hybrid ARM 187
A type of adjustable rate mortgage which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

I

impairment 35
The act of injuring or diminishing the value of a fee interest.

implicit rent 38
The dollar value of the use of a property by the owner.

imputed interest rate. 81, 281
The Applicable Federal Rate (AFR) set by the Internal Revenue Service (IRS) for carryback sellers to impute and report as minimum interest income a portion of principal when the note rate on a carryback debt is a lesser rate.

index 182
A regularly issued composite market interest rate for an investment such as Treasury Securities or inter-bank loans used to set the basis for periodic interest rate adjustments.

installment note 64
A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final balloon payment. [See **RPI** Form 420, 421 and 422]

installment sale . . . . 22 , 58
Financing provided by a seller who extends credit to the buyer for future periodic payments of a portion of the price paid for real estate, also known as carryback financing.

interlineation 77
The process of modifying boilerplate wording in a form by inserting additional language between the printed lines.

inter vivos trust 128
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. [See **RPI** Form 463]

introductory interest rate 181
The initial rate of interest on an adjustable rate mortgage (ARM), typically lower than the fully-indexed note rate and lasting for a set introductory period, allowing for a greater loan amount to be borrowed. Also known as a teaser rate.

L

land sales contract 250, 266
An agreement infrequently used by a carryback seller in a sale of real property to retain title to the property until all or an agreed part of the purchase price has been paid. Also commonly called a land-contract, conditional sales contract, installment sales contract or real property sales contract.

lease-purchase sale 271
A sales transaction characterized by a purchase agreement containing a provision for the present transfer of possession on a lease and buildup of equity in ownership by the tenant over the term of the lease before closing the sale by crediting the purchase price with a portion of the buyer's lease payments.

leveraging. 158
A double-edged sword of possible greater returns or potential total loss. In real estate, leveraging is the concept that a lien either increases the owner's risk they will lose the property (and their investment) to foreclose or increases the return on their investment.

lis pendens 251
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

listing agreement 10
A written employment agreement used by brokers and agents when an owner, buyer, tenant or lender retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

long-term rate 56
An interest rate fixed for the duration of the loan.

M

masked security device 22, 264
Alternative documentation for a carryback sale, substituted for a note and trust deed in a deceptive attempt to avoid due-on enforcement, Regulation Z, reassessment for property taxes, profit reporting and the buyer's right of reinstatement or redemption on default. [See **RPI** Form 300-1 and 300-2]

mortgage-in-fact 241
A grant deed given by an owner for the sole purpose of securing the performance of an obligation owed a creditor, such as payment of a debt.

N

negative amortization 150, 164,186
Occurs when monthly installment payments are insufficent to pay the interest accruing on the principal balance, requiring the unpaid interest to be added to the principal.

nonrecourse..215, 233, 248
A debt secured by real estate, the creditor's source of recovery on default limited solely to the value of their security interest in the secured property.

nonrecourse mortgage 7, 78, 206
A mortgage subject to anti-deficiency laws which do not permit the mortgage holder (lender or carryback seller) to pursue a borrower to collect any loss due to a deficiency in the value of the secured property on foreclosure or a short payoff.

note..76
A document, often secured by a trust deed on real estate, evidencing an obligation to pay money to a creditor, usually a lender or carryback seller. [See **RPI** Form 421 and 424]

note rate...56
The interest rate agreed to between the homebuyer and the lender on the promissory note. Contrast with real interest rate.

Notice of Default (NOD) 46
The notice filed to begin the nonjudicial foreclosure process. Generally, the NOD is filed following three or more months of delinquent mortgage payments.

Notice of Delinquency (NODq) 46
The notice sent by a mortgage holder to a person who requested the notice within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on their mortgage.

novation 124
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

P

pass-through provisions 151
An all-inclusive trust deed (AITD) provision used by a carryback seller which provides for the payment of any demands made by the underlying mortgage holder, other than regular principal and interest payments, to be passed through to the buyer when triggered by the buyer's conduct. [See **RPI** Form 442 and 443]

passive category income 297
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

pledge 304
To offer an asset (such as an existing carryback note) as collateral or security for another, unrelated debt. Also known as hypothecation. [See **RPI** Form 242]

portfolio category income 4, 280, 297
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

power-of-sale 243
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

prepayment penalty 81, 228
A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision. [See **RPI** Form 418-2]

prime offer rate 91
A base rate used by banks to price short-term business loans and home equity lines of credit, set 3% above the federal funds rate.

privity of estate 114
A mutual or successive relationship to the same rights in property; a connection between persons to the same estate in property.

private mortgage insurance (PMI) 3, 236
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios higher than 80%.

promissory note .... 56, 64 , 90
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

property profile 13
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

put option 237
The provision in all trust deeds which, in tandem with anti-deficiency laws, grants an owner-occupant of a one-to-four unit residential property under a purchase-assist mortgage the right to defulat and force the lender to buy the property through foreclosure for the remaining loan amount.

Q

qualified mortgage (QM) 92
A home mortgage which meets ability-to-repay rules under the Truth in Lending Act (TILA).

R

recast 135
A mortgage holder's demand to modify the note terms and receive payment of additional fees in exchange for waiving the due-on clause in their mortgage.

reconveyance 62, 206
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid. [See **RPI** Form 472]

recourse 32, 207, 217, 227, 237
On a debt secured by real estate and not subject to anti-deficiency defenses, the creditor may pursue a borrower on default for a loss due to a deficiency in the value of the secured property if the lender forecloses judicially.

redeem 48
The clearing of title to a parcel of real estate of a monetary lien, such as a mortgage, through payment of the debt in full as is required during a redemption period to avoid loss of the property either at a trustee's foreclosure sale or following a judicial foreclosure sale.

reinstatement 48, 84
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

S

security interest 238
A generic term designating the interest held in real estate or personal property by a lender, carryback seller or judgment creditor which is evidenced by either a trust deed, UCC-1 financing statement or abstract of judgment. [See **RPI** Form 450 and 436-1]

seller financing 2
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing. Also known as an installment sale, credit sale or carryback financing.

shared appreciation mortgage 66
A type of split-rate note calling for the proprty owner to periodically pay interim interest at a fixed rate, and when the balance is due, to further pay the holder of the note as additional interest an agreed fraction of the property's increased value. [See **RPI** Form 430]

short-term rate 56
A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.

stepped-up basis 307
The setting of an asset's cost basis to fair market value for income tax purposes when transferred by death of the owner.

straight note 23, 64
A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

subordination 194, 207
The rearrangement of mortgage lien priorities on title in which a mortgage lien takes a lesser or junior position to another mortgage lien on a property.

subordination agreement 13, 193
An agreement entered into by a mortgage holder to permit their security interest in title to the mortgaged property to take an inferior position to another encumbrance. [See **RPI** Form 281]

subprime 179
In mortgage lending, a borrower who poses a higher risk of not timely repaying a mortgage, or a mortgage with a high risk of default due to inferior underwriting standards.

T

trustee (on a morgage) 48
A party to a mortgage who, as a legal fiction, holds title to property as security for the performance of an obligation with the authority to sell the property or reconvey the trust deed on instructions from the mortgage holder.

U

unconscionable advantage 260
When an equity purchase investor or a mortgage holder exploits an element of oppression, helplessness or surprise to exact unreasonably favorable terms from a property owner or tenant.

unsecured note 32
A document evidencing a debt owed by one person to another where the debt is not secured by collateral, also called an unsecured promissory note. [See **RPI** Form 424]

usury **69, 255**
A limit on the lender's interest rate yield on nonexempt real estate loans.

V

vender's lien **249**
An unrecorded interest on title to property sold granting the seller the right to foreclose on the property when the buyer defaults on payment of remaining amounts owed on the purchase price.

W

waiver **231**
A mortgage holder's consent to forego a right to enforce a provision or agreement.

waiver agreement **129, 135**
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement. [See **RPI** Form 431 and 432]

Y

yield **55**
The interest earned by an investor on an investment (or by a bank on the money it has loaned). Also, called return.