# Real Estate Finance

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# Table of Contents

**Carryback Financing**

## Lenders



## Recourse and Nonrecourse Loans



## Default and Foreclosure

## Tax Aspects of Financing

# Table of Forms

## Full Forms

## Partial Forms

Chapter 1

# Wellenkamp to Garn and beyond

## Learning Objectives

After reading this chapter, you will be able to:

- recognize key cases and turning points in the law governing mortgage holder enforcement of the due-on clause in trust deeds;
- describe the shift in influence from mortgage holders to buyers, and back again, as due-on rules evolved in response to institutional pressures forcing changes in federal mortgage law;
- understand the government's role in mediating the economy through monetary and fiscal policy; and
- identify the financial and political circumstances which led to the housing bubble and mortgage crisis of the 2000s.

## Key Terms

**comparative advantage**

**due-on clause**

**Federal Home Loan Bank Board (FHLBB)**

**Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)**

**formal assumption**

**further encumbrance**

**Garn-St. Germain Federal Depository Institutions Act of 1982**

**mortgage-backed bond (MBB)**

**recast**

**restraint on alienation**

**secular stagnation**

**subject-to transaction**

## Lenders vs. owners in the recent past

The positions, goals and anticipations of the lender originating a mortgage (or *mortgage holder* servicing and collecting income from a mortgage) and the owner of real estate are *diametrically opposed*.

This adversarial relationship stems partly from greed, an entrepreneurial trait which is generally what brings both parties to a property in the first place.

California Supreme Court decisions in the 1960s and 1970s brought the confrontation between mortgage holders and owners into sharp focus, as did *anti-deficiency legislation* in the 1930s.

Property owners took one case of mortgage holder injustice after another to the courts. They challenged the mortgage holders' right to flex their *due-on* muscle by raising interest rates at will when the owner of real estate encumbered by a mortgage needed to sell or further encumber the property for funds.

To understand the cause of ongoing mortgage holder-versus-owner battles today (which are today limited to foreclosure conduct), a review of the events in the 1960s and the 1970s is helpful. As case law developed before the early 1980s, important factors included the shifting control of the marketplace from mortgage holders to owners, then back to mortgage holders again, and the often conflicting policies and economies of California and the larger nation.

## The early '60s: a stable market

Rising interest rates in the early 1960s produced a severe real estate recession in 1965-1967 while the general economy improved, due solely to the stimulus of war effort employment.

The economic boom experienced just prior to that recession, in 1963-1964, lead to disastrous results for the **savings and loan associations (S&Ls)** in Southern California.

Much like the lending environment during the **Millennium Boom**, individual credit was secondary. Anyone, it was said, was able to use the back of an old envelope to sketch a building plan and obtain a lender's "horseback" commitment for a construction loan. The lender's objective was to get the funds out to as many borrowers as possible.

Lenders viewed the excess monies on deposit as lettuce about to rot on the shelf. Money had to be lent, quickly. As a result, lenders chased deals to place the funds, a classic prelude to investment error whether practiced by lenders or investors.

## Broker control during the early '60s

In the early 1960s, builders and buyers selected projects and properties with little concern for the availability of mortgage funds. Funds were readily advanced for the asking. Interest rates were below 7%, and **inflation** was much lower.

To no one's surprise, builders funded by lenders created *excess inventory*. By 1966, vacancy rates and foreclosures soared. Mortgage lenders had lent and sellers had sold to unqualified builders and buyers, soon triggering defaults and increasing foreclosure rates.

*Editor's note — During this time, brokers did their job rendering services needed to bring these parties together.*

Suddenly, the real estate industry became mired in its own excesses, having grown too fast in the absence of financial safeguards on mortgage lending. Turnover rates for owners and tenants dropped, and sales volume fell naturally.

By the late 1960s, lenders started looking for ways to protect themselves from insolvency, and, with administrative governmental assistance in a rampant series of institutional mergers, regained control of their mortgage investments.

## Lenders amass their forces

In 1964, the California Supreme Court modified the common-law application of the **due-on clause**. While receiving little fanfare at the time, this case was the first in a series of rulings relating to the mortgage holder's use of a mortgage's *due-on* trust deed provision.[1] [See Chapter 19]

Common law had rendered *due-on clauses* absolutely **void and unenforceable**. The due-on clause, simply read, limited the free use and disposition of any property ownership interest — known as a **restraint on alienation**.[2]

**due-on clause**
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

**restraint on alienation**
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

In *Coast Bank*, the law of *restraints on alienation* was judicially altered, becoming more permissive with regard to a mortgage holder's use of the due-on clause. But it came with one warning: the enforcement of the clause was to be "reasonable."

As a result of this new *reasonable enforcement* test, the lower courts and attorneys for mortgage holders began carving out purposes for a mortgage holder's use of the clause which were arguably reasonable under circumstances surrounding the mortgage.

If reasonable circumstances — a jeopardized security position or increased risk of default, for instance — existed to justify a mortgage holder's call, then the due-on clause was enforced. Payoff of the mortgage balance was demanded, but rate increases were offered as an alternative. However, if the rate increase was not agreed to, foreclosure proceedings were initiated for failure to pay off the mortgage.

## The late '60s: marketplace instability

In 1965, mortgage rates increased and the money supply tightened. Availability of mortgage funds significantly decreased and *inflation* started to soar.

Portfolio lenders did not foresee this massive inflation, which began to adversely affect their solvency. Their **cost of funds** rose while their portfolio assets were fixed rate mortgages (FRMs) with 30-year amortization schedules.

1 **Coast Bank** v. **Minderhout** (1964) 61 C2d 311

2 Calif. Civil Code §711

During this time, approximately a quarter of the *S&Ls* in California were in serious financial turmoil. The S&Ls had lent to everyone secured by anything, and had done so at rates inadequate to cover the risk of inflation reflected in their *cost of funds* – interest paid on deposits.

The result was property foreclosures by the thousands — and by entire tracts — as well as the collapse of many large California-based S&Ls. **Real estate-owned (REO)** became common jargon in the language of the real estate broker. Mortgage holders acquired property in foreclosure which had to be sold, and insolvency ran rampant. Thus, a rapid succession of mergers occurred.

As a result, the big got bigger. As struggling lenders merged into bigger, stronger institutions, the ranks of the brokerage business and the real estate trade organizations were decimated.

## Sympathy for lenders in some courts

To top off the bad economic climate of the late 1960s for the real estate industry's non-lending segments, California appellate courts decided two due-on-sale cases in favor of the beleaguered mortgage holders.

It thus became reasonable — and possible — for mortgage holders to use the due-on clause as a profit center. They were permitted to adjust their portfolio yields to reflect higher market yields when a property owner subject to their trust deed lien decided to sell their property.[3]

Although the Supreme Court repudiated the reasoning of one case (*Cherry)* two years later, it took nearly another decade for the legal confusion caused by the reasonableness doctrine of these cases, starting with the earlier *Coast Bank* case, to be put to rest judicially in **Wellenkamp v. Bank of America**.[4]

**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.

*Disclosure: Fred Crane, the Legal Editor or this publication, was the attorney of record for property owners on the two leading due-on enforcement cases of the time,* ***Wellenkamp*** *v.* ***Bank of America*** *(1978) 21 C3d 943 and* ***Fidelity Federal Savings & Loan Assoc****. v.* ***de la Cuesta*** *(1982) 458 US 141.*

## Vocabulary development geared to profit mortgage lenders

In the parlance of the day, conventional mortgages requiring *formal assumption* and *modification* upon a buyer's takeover became known as **non-assumable mortgages**. In contrast, **assumable mortgages** were insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and did not require formal assumption or modification. [See Chapter 21]

When a buyer assumed a non-assumable mortgage, the interest rate was increased to the mortgage holder's current rate. Points and fees were charged as though the mortgage was newly originated. Terms were **recast** and adjusted upward by exploitation of the due-on clause on the buyer's takeover on a mortgage.

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3 **Cherry** v. **Home Savings & Loan Association** (1969) 276 CA2d 574; **Hellbaum** v. **Lytton Savings and Loan Association of Northern California** (1969) 274 CA2d 456

4 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

Thus, mortgage holders were able to obtain more than the fixed rate of return, their original bargain. On an owner's sale or **further encumbrance** of their property, mortgage holders interfered to exact additional profits with a rate adjustment.

## Non-disclosure as the "Medovoi" syndrome

In an effort to rejuvenate sales, brokers and owners developed methods to avoid the due-on clause.

For example, brokers had the owner transfer title to the mortgaged property into a trust or family partnership. The mortgage holder was advised of the action and explanations were made, though these were hardly the reasons for the establishment of the trust or partnership vesting. Title and escrow companies often held title for the true owners.

Then, without detection by the mortgage holder, the right to the beneficial use of the trust's property was transferred, or the ownership of the partnership was assigned. Both transfers were off the record and the mortgage holder was not aware the due-on clause had been triggered.

**further encumbrance**
A claim or lien on a parcel of real estate, such as junior trust deeds, CC&Rs, easements, taxes or assessments.

Mortgage holders were not advised even when the grant deed transfer was recorded. **All-inclusive trust deeds (AITDs)** became popular. Mortgage holders were completely unaware of transfers as long as sellers continued to make payments and hazard insurance policies remained in place. [See Chapter 30]

When the mortgage holder happened to discover the transfer through tax rolls, insurance policies or inspection of the record for transfers, buyers attempted to avoid full disclosure.[5]

Some of these creative transfer methods had built-in hazards for owners; many sales occurred without documentation or recording. Grant deeds piled up in the safes of escrow companies and brokerage offices to someday be recorded when buyers arranged other financing or resold.

This failure to record caused problems for both owners and mortgage holders since there were too many facilitators handling payments and deeds. In a word: chaos.

## Lobbying to vary from fixed

At the outset of the '70s, a few large mortgage holders began to see the judicial handwriting on the wall. They knew the due-on clause was not a long-term tool to correct their erroneous financial decisions.

Lenders and mortgage holders sought legislation to allow them to shift the burden of rising interest rates and costs of funds onto the owners who had borrowed.

The **variable rate mortgage (VRM)** — a California precursor to the **adjustable rate mortgage (ARM)** — was lobbied into existence in 1969.

5 **Medovoi** v. **American Savings and Loan Association** (1979) 89 CA3d 244

The terms of a *VRM* allowed mortgage lenders to pass the cost of inflation on to the owners of real estate encumbered by the VRM mortgage.[6] [See Chapter 6]

## Further encumbrance interference

A 1971 California lower-court case dealt with an owner who used their equity to secure borrowed funds while still retaining ownership. The owner further encumbered their property with a second trust deed to secure the mortgage.

The first mortgage holder called the mortgage due, claiming the unconsented-to *further encumbrance* of the property in the form of a junior trust deed breached the due-on clause and triggered the right to prematurely call the mortgage due.

However, the California Supreme Court held a mortgage holder was not permitted to use the due-on clause on the owner's further encumbrance of the property without justifying a *reasonable need* to protect the mortgage based on an increased risk of loss. They held the mere placement of a second mortgage on the property gave the first mortgage holder no legitimate cause for concern over the loss of the mortgage balance or their senior trust deed position held on title to the property. Hence, there was no impairment of the first mortgage holder's security interest in the property due to the further encumbrance without something more.[7]

As a result of the *La Sala* ruling, the market for arranging second mortgages promptly expanded to fill the vacuum brought on by inability to use the equity in a property to secure borrowed funds. Now a lender was able to originate a second mortgage without triggering the first mortgage holder's exercise of the due-on clause.

## Misdirected attention to security devices

In 1974, the California Supreme Court again looked into mortgage holders' use of the due-on clause. Here, a mortgage holder prematurely called a mortgage due, claiming the transfer of *equitable ownership* under a **land sales contract** triggered the due-on clause.[8] [See Chapter 31]

The *Tucker* court rejected the mortgage holder's assertion that their need to enhance their portfolio yield with additional profits was reasonable justification to interfere with the change of ownership. The mortgage holder tried to sell the Supreme Court on their **good faith interference**, but the court didn't buy it.

*Good faith* meant a genuine, fact-supported belief the transfer of ownership either **impaired** the mortgage holder's security interest in the property or created a substantial **risk of default** on the obligation.

6 CC §1916.5

7 La Sala, *supra*

8 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

Deceptive practices during uncertain times

*As control of the real estate industry swung farther into the hands of due-on mortgage holders throughout the 1970s, some agents engaged in deceptive practices when conveying property for their clients.* ***Contract escrows*** *were opened in increasing numbers to hold documents off-record until the legal issues regarding due-on clauses were better understood.*

*As such,* ***reverse trust deeds*** *became popular. In a reverse trust deed, as the name suggests, the economic roles of the buyer and seller in the transaction are reversed. The buyer documents the amount of the down payment on the property as a loan made to the seller, disguised as an owner borrowing money. The seller signs a note for the amount of the down payment and a trust deed in favor of the buyer, which becomes a lien on the property.*

*When escrow closes on the sale, the buyer's reverse trust deed is recorded and 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).*

*All other documents regarding the buyer's* ***actual*** *purchase are left unrecorded and placed into a contract or holding escrow.*

*Thus, the official record stated the seller was still the owner, and the buyer was merely a lender of funds to the seller. Yet the change of ownership occurred and possession was transferred and the operative documents were held off-record, avoiding due-on enforcement.*

Following *Tucker*, the need for impairment became so clear the mortgage holder in that case later filed only judicial foreclosures to get legal cover when seeking to use the due-on clause (and intimidate the owner).

*Tucker* made mortgage holders aware of the potentially expensive threat of punitive damages for their **tortious conduct**.

Also, a later case imposed **attorney fees** on a lender who improperly uses the due-on clause against a non-assuming buyer.[9]

*Disclosure: Fred Crane, the Legal Editor of this publication, was the attorney of record for this case,* ***Saucedo*** *v.* ***Mercury Savings and Loan Association*** *(1980) 111 CA3d 309.*

## Time for the Wellenkamp assumption

The earlier *La Sala* case dealt specifically with further encumbrances in the form of second mortgages. A footnote in *La Sala* indicated a further review and application was to be made of the reasonableness standard when a case involving a sale came along.

*Tucker*, a case involving a carryback sale, became the fulfillment of that footnote. But the carryback sale was structured as a *land sales contract*, not a grant deed, trust deed and note.

9 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

The facts of *Tucker* regarding the **carryback financing** device used in the sale distracted nearly everyone from the legal concepts controlling mortgage holder conduct on a change in ownership. [See Chapter 31]

Use of a land sales contract caused uncertainty as to whether the same rule applied to other forms of sale, such as a grant deed conveyance on a **cash-to-loan** sale.

## A sale without mortgage holder interference

Mortgage holders continued to take advantage of sellers and their ill-informed brokers and agents who were unaware of a property owner's **right to sell**, further encumber or lease their property without mortgage holder interference.

Mortgage holders played their hand at **assumptions** until sellers, buyers and brokers learned to call these mortgage holders' bluffs. They eventually did so as the result of individual experiences relayed to others, viral rather than organizational efforts. Here, a weak real estate sales market, brought on by increasing mortgage rates, spurred individual buyers and their brokers to challenge the mortgage holders.

## Agent's conduct with mortgage holder of record

Between 1974 and 1978, prior to the *Wellenkamp* decision, agents negotiating sales involving mortgage takeovers frequently did not fully understand their clients' rights. Uninformed agents were known to call the mortgage holder of record on the listed property to seek advice from the adversary on a buyer's mortgage assumption before writing a purchase offer.

The mortgage holder's response was always adverse to the client's best interests, be they the seller or buyer. The nature of the inquiry led the mortgage holder to infer the seller and buyer were ignorant of the buyer's right to take over the mortgage in a **subject-to transaction**.

**subject-to transaction**
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

On closing a *subject-to transaction*, the mortgage holder was promptly advised of the sale and the buyer's name and address. The transfer arrangements, usually through an independent escrow since title companies colluded fully with mortgage holders, had deliberately avoided a modification and any increased portfolio yield on the 30-year FRM.

Mortgage holders then pressed buyers for a **formal assumption**. When the sellers, buyers and agents — armed with the *Tucker* decision — presented a concerted front against formal assumption, mortgage holders called mortgages and filed **Notices of Default (NODs)** with less frequency. [See Chapter 20]

## Wellenkamp prohibited lender profiteering

In 1978, the California Supreme Court put a stop to the mortgage holders' use of the due-on clause to *unilaterally adjust* their mortgage terms. This brought an end to the era of automatic due-on clause use as a tool to adjust portfolio yields.

In California, as in most other states, mortgage law prohibits enforcement of any trust deed provision which purports to restrict the owner's right to sell, lease or encumber their property.[10]

**formal assumption**
A buyer's promise to perform all the terms of the mortgage, given to the mortgage holder on the buyer's takeover of an existing mortgage, typically involving a modification of the interest rate and payments and an assessment of points and fees. Compare with a subject-to transaction.

The California Supreme Court decision in *Wellenkamp* simply stated what knowledgeable real estate lawyers already knew — California Civil Code §711 made it illegal for mortgage holders to use a due-on clause for profit when the transfer of secured property to a buyer did not place their security interests in danger of **impairment**.[11]

Any lender or mortgage holder interference with a sale was prohibited, except when it was **reasonably necessary** to protect the mortgage holder's security interest in the transferred real estate.

## Prohibited restraints on alienation

Significantly, the California Supreme Court described the provision as the due-on clause, not the **due-on-sale clause**.

This meant the ruling was not limited to just the sales aspect of ownership — *any* ownership interest was included. In 1983 the courts accordingly extended this right-to-alienate ruling to *leasehold assignments*, barring a landlord's unreasonable termination of a lease when the tenant assigned it to another tenant (until California deregulated landlords in 1990).[12]

Lenders and mortgage holders were now prevented from shifting the cost of their mortgage rate-setting mistakes onto buyers and borrowers. The risks of forecasting interest rates were to remain with the lenders and mortgage holders who created the portfolio yield problem — until 1982.

## Automatic enforcement

In June 1982, the United States Supreme Court gave federally chartered S&Ls the ability to *automatically* enforce their *due-on-sale clauses* for profit and economic viability on the following actions involving a mortgaged property:

- a **sale**;
- a **lease** with a term of three years or more; or
- a **further encumbrance** of the secured property.

The ruling enabled Federal S&Ls to call a mortgage without concern for the impairment of their security or the buyer's **creditworthiness**.[13]

This resulted in serious inconsistencies between state and federal due-on practices. The resale differences for property encumbered by a federal S&L mortgage significantly hindered the federally chartered S&Ls' ability to lend at rates obtainable by other mortgage lenders. To compete, they were lending at rates a quarter of a percent less than market.

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10 CC §711

11 **Wellenkamp** v. **Bank of America** (1978) 21 C3d 943 (Disclosure: the legal editor of this publication was the attorney of record for the property owner in this case.)

12 **Cohen** v. **Ratinoff** (1983) 147 CA3d 321

13 12 Code of Federal Regulations §591.2(b); **Fidelity Federal Savings and Loan Association** v. **de la Cuesta** (1982) 458 US 141 (Disclosure: the legal editor of this publication was the attorney of record for the property owner in this case.)

## Borrowers recapitalize their lenders, by federal law

**Garn-St. Germain Federal Depository Institutions Act of 1982**
A federal law 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*)** was intended to settle this due-on imbalance and impending widespread mortgage holder insolvency brought on by the 1980s recession, the worst since the Great Depression (until 2008, of course).

*Garn* extended the rights which *de la Cuesta* gave federally chartered S&Ls to *all* mortgage holders.

Signed into law on October 15, 1982, *Garn* brought about blanket preemption of state law limitations on due-on practices. Together, *de la Cuesta* and *Garn* created a new body of federal mortgage law, eliminating states' rights to protect buyers from mortgage holder due-on interference.

*Garn* made one limited concession for interference-free mortgage assumptions. A three-year **window period** was established which prohibited due-on interferences on mortgages originated between August 25, 1978 (the date of the *Wellenkamp* decision) and October 15, 1982 (the date *Garn* became law).

## The FHLBB steps in

**Federal Home Loan Bank Board (FHLBB)**
The Depression-era regulatory body established to fund savings and loan associations (S&Ls) and provide mortgage market liquidity. The FHLBB became the Office of Thrift Supervision in 1989, and then dissolved in 2011 shifting its duties to the Consumer Financial Protection Bureau (CFPB) and other federal agencies.

The *Garn* legislation, which persists today, provides only general guidelines for due-on enforcement. *Garn* gave the **Federal Home Loan Bank Board (FHLBB)** and other regulatory agencies the authority to issue rules, regulations and opinions interpreting *Garn*.[14]

In drawing up these regulations, the FHLBB took care to specifically define what events constitute a sale or transfer under *Garn*. The FHLBB defined a *transfer* as the conveyance of any right, title or interest in the mortgaged property, whether equitable or legal, voluntary or involuntary (as in a judgment or tax lien sale).

However, the FHLBB regulations left some significant issues undetermined. Loopholes still exist in the due-on catch-all. Neither the regulations nor *Garn* itself mention anything about transfers structured:

- with delayed purchase agreements;
- with escrow instructions; or
- between limited partnership and limited liability company (LLC) interests.

These loopholes are exploited as paths to avoid due-on enforcement under *Garn*. However, in the evolution by lenders of the due-on wording in trust deeds originating after *Garn*, lenders added wording that prohibited the use of entities for transfers that were to take place off title, by sale of the entity which owned the secured property but not a change in title to the real estate.

## The failed financial deregulation experiment

*Garn* was heralded as an economic catalyst to remedy the cyclical failure of lending institutions in the inflationary 1970s by:

- allowing **S&Ls** to venture directly into exotic, highly speculative investments;

14 12 United States Code §1701j-3(e)

*The due-on clause has not been an issue for California buyers and sellers since 1982, the year Garn permitted unfettered mortgage holder interference in ownership transactions on mortgaged properties. After 1982, interest rates followed a 30-year virtuous cycle of decline ending in 2013. All the while, an abundance of mortgage money was readily available to buyers at ever-reducing rates.*

*However, when* ***inflationary conditions*** *or massive government, corporate or mortgage borrowing develop in the national economy, short- and long-term interest rates rise in response to increased demand and inflationary pressure.*

*Gradually, rising* ***short-term interest rates*** *cripple buyer demand. In an initial response, buyers resort to ARMs to extend their borrowing reach and fund home purchases at increased prices. As sales volume peaks, prices subsequently fall. As a result, the related real estate providers of brokers, lenders, credit agencies, title companies, and escrow officers are temporarily paralyzed.*

*Persistent popular expectations of increasing inflation eventually have an adverse effect on the ability to buy and sell real estate. In response, the* ***Federal Reserve (the Fed)*** *ultimately induces an economic slowdown to moderate inflationary expectations by raising short-term interest rates. In turn, homebuyers' overreliance on ARMs is stemmed.*

*Short-term interest rates need to increase faster than the rate of inflation if the Fed is to hold inflation at a target level acceptable to the* ***long-term bond market****. Only then will long-term FRM rates remain fairly constant or decline, provided the Fed's monetary policy does not allow government and corporate borrowing to interfere with market rates.*

The swing in mortgage rates

- raising the **federal guarantee** on individual savings accounts from \$40,000 to \$100,000;
- allowing mortgage holders unfettered use of **due-on clauses** to increase portfolio yields through *loan modifications* and *recast rights*; and
- eliminating **loan rate competition** between state and federally chartered mortgage lenders by leveling the playing field.

Money market deregulation in the late 1970s and the congressional due-on legislation in 1982's *Garn* brought about sanctioned mismanagement in the S&L industry. By the early 1980s, FRMs and dramatically rising *short-term rates* (over 14%) were blamed in part for extensive S&L insolvency. This eventually led to the multi-billion dollar S&L debacle of the late 1980s.

**Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)**
Federal legislation enacted in 1989 in the wake of the savings and loan (S&L) crisis to strengthen regulations on lenders and appraisers and improve the availability of mortgage funds.

## S&L mismanagement

S&L mismanagement through the mid-1980s ran too long without regulatory oversight, causing losses the industry was unwilling to cover itself. The **Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)** was passed in 1989 to relieve the S&L industry of its financial insolvency due to *undercapitalization*.

*FIRREA* was designed to prevent the S&L industry, considered a historically stable source of financing for homeownership, from collapsing. It renamed the S&Ls **thrifts** (after a quality they had not demonstrated) and re-regulated the S&L industry.[15]

This re-regulation caused most S&Ls to promptly convert to national banks to avoid the financial burden and corrective regulations imposed by FIRREA.

The due-on clause, however, persisted through FIRREA's legislative reshuffling, remaining as a mortgage holder's profit-making device. A further transfer of wealth from real estate owners to lenders occurred where the mortgage held by the lender was an ARM.

## Mortgage holders see dollar signs in due-on clauses

Following the elimination of California's due-on protection in 1982's *Garn*, interest rates began their 30-year cyclical downward trend. Since then, rates have not risen for long enough periods to permit brokers to gain practical experience handling the due-on issue of **mortgage holder interference**. [See Chapter 19]

However, annual **foreclosure sales** increased nearly eightfold in the early 1990s. The glut of foreclosed properties drove down home prices, which were already declining due to late 1980s interest rate increases and California's falling employment and per capita income.

## Rupturing the financial levies

In 1998 the Fed started raising short-term interest rates to induce a routine **recession** to orchestrate an adjustment in economic growth. As planned, the recession took hold in early 2001, one year after the Fed finally pushed short-term rates higher than long-term rates.

But this effort to cool the economy was to be short-lived. The economic reaction of both the Fed and the administration to September 11, 2001 froze the price of homes at their artificially elevated peak before the corrective work of a recession took place. Thus, the stage was not set for sustainable future price growth based on historic pricing trends. The public forgot about house values dropping as the natural consequence of a recession.

Following September 11, 2001 the Fed opened the floodgates controlling the flow of money into mortgages. The Fed loaned money and bought **treasuries** in the money markets, adding large amounts of fresh cash to the money supply through bankers of all sorts. The seeds of the *Millennium Boom* thus began to sprout and, unabated by rates or regulations, eventually flowered.

## Federal money floods the market

Cheap, short-term federal money provided upwards of $2 trillion to be lent. The availability of this easy unregulated money gave Wall Street bankers the impetus to provide mortgage funds to as many borrowers as possible.

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15 Pub. L. 101–73

The result was an aggressive mortgage lending environment on Wall Street which eventually evolved into a proliferation of **subprime** lending. Mortgage standards were further relaxed, luring unprepared or underqualified tenants into homeownership.

## Releasing more than just money: mortgage market deregulation

During the same post-2001 period, the U.S. Treasury and Congress continued **deregulating** mortgage lenders and Wall Street bankers. Deregulation, encouraged by the Fed, removed most of the previously established fundamental parameters for safe mortgage lending.

At the same time, Wall Street also began buying up established mortgage banking operators around the nation. By 2005, Wall Street bankers dominated all aspects of mortgage management nationwide, with the exception of broker-packaged mortgage originations.

Short-term rates for acquiring funds were increased to significantly reduce the flow of funds into mortgages. However, by the time short-term rates began to rise, Wall Street was almost exclusively relying on investor funds flowing in from the **mortgage-backed bond (MBB)** market. Thus, Wall Street no longer looked to the Fed to replenish its mortgage coffers. *Mortgage-backed bonds* provided the flow of money needed to originate, bundle and sell positions in America's mortgages.

**mortgage-backed bond (MBB)**
An asset-backed security representing a claim on the cash flows from payments received on a mortgage.

## Financial cause and effect

The Fed's aggressive open-market lending, regulatory failures and unrealistic government homeownership policies after 2001 set the stage for the real estate bust.

Leading up to the collapse of the financial markets, parameters for structuring real estate mortgages had essentially ceased to exist. In their absence, the forces of **comparative advantage** encouraged Wall Street bankers to undertake drastic leveraging efforts to keep investors in their MBB purchase programs. Banks of all sorts and in all countries bought into the scheme, taking on the excessive risk of loss built into increasingly exotic loan products such as *option ARMs*. [See Chapter 6]

**comparative advantage**
The advantage a person who produces a product at a greater margin of profit has over a competitor.

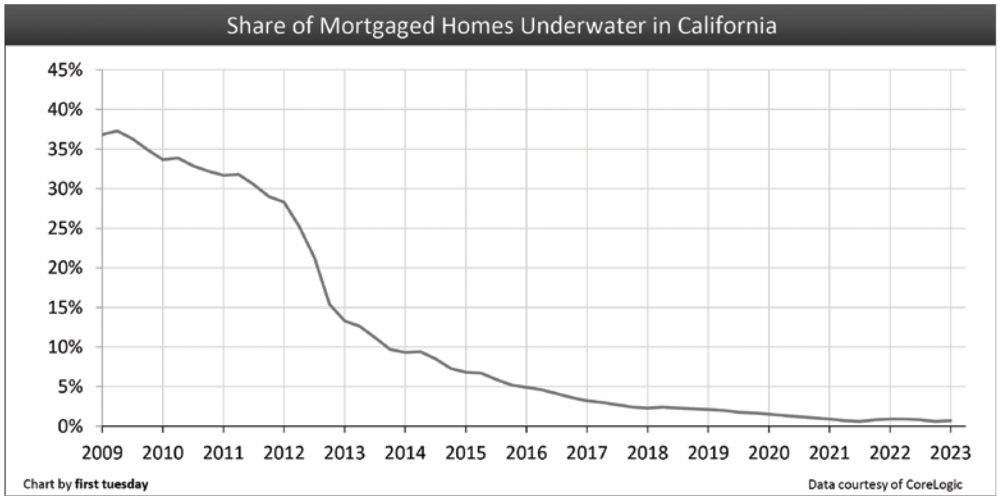
Deregulation allowed increasingly risky mortgage lending up until 2007. That year, mortgage borrowers began defaulting en masse. Lenders and mortgage holders were inundated with foreclosures due to the imprudent lending practices permitted by a deregulated and out-of-control financial sector.

## A willing congressional accomplice

Congress was a willing accomplice in this fiasco. By 2005, the legislative branch had succeeded in removing what few restraints remained on mortgage lending by withdrawing bankruptcy court authority to help insolvent and over-mortgaged homeowners. This was the final straw following 25 years of loosening controls over Wall Street's involvement in the mortgage industry.

Figure 1

Share of Mortgaged Homes Underwater in California




Almost overnight during 2007, the cash-engorged hey-day of the Millennium Boom boiled over into what became the **Great Recession**.

The *Great Recession* eliminated trillions of dollars in asset wealth across the nation. It left nearly 40% of California's 6.5 million homeowners in a **negative equity** condition, with their houses worth far less than the remaining amounts owed on their mortgages.

As a result, a majority of homeowners who bought during the Boom became prisoners in their own homes, with no ability to sell and relocate. [See Figure 1]

To compound matters, ARMs began to reset at higher rates causing their monthly payments to swell. Homeowners who bought after 2001 had lost too much of the equity necessary to refinance. California was thus faced with a **foreclosure crisis** of unprecedented proportions.

## Back from the bottom

In response to the **vicious economic cycle** caused by the Millennium Boom's implosion, the U.S. Treasury, the Fed and California's state government released a wave of aid specifically targeting the real estate construction, sales and mortgage sectors. This aid took the form of:

- government subsidies (tax credits) to homebuyers; and
- the Fed's purchase of large quantities of newly-issued MBBs to keep funds flowing in the mortgage origination markets.

California's government applied hundreds of millions of dollars to stabilizing the real estate market beginning in 2008. In 2010, the state granted $100 million in **tax credits** toward the purchase of existing homes — primarily *REO* properties — and another $100 million to the purchase of homes in builder inventory.

That, and other state and federal stimulus, temporarily propped up the real estate market in 2009-2010, giving a boost to sales volume and pricing as intended. But those stimulus efforts were inadequate to generate more than a momentary bump and cannibalized sales from the two years to follow. The economic recovery did not take the "V" or "U" shape many hoped for. Instead, the recovery has come to look more like an **aborted checkmark** following the 2009-2010 stimulus effort.

Economic growth since 2008 has been very modest, gaining momentum at times, then dropping back, as was seen in 2011 and 2014. This current recovery paradigm is known as **secular stagnation**: a protracted period of lackluster economic growth, huge increases in disability retirement and early social security benefits and a business demand for lower wages.

**secular stagnation**
An abnormally lengthy period of sluggish economic growth.

## A new paradigm

Nearly three decades of financial deregulation created a mortgage lending environment ripe for abuse. The result was a precarious house of cards, made of poorly vetted and exceedingly risky mortgages and related investment instruments. It all came crashing down in what became the United States' worst economic downturn since the Great Depression.

Lawmakers moved swiftly to ensure such a fiasco is not soon repeated. **The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)** was born from calls for sweeping re-regulation of the financial system aimed at ensuring Millennium Boom conditions will not again threaten our economic stability.

*Dodd-Frank*, passed into law in 2010, rolled out in the form of regulatory pieces over the following five years. Regulators, including the newly-formed **Consumer Financial Protection Bureau (CFPB)** introduced a host of new protections intended to produce financial stability and the safety of the consumer.

All this regulatory activity has completely rewritten the way real estate transactions are financed and mortgage business is managed. We'll take a closer look those changes in the following chapter.

## Chapter 1 Summary

From 1960 to 1965, an overabundance of funds to be lent on real estate drove lenders to make loans for construction and purchase of property to virtually anyone. This excess of investment contributed to overbuilding. Shortly thereafter, vacancies and foreclosures soared.

At the same time, the Supreme Court handed down a ruling which expanded the application of the due-on clause, enabling mortgage holders to use the provision to call mortgages due and immediately payable so long as it was demonstrably "reasonable."

Through the early 1970s, mortgage holders were able to obtain more than the fixed rate of return for which they originally bargained. When a buyer assumed a mortgage, mortgage holders increased the interest rate, charged additional points and fees and recast its terms.

Owners and their brokers, however, devised methods to avoid triggering a due-on clause by covertly transferring ownership out of the mortgage holder's view.

The tide began to turn in favor of owners with a 1971 court decision prohibiting enforcement of the due-on clause on an owner's further encumbrance of the property without justifying a reasonable need to protect against the risk of loss.

Mortgage holders had to demonstrate their interference was done in the good faith belief the transfer of ownership posed a risk to their security interest in the property. However, mortgage holders took advantage of owners who were unaware of their ownership rights to sell.

The 1978 California Supreme Court decision in Wellenkamp v. Bank of America put a stop to mortgage holders' unilateral use of the due-on clause to adjust their portfolio yields.

In 1982, the United States Supreme Court gave some larger mortgage holders the ability to automatically enforce the due-on clause on a sale. That same year, Congress enacted the Garn-St. Germain Federal Depository Institutions Act (Garn) to increase the earnings of struggling savings and loan associations (S&Ls). But deregulation and Garn brought about S&L mismanagement, causing losses the industry was unable to cover.

The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989 was passed to re-regulate the insolvent S&Ls, but the due-on clause persisted after FIRREA and remained a lender's profitmaking device.

To stimulate the economy following the events of September 11, 2001, the Fed added large amounts of cash to the money supply by making loans and buying treasuries in the money markets. Mortgage lending standards became lax and subprime borrowers were lured into homeownership with risky mortgages. At the same time, the government acted to deregulate mortgage lenders and Wall Street bankers by removing parameters for safe mortgage lending.

Mortgage borrowers began defaulting en masse, leaving lenders drowning in foreclosures due to imprudent lending practices. As a result, the Great Recession decimated trillions of dollars in wealth and left over a third of California homeowners in negative equity.

With its creation by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the newly-formed Consumer Financial Protection Bureau (CFPB) is working to introduce a host of new protections intended to produce financial stability and the safety of the consumer.

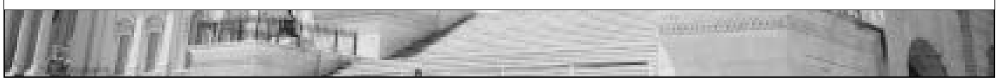


**Quiz 1 Covering Chapters 1-2 is located on page 619.**

*Notes:*

# Chapter 2

# Consumer mortgage re-regulation



## Learning Objectives

After reading this chapter, you will be able to:

- understand the California Department of Real Estate (DRE) mortgage loan originator (MLO) license endorsement requirements;
- identify the parameters for assessing a borrower's ability to repay a consumer mortgage;
- differentiate between the general ability-to-repay (ATR) rules and the qualified mortgage (QM) rules; and
- distinguish between the four kinds of QMs.

## Key Terms

**balloon payment**

**balloon-payment qualified mortgage**

**business mortgage**

**consumer mortgage**

**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)**

**general ability-to-repay (ATR) rules**

**general qualified mortgage**

**mortgage loan originator (MLO)**

**residential mortgage**

**Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**

**small lender**

**small lender qualified mortgage**

**temporary qualified mortgage**

## Two sets of laws control consumer financing

Two major consumer protection laws were passed in the 2000s:

- the 2008 **Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**, which created a uniform national licensing scheme for **mortgage loan originators (MLOs)** and the **Nationwide Mortgage Licensing System and Registry (NMLS)** for registering MLOs;[1] and

1 12 United States Code §§51 et seq.; 12 Code of Federal Regulations §§1007-1008

**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)**
A federal consumer protection law which created minimum standards and oversight for consumer mortgage origination.

- the 2010 **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)**, which created minimum standards and oversight for consumer mortgage origination.[2]

The SAFE Act applies to **residential mortgages**. A *residential mortgage* is a mortgage secured by one-to-four unit residential property made primarily for funding a:

- personal;
- household; or
- family use.

Note that seller carryback mortgages are not loans, and thus not covered by California's SAFE Act.[3]

**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.

For comparison, the Dodd-Frank changes apply to **consumer mortgages**. A *consumer mortgage* is a mortgage secured by a one-to-four unit residential property made primarily for funding a:

- personal;
- household; or
- family use.

Both residential mortgages and carryback consumer mortgages are consumer mortgages.

**business mortgage**
A debt incurred for other than personal, family or household (consumer) purposes and secured by any type of real estate.

In contrast to consumer mortgages, **business mortgages** are made for other than personal, household or family use, or secured by real estate other than a one-to-four unit residential property. *Business mortgages* are not regulated by federal law with the exception of due-on clause enforcement.[4]

Thus, whether these consumer protection laws apply to a mortgage is determined not only by the purpose the mortgage is funding, but the type of property securing the mortgage.

## Endorsement required under the SAFE Act

The federal *SAFE Act* compelled each state to adopt and enforce a minimum standard for MLO licensing.

California adopted its version of the SAFE Act in 2010. To implement the SAFE Act, the California Department of Real Estate (DRE) and the NMLS work together.

**Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**
A federal consumer protection law which created a uniform national licensing and registration scheme for mortgage loan originators (MLOs).

The DRE sets the minimum standards for DRE licensees who arrange consumer mortgages for a fee as MLO endorsees.

The NMLS:

- processes MLO applications;
- assigns unique NMLS ID numbers; and

2 Public Law 111-203
3 Calif. Business and Professions Code §10166.01(d)
4 12 USC §1701j-3(e)

- administers the national MLO registry.

DRE licensees are required to obtain an MLO endorsement and unique NMLS ID when they:

- take an application for or negotiate a residential mortgage loan, an activity called **arranging**; and
- they receive fees for arranging the residential mortgage loan.[5]

Both prongs of the definition are to be met before the endorsement is required. Thus, a broker who arranges a *residential mortgage* loan for a fee, called a **mortgage broker**, is required to obtain an MLO endorsement. On the other hand, a lender who makes a residential mortgage loan from their own funds without expectation of a fee or discount for arranging the residential mortgage loan is not required to hold an endorsement. Pass-through of costs (e.g., credit report fee) and interest are not fees triggering the second prong of this definition.

**residential mortgage**
A consumer mortgage other than a carryback mortgage requiring the licensee arranging the mortgage to be mortgage loan origination (MLO)-endorsed by the California Department of Real Estate (DRE).

*Editor's note — Though it is the mortgage brokerage activity which triggers the MLO endorsement requirement (and in turn, the underlying DRE license requirement), MLOs may also make mortgages. A person who makes a mortgage is known as a* ***lender****.*

*The sole act of making a mortgage does not trigger the MLO endorsement requirement. However, a lender who, in a calendar year, makes eight or more mortgages — consumer or business — secured by one-to-four unit residential property is required to have a DRE broker license.*[6]

## Obtaining the endorsement

The MLO endorsement attaches to the real estate license. To obtain an MLO endorsement to arrange residential mortgage loans, a licensee's DRE real estate license needs to be current and in good standing.[7]

To become MLO-endorsed, a licensee is required to:

- complete 20 hours of pre-license education;
- complete the national and California state MLO exams; and
- submit an MLO endorsement application through the NMLS, which includes:
  - providing personal, employment and financial history;
  - supplying fingerprints and an authorization for a criminal background check to the NMLS; and
  - authorizing the NMLS to obtain the licensee's credit report.[8]

**mortgage loan originator (MLO)**
An individual who receives fees to arrange a consumer mortgage.

5 Bus & P C §10166.02(b)
6 Bus & P C §10131.1(b)(1)(C)
7 Bus & P C §10166.02(b)
8 Bus & P C §10166.04; §10166.02(b)

A licensed sales agent with an MLO endorsement may arrange residential mortgage loans only if their employing broker also holds an MLO endorsement.[9]

## Individual and company endorsement

Individual MLO brokers who operate independently are required to hold both an individual MLO endorsement and a company MLO endorsement. The company endorsement is either:

- a *sole proprietorship* MLO endorsement; or
- a *corporation* MLO endorsement.

Separate applications are required for the broker's individual and company MLO endorsements. The broker is not required to re-submit fingerprints, complete additional education or exams for the company MLO endorsement. However, a corporation MLO endorsement requires an additional credit report.

Individual brokers who are employed by a broker are not required to obtain a company endorsement. However, their employing broker needs to be MLO-endorsed before any residential mortgages may be arranged, other than an excluded carryback consumer mortgages arranged in a one-to-four unit residential property sales transaction.

## Pre-license education

The 20-hours of MLO pre-license education includes:

- three hours covering federal law and regulations;
- three hours of ethics, including instruction on fraud, consumer protection and fair lending issues; and
- two hours of training related to lending standards for nontraditional mortgages.

The remaining 12 hours are elective hours. Once completed, the pre-license education does not need to be repeated.[10]

## MLO national exam

Both federal and state MLO endorsement exams are administered by the NMLS. The national exam contains 125 multiple choice questions (115 of which are scored), to be completed in a 190 minute time limit.

These questions are broken down as follows:

- 35% federal mortgage-related laws;
- 25% general mortgage knowledge;
- 25% mortgage origination activities; and
- 15% ethics.

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9 10 Calif. Code of Regulation §2756

10 Bus & P C §10166.06

## MLO state exam

The California state MLO exam contains 60 multiple choice questions (50 of which are scored), to be completed in 90 minutes. These questions are broken down as follows:

- 5% California Department of Financial Protection and Innovation (DFPI) and DRE;
- 10% California laws and regulations (laws related to land, homeownership and lending);
- 25% California license law and regulations (licensee requirements and qualifications);
- 50% compliance (required and forbidden conduct for MLOs); and
- 10% disciplinary action for noncompliance.

To pass the exams, the licensee needs to score at least 75%. If the licensee fails, they may retake the exam up to two times with a minimum wait period of 30 days between each attempt. If they fail the exam three times, they need to wait a minimum of six months before making another attempt.

## Endorsement application and minimum requirements

At a minimum, MLO endorsement applicants are to show they have:

- never had an MLO license revoked in any jurisdiction;
- not been convicted of, pled guilty or pled no contest to a felony in a domestic, foreign or military court:
  - during the seven-year period preceding the date of the application; or
  - at any time, if the felony involved fraud, dishonesty, a breach of trust or money laundering; and
- demonstrated financial responsibility and general fitness to warrant a determination that the MLO will operate honestly, fairly and efficiently.[11]

DRE does not enforce a minimum credit score for MLO endorsement applicants. Likewise, negative financial events, such as bankruptcies, are not alone cause for a denial of an MLO endorsement.

Instead, the DRE looks for a history of:

- liens;
- judgments;
- mishandling of trust funds; or
- financial or personal conditions which indicate a pattern of dishonesty on the part of the applicant.

The credit report is used to verify or refute the financial history provided in the application.[12]

11 Bus & P C §10166.05

12 Bus & P C §10166.05(c); 10 CCR §2758.3

MLO Endorsement Fees

| | |
|---|---|
| ***Exam Fees*** | |
| *National Exam* | *$110* |
| *State Exam* | *$69* |
| ***Background Check and Credit Report Fees*** | |
| *Background Check* | *$36.25* |
| *Credit Report* | *$15* |
| ***Application and Annual Endorsement Fees - Individual*** | |
| *Individual Broker Endorsement* | *$300* |
| *Individual Sales Agent Endorsement* | *$300* |
| *+ NMLS Processing Fee* | *$30* |
| ***Application and Annual Endorsement Fees – Company*** | |
| *Sole Proprietorships* | *$0* |
| *Corporations* | *$300* |
| *+ NMLS Processing Fee* | *$100* |
| ***Application and Annual Endorsement Fees – Branch*** | |
| *Branch Office* | *$0* |
| *+ NMLS Processing Fee* | *$20* |

## Renewing the endorsement

Once obtained, MLO endorsements are renewed annually between November 1st and December 31st.

To renew, MLOs are to:

- complete eight hours of MLO-specific continuing education;
- attest to the accuracy of their information in the registry; and
- pay an annual renewal fee to the NMLS.

The eight hours of continuing education required by the DRE includes:

- three hours of federal law and regulations;
- two hours of ethics (including instruction on fraud, consumer protection and fair lending issues);
- two hours on lending standards for nontraditional mortgages; and
- one hour of elective material.[13]

## The Dodd-Frank Act initiated consumer protection

In the wake of the Millennium Boom, Dodd-Frank created the *Consumer Financial Protection Bureau (CFPB),* and placed the CFPB in charge of implementing and regulating all consumer protection laws, including:

- the Truth in Lending Act (TILA)'s Regulation Z (Reg Z);
- the Real Estate Settlement Procedures Act (RESPA)'s Regulation X (Reg X); and

13 Bus & P C §§10166.09-.10

- the appraisal rules in the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which is regulated by other entities with guidance from the CFPB.[14]

Dodd-Frank established numerous new mortgage regulations, the most critical being:

- minimum standards for consumer mortgages, discussed later in this chapter;
- integrated consumer mortgage disclosures [See Chapter 33];
- loan originator compensation rules [See Chapter 33]; and
- more stringent servicing rules. [See Chapter 10]

## The Reg Z ability-to-repay rules

MLOs or other persons who make consumer mortgages, called **lenders**, are subject to Reg Z **ability-to-repay (ATR)** rules when they make more than five consumer mortgages in any calendar year. This threshold controls:

- lenders, both private or institutional; and
- carryback sellers.[15]

Mortgage brokers who arrange consumer mortgages also need to understand the *ATR* rules to fulfill their duty to find the best mortgage product for their borrower's needs. A thorough assessment of each mortgage offer for compliance with the ATR rules protects the borrower against default, and the mortgage broker and lender against later claims the consumer mortgage was improperly originated.

Additionally, a mortgage broker who brokers mortgages to private lenders, such as individual investors, is to confirm whether the private lender's consumer mortgage lending volume subjects the lender to the Reg Z ATR rules.

This analysis sets the parameters for the consumer mortgage the mortgage broker arranges on behalf of the borrower. If the private lender's consumer mortgage origination volume does not subject them to the ATR rules, the mortgage broker may arrange the mortgage to meet both the borrower's and private lender's needs, without regard to federal restrictions on consumer mortgage terms.

However, if the mortgage broker is brokering consumer mortgage to a private lender who is subject to the ATR rules, the mortgage origination is necessarily bound by the lender's adherence to the ATR rules.

## Two ways to comply

A consumer mortgage meets the requirements of the ATR rules in one of two ways:

- by conforming to the **general ATR rules**; or

14 15 United States Code §§1601 et seq.; 12 CFR

15 12 CFR §1026.43(c)(1); 12 CFR §1026.2(a)(17)(v)

- by conforming to one of the four **qualified mortgage (QM)** definitions.[16]

Whether a lender structures a mortgage under the general ATR rules or one of the *QM* rules depends on their mortgage activity, investment goals and risk tolerance.

## The general ability-to-repay rules

The *general ATR rules* give a lender more flexibility. Unlike consumer mortgages made under the QM rules, consumer mortgages made under the general ATR rules aren't restricted in their features, terms or points and fees which may be charged.

**general ability-to-repay (ATR) rules**
A consumer mortgage conforming to the federal ability-to-repay (ATR) rules, without a qualified mortgage (QM) safe harbor or rebuttable presumption status.

Beyond the few hard rules set below, a lender or carryback seller subject to the ATR rules is able to set their own acceptable level of **risk tolerance** for defining the buyer or borrower's repayment capacity under the general ATR rules.

In exchange for this flexibility, consumer mortgages made under the general ATR rules do not provide any *liability exposure protection* for failing to comply with the ATR requirements. In other words, they provide the lender neither a safe harbor nor a rebuttable presumption of compliance with the ATR rules.

Additionally, the mortgage holder under the general ATR rules loses the ability to:

- sell the consumer mortgage to Fannie Mae or Freddie Mac (collectively, the *government-sponsored entities (GSEs)*); or
- receive a government guarantee for the consumer mortgage.

Thus, consumer mortgages which are made under the *general ATR rules* are either retained in the mortgage holder's portfolio or sold to private investors.

A lender may not close a consumer mortgage under the general ATR rules until they have assessed and determined the borrower's ability to repay the consumer mortgage.

## Ability-to-repay assessment

The assessment includes the requesting and reviewing of third-party documents to verify eight items:

1. The borrower's current and expected income or assets, other than the value of the property securing the consumer mortgage. These are verified through a review of:
   - W-2s for the last two years;
   - federal or state tax returns for the last two years;
   - payroll receipts;
   - bank statements; and

16 12 CFR §1026.43(c)-(f)

   - any other third-party documents verifying income.[17]

2. If employment income is used, the borrower's current employment status. [See **RPI** Form 210 and 210-1]
3. The borrower's monthly payment on the consumer mortgage sought.
4. The borrower's monthly payment on other consumer mortgages that are or will be secured by the property.
5. The borrower's monthly payment for mortgage-related obligations, such as property taxes, mortgage insurance, improvement district assessments or homeowners' association (HOA) assessments, in connection with the mortgage sought.[18]
6. The borrower's current debt, alimony and child support obligations.
7. The borrower's monthly debt-to-income ratio (DTI) or residual income.
8. The borrower's credit history.[19]

## Substantially equal monthly payment schedule

When calculating whether the borrower is able to repay the mortgage, the MLO uses a **substantially equal** monthly payment schedule which fully amortizes the consumer mortgage.

What are *substantially equal* payments? For fixed rate consumer mortgages (FRMs), the measurement is straightforward.

Consider a $200,000 30-year FRM. At a 7% interest rate, the MLO will use a monthly payment of $1,331 to determine the buyer's or owner's ability to repay the debt.

For adjustable rate mortgages (ARMs), consider a $200,000 30-year consumer mortgage with a 6% initial interest rate. [See Chapter 6]

After five years, the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual periodic interest rate adjustment cap. The index value in effect on origination is 4.5%. The fully indexed rate is 7.5% (4.5% plus 3%).

Even though the scheduled monthly payment required for the first five years is $1,199, the lender is required to use the substantially equal monthly payment which will fully amortize payment of the $200,000 over 30 years, using the fully indexed rate of 7.5%. Thus, the lender will use a monthly payment of $1,398 to determine the borrower's ability to repay the consumer mortgage.[20]

## Further allowances and limitations under the general ability-to-repay rules

The general ATR rules allow:

- balloon payment mortgages;
- interest-only mortgages; and

17 12 CFR §1026.43(c)(4)
18 12 CFR §1026.43(b)(8)
19 12 CFR §1026.43(c)(2)
20 Official Staff Commentary to 12 CFR §1026.43(c)(5)(i)-5

- negative amortization mortgages.

The payment considered for the ATR rules on a consumer mortgage with a balloon payment is the maximum payment during the first five years. A different threshold applies if the mortgage is a **Section 35 mortgage**.[21] [See Figure 1]

To determine if a borrower is able to repay a mortgage with an **interest-only** or negative amortization feature, a lender will use a monthly payment schedule which will fully amortize the consumer mortgage by its maturity date — the due date for final/balloon payment of principal.[22]

Prepayment penalties may not be charged on consumer mortgages under the general ATR rules.[23]

## The definition of a qualified mortgage

The alternative way for a lender to meet the Reg Z ATR requirements is to make a *QM*.

A mortgage holder who originates a QM in **good faith** is deemed to have met the Reg Z ATR requirements.

The benefits the lender receives for consumer mortgage originations meeting the more restrictive QM rules include:

- the ability to sell the consumer mortgages meeting the QM criteria to the GSEs;
- access to government insurance or guarantees for consumer mortgages it originates; and
- safe harbor protection from liability exposure for failing to comply with the ATR requirements (different treatment applies to Section 35 mortgages).[24]

## Types of qualified mortgages

To permit some flexibility for small lenders, four types of QMs have been established entitled:

- the **general QM**;[25]
- the **temporary QM**;[26]
- the **small lender QM**;[27] and
- the **balloon-payment QM**, with both temporary and permanent definitions.[28]

QMs of the general and temporary types may be originated as consumer mortgages by all lenders. Balloon-payment and small lender QMs may only be originated by small lenders.

21 12 CFR §1026.43(c)(5)(ii)
22 12 CFR §1026.43(c)(5)(ii)(B); 12 CFR §1026.43(c)(5)(ii)(C)
23 12 CFR §1026.43(g)
24 12 CFR §1026.43(e)-(f)
25 12 CFR §1026.43(e)(2)
26 12 CFR §1026.43(e)(6)
27 12 CFR §1026.43(e)(5)
28 12 CFR §1026.43(f); 12 CFR §1026.43(e)(6)

Figure 1

Section 35 mortgages

*Regulation Z (Reg Z) now has a separate designation for higher-priced mortgages, also known as* ***Section 35 mortgages****. A Section 32 high-cost mortgage and a Section 35 mortgage have similar guidelines for designation and use, but they are not interchangeable and have different lending restrictions and disclosure requirements.*

*A Section 35 mortgage is a closed-end consumer mortgage secured by a one-to-four unit owner-occupied residential property or personal property used as a principal residence, with an annual percentage rate (APR) which exceeds the average prime offer rate (APOR) for a comparable transaction by more than:*

- *1.5% for mortgages secured by a first lien with a Freddie Mac conforming loan amount;*
- *2.5% for mortgages secured by a first lien with a mortgage amount exceeding Freddie Mac's conforming loan limit (i.e., jumbo mortgages); and*
- *3.5% for mortgages secured by a subordinate lien on a dwelling. [12 Code of Federal Regulations §1026.35(a)(1)]*

*A closed-end mortgage is a mortgage which is disbursed once, and paid off over time. Most mortgages are closed-end mortgages.*

*In contrast, an open-end mortgage is a mortgage which gives the borrower the ability to withdraw mortgage funds in a line of credit, similar to how a credit card functions. Interest is charged on amounts withdrawn. A home equity line of credit (HELOC) is an example of an open-end mortgage.*

*Section 35 mortgages have mandatory impound requirements, and special appraisal requirements. [12 CFR §1026.35(b)(1)]*

*A Section 35 mortgage designation imposes a more restrictive application of the ability-to-repay (ATR) rules.*

*Editor's note – The rules for temporary QMs apply only to transactions entered into before April 1, 2016.*

## The general qualified mortgage

To be a general QM, the consumer mortgage meets six criteria:

1. Regular periodic payments. No interest only, negative amortization or balloon payment features are allowed.[29]
2. A mortgage term of 30 years or less.[30]
3. Maximum points and fees of no more than 3% of the principal amount for mortgages of $130,461 or more in 2024, adjusted annually for inflation.[31]
4. Monthly payments used to determine repayment ability are to be based on a full amortization schedule, using the maximum interest rate that applies during the first five years.[32]
5. Assets, debts and income are to be verified and documented. Income used needs to be verified, stable and expected to continue. The lender is responsible for verifying employment. [33]

**general qualified mortgage**
A type of qualified mortgage (QM) which meets the definition of a qualified mortgage under Regulation Z (Reg Z) and has a debt-to-income ratio (DTI) of 43% or less, other than a balloon-payment QM, small lender QM and temporary QM.

29 12 CFR §1026.43(e)(2)(i)
30 12 CFR §1026.43(e)(2)(ii)
31 12 CFR §1026.43(e)(3)
32 12 CFR §1026.43(e)(2)(iv)
33 12 CFR §1026.43(e)(5)

6. The maximum total DTI, also known as the **back-end DTI,** is 43%.[34]

## The temporary qualified mortgage

**temporary qualified mortgage**
A transitional qualified mortgage (QM) under Regulation Z (Reg Z) for lenders originating mortgages insured or guaranteed by the federal government or sold to Fannie Mae or Freddie Mac.

A *temporary QM* allows the GSEs and government agencies time to adjust their criteria to meet the QM definition.

For mortgages **sold** to the GSEs, the temporary QM definition will exist until the earlier of exiting their federal conservatorship, or October 1, 2022.

For mortgages **guaranteed or insured** by the federal government, the temporary QM definition applies until the earlier of the government agency's creation of its own definition of a QM, or October 1, 2022.

A temporary QM is to meet the general QM requirements for regular periodic payments, maximum mortgage terms, and total points and fees restrictions.

In addition, temporary QMs are required to be eligible for purchase by a GSE, or insurance or guarantee by the:

- Department of Housing and Urban Development's (HUD's) Federal Housing Administration (FHA);
- the U.S. Department of Veterans Affairs (VA);
- the Department of Agriculture (USDA); or
- the Rural Housing Service (RHS).[35]

The temporary QM does not restrict the total back-end DTI ratio to 43%. Instead, it temporarily defers to the GSEs and the government agencies for underwriting procedures. However, lenders, government agencies and the GSEs may place more restrictive requirements on consumer mortgages they make, insure, guarantee or purchase.

The GSEs do not purchase consumer mortgages which are not QMs.

HUD's QM definition follows the general QM definition, with limited exceptions to the 3% up-front points and fees rule, to facilitate smaller mortgages.

## The small lender qualified mortgage

**small lender qualified mortgage**
A type of qualified mortgage (QM) under Regulation Z (Reg Z) which allows small community mortgage lenders to include features otherwise prohibited in consumer mortgages.

The **small lender QM** allows small lenders to originate consumer mortgages with more flexible standards for being QMs.

In 2024, a **small lender** is a lender with assets of $2.64 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, if the mortgage application is received before April 1).[36]

To meet the requirements of a *small lender QM*, the consumer mortgage may not:

- allow for negative amortization;
- have a term longer than 30 years; and

34 Handbook 4155.1 Rev-5 Ch-4 §F.2.c
35 12 CFR §1026.43(e)(4)(2)
36 12 CFR §1026.35(b)(2)(iii)(B),(C)

- have total points and fees more than 3% of the mortgage amount.

The buyer/owner's ability to repay is determined by calculating monthly payments based on a full amortization schedule, using the maximum interest rate that may apply during the first five years. DTI caps are not imposed, but DTI is to be considered in the underwriting analysis.[37]

For a small lender QM to retain its status when funded as part of a *warehouse line of credit* (or other agreement entered into prior to the funding of the mortgage to sell the mortgage, known as a *forward commitment*) the mortgage may only be sold to another small lender.

If a small lender QM isn't subject to a forward commitment, the mortgage is to be retained in the small lender's portfolio for at least three years. It may be sold after three years, but only to another small lender.[38]

**small lender**
A lender with assets of $2.112 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, for applications received before April 1).

## The balloon-payment qualified mortgage

Consumer mortgages with balloon payments to be classified as QMs, called **balloon-payment QMs**, may only be originated by small lenders.

A **balloon payment** is any final payment on a note which is greater than twice the amount of any regularly scheduled payments.[39] [See Chapter 11; see **RPI** Form 418-3 and 419]

A small lender may only make a balloon-payment QM when it originated at least one first-lien consumer mortgage secured by a property in a rural or underserved area in the prior calendar year (two years if the mortgage application is received before April 1).

Like a general QM, a balloon-payment QM:

- may not allow for negative amortization;
- may not have a consumer mortgage term in excess of 30 years;
- may not have total points and fees in excess of 3% of the mortgage amount; and
- requires the lender to verify buyer/owners' income, assets and debt according to the general QM rule.[40]

Additionally, a balloon-payment QM:

- needs to have a fixed interest rate and periodic payments based on an amortization schedule of no more than 30 years;
- needs to have a term of at least five years before it is due;[41] and
- may not be sold after origination to an entity other than another small lender eligible to make balloon-payment QMs.[42]

No maximum DTI requirements are imposed.

**balloon-payment qualified mortgage**
A type of qualified mortgage which allows small lenders to include a balloon feature.

**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]

37 12 CFR §1026.43(e)(5)
38 12 CFR §1026.43(e)(5)(ii)(A)-(B)
39 12 CFR §1026.18(s)(5)(i)
40 12 CFR §1026.43(f)(1)(i)
41 12 CFR §1026.43(f)(1)(iv)
42 12 CFR §1026.43(f)(1)(v)

## Prepayment penalties

Charging a prepayment penalty on any consumer mortgage is restricted.

A *prepayment penalty* is levy charged by a mortgage holder to a property owner who pays off the outstanding principal balance on a mortgage prior to its maturity. [See **RPI** Form 418-2]

Prepayment penalties are only permissible on QMs, not consumer mortgages which are not QMs. When permitted, the restrictions include:

- the penalty period is limited to three years after origination; and
- the amount of the penalties may not exceed:
  - 2% of the outstanding balance during the 2nd year; and
  - 1% of the outstanding balance during the 3rd year.[43]

This restriction also applies to carryback sellers, regardless of the number of consumer mortgages they have carried back on sales of homes to buyer-occupants. [See Chapter 8]

A lender (not a carryback seller) offering a buyer/owner a mortgage with a prepayment penalty is also required to offer the option of a mortgage without a prepayment penalty.[44]

## Civil liability for violations

A buyer/owner may bring an action against a lender who fails to meet the ATR rules by:

- filing an action against the lender within three years of the violation;[45] or
- using the violation as a defense against a lender's foreclosure action.[46]

A lender who violates the ATR rules is subject to:

- actual money losses incurred, called damages;
- special statutory monetary sums equal to all finance changes and fees paid by the buyer/owner;
- other TILA statutory monetary sums; and
- court costs and attorney fees.[47]

A lender who is found to have violated the ATR rules under a defense against foreclosure recoupment action is subject to no more than three years of finance charges and fees paid, plus costs and attorney fees.[48]

Civil penalties available against lenders who violate Reg Z are also extended to MLOs who violate their responsibilities under Reg Z.[49]

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43 12 CFR §1026.43(g)
44 15 USC §1639c(c)(4)
45 15 USC §1640(e)
46 15 USC §1640(k)
47 15 USC §1640(a)(4)
48 15 USC §1640(k)(2)(B)
49 15 USC §1639b(d)

As with other consumer protection laws, a lender is exempt from liability when a buyer/owner obtains a consumer mortgage through fraud.[50]

50 15 USC §1640(l)

## Chapter 2 Summary

The two major consumer protection laws passed in the 2000s were:

- the 2008 Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act), which created a uniform national licensing scheme for mortgage loan originators (MLOs); and
- the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which created minimum standards and oversight for consumer mortgage origination.

California Department of Real Estate (DRE) licensees who receive fees to arrange a consumer mortgage, called MLOs, are required to obtain a DRE MLO license endorsement. Once obtained, MLO endorsements are renewed annually.

Lenders are subject to Regulation Z (Reg Z) ability-to-repay (ATR) rules when they make more than five consumer mortgages in any calendar year. Mortgage brokers who arrange consumer mortgages also need to understand the ability-to-repay rules to fulfill their duty to find the best mortgage product for their borrower's needs.

A consumer mortgage meets the requirements of the Reg Z ATR rules in one of two ways:

- by conforming to the ATR rules; or
- by conforming to one of the four qualified mortgage (QM) definitions.

The ATR rules give a lender the most flexibility. Unlike consumer mortgages made under the alternative QM rules, consumer mortgages made under the ATR rules aren't restricted in their features, terms or points and fees which may be charged. In exchange for this flexibility, consumer mortgages made under the ATR rules do not provide the lender with any liability exposure protection for failing to comply with the ATR rules.

In contrast, the benefits the lender receives for consumer mortgage originations meeting the more restrictive QM rules include:

- the ability to sell the consumer mortgages meeting the QM criteria to the government sponsored enterprises (GSEs);

- access to government insurance or guarantees for consumer mortgages it originates; and
- safe harbor protection from liability exposure for failing to comply with the ATR requirements.

Four types of QMs have been established entitled:

- the general QM;
- the temporary QM;
- the small lender QM; and
- the balloon-payment QM, with both temporary and permanent definitions.

## Chapter 2 Key Terms

**balloon payment** ........ **pg. 31**
**balloon-payment qualified mortgage** ........ **pg. 31**
**business mortgage** ........ **pg. 20**
**consumer mortgage** ........ **pg. 20**
**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)** ........ **pg. 20**
**general ability-to-repay (ATR) rules** ........ **pg. 26**
**general qualified mortgage** ........ **pg. 29**
**mortgage loan originator (MLO)** ........ **pg. 21**
**residential mortgage** ........ **pg. 21**
**Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)** ........ **pg. 20**
**small lender** ........ **pg. 31**
**small lender qualified mortgage** ........ **pg. 30**
**temporary qualified mortgage** ........ **pg. 30**

**Quiz 1 Covering Chapters 1-2 is located on page 619.**

Chapter 3

# 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)** | **installment note** |
| **all-inclusive trust deed (AITD) note** | **promissory note** |
| | **reconveyance** |
| **Applicable Federal Rate (AFR)** | **shared appreciation mortgage** |
| **balloon payment** | **straight note** |
| **graduated payment mortgage** | **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.

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.

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

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]

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**.

**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 balloon payment. [See **RPI** Form 420 - 422]

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.*

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**.

**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]

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 balloon payment.

The two major variations of the installment note are the:

- **interest-included notes** [See Form 420 accompanying this chapter]; and
- **interest-extra notes.** [See Form 422 accompanying this chapter]

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]

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 **balloon payment**, on a **due date** specified in the note.

However, balloon payments on consumer mortgages are only allowed under the general **ability-to-repay (ATR)** rules or small creditor balloon **qualified mortgage (QM)** rules. [See Chapter 2]

**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]

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*.

**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 ____________________ |

**FORM 420** 03-11 

## 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

Form 422

Note Secured By Deed Of Trust — Interest Extra

**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 ____________ |

**FORM 422** 03-11 

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]

2 12 CFR §1026.43(a)(3)(ii)

## Payment variations

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.

**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]

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

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 6]

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

*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.

**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]

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**. [See Chapter 6]

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 30]

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]

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.

**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.

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

**Form 430**

**Shared Appreciation Note**

**Page 1 of 2**

**SHARED APPRECIATION NOTE**
Installment — Contingent 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 of principal and interest plus additional contingent interest set as a percentage of the net equity increase in the value of the secured property.

$______________, 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, ☐ quater, ☐ 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 will 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 will 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 needs to 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 is to 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 is to 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.

PAGE 1 OF 2 — FORM 430

- any due date.

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.

**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]

---------- PAGE 2 OF 2 — FORM 430 ----------

**6. ADDITIONAL CAPITAL IMPROVEMENTS:**
Payor may have the value of capital improvements added to their 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 will be determined by appraisal at the time of improvement under Section 5.1.

**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 commercial 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 $_______________ will 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 will be added to the principal and thereafter bear interest as the principal.

10.2 If default occurs on any installment of principal or interest when due, then the whole sum of principal and interest will be due at the option of Payee.

10.3 In any action to enforce this agreement, the prevailing party is to 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

Shared Appreciation Note

Page 2 of 2

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. [See Chapter 30]

## 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 (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] [See Chapter 2]

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]

**usury**
A limit on the lender's interest rate yield on non-exempt real estate loans.

3 12 CFR §1026.43(c)

4 Calif. Constitution, Article XV

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 38]

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.

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]

5 Calif. Const. Art. XV §1
6 **Boerner** v. **Colwell Company** (1978) 21 C3d 37
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 3 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:

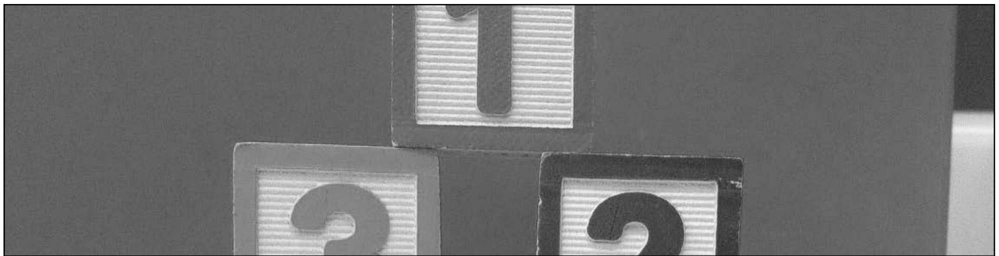
- 10%; or
- the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%.

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 3 Key Terms

**balloon payment** .......... **pg. 37**
**graduated payment mortgage** .......... **pg. 40**
**installment note** .......... **pg. 36**
**promissory note** .......... **pg. 36**
**reconveyance** .......... **pg. 44**
**shared appreciation mortgage** .......... **pg. 40**
**straight note** .......... **pg. 36**
**usury** .......... **pg. 43**

**Quiz 2 Covering Chapters 3-8 is located on page 620.**



# Chapter 4

# 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**
**accrual note**
**add-on note**
**allonge**
**consumer mortgage**
**exculpatory clause**
**grace period**
**hypothecation**
**imputed interest rate**
**interlineation**
**nonrecourse debt**
**note**
**reinstatement**

## 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 given as evidence of a debt owed by one person to another, sometimes called a promissory note. [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** 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 Department of Real Estate (DRE) 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 13]

**interlineation**
The process of modifying an instrument or document by inserting additional language between the lines to clarify a particular provision, usually adding something that was omitted.

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 **balloon payment**.

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

**hypothecation**
The pledging of something as security without the necessity of giving up possession to it. [See **RPI** Form 242]

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]

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

**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 debt,** 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 40]

## 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]

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 52]

**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 3 and Chapter 6]

## 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. [See Chapter 8]

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] [See Chapter 8]

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. [See Chapter 13]

## 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 for the mortgage holder's receipt of a payment following its due date after which the missed payment is delinquent and subject to a late charge. [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. [See Chapter 10]

## 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 balloon payment of principal

Installment payments continue until the note principal is:

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

Unless prior agreements call for a 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 Code of Federal Regulations §1026.43(g)

If a 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 on an owner of property by a mortgage holder for immediate payment of all amounts remaining unpaid on a mortgage. Also known as a call.

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] [See Chapter 42]

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 Form 418-2 in Chapter 8];
- late charges and grace periods [See Form 418-1 in Chapter 10];
- compounding on a default [See Form 418-1 in Chapter 10];
- a final/balloon payment notice [See **RPI** Forms 418-3 and 419];
- extension of the due date [See **RPI** Forms 418-3 and 425];
- an option for a payoff discount [See Form 418-2 in Chapter 8];
- 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 Chapter 9; 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 ______________ |

**FORM 422** 03-11 

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)**.

## 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 4 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.

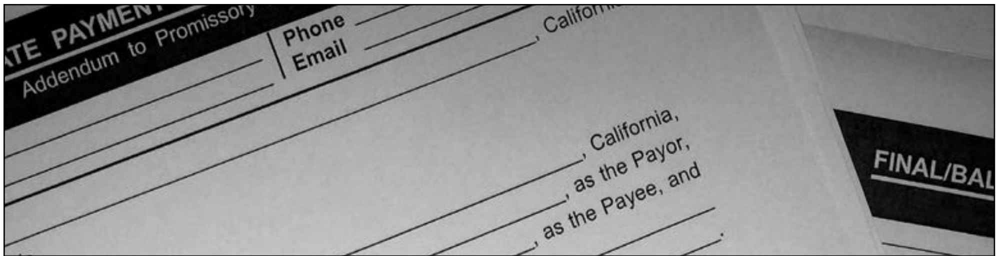
The failure of the borrower to timely pay an installment on the note allows the mortgage holder to declare the note due, called acceleration.

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 4 Key Terms

**allonge** ........ pg. 51
**consumer mortgage** ........ pg. 48
**exculpatory clause** ........ pg. 50
**grace period** ........ pg. 54
**hypothecation** ........ pg. 50
**imputed interest rate** ........ pg. 53
**interlineation** ........ pg. 49
**nonrecourse debt** ........ pg. 50
**note** ........ pg. 48
**reinstatement** ........ pg. 56

**Quiz 2 Covering Chapters 3-8 is located on page 620.**




# Chapter 5

# 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**
**business 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. [See Chapter 3]

The schedule and conditions for payment of principal and interest are also contained in the *note*.

**promissory note**
A document given as evidence of an underlying 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.

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]

**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.

Lenders who originate consumer mortgages are subject to federal **ability-to-repay (ATR)** rules, which restrict the use of some special provisions.[1] [See Chapter 2]

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. [See Chapter 8]

**prepayment penalty**
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

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:
    - o **1.5%** on a first mortgage with a principal amount no more than the **conforming loan limits** set by Freddie Mac;
    - o **2.5%** or more on a first mortgage with a principal amount more than the *conforming loan limits* set by Freddie Mac; and
    - o **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] [See Chapter 8 and Chapter 14]

**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.

**conforming loan**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

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]

**qualified mortgage (QM)**
A consumer mortgage granted safe harbor status under Regulation Z (Reg Z) ability-to-repay (ATR) rules under one of four definitions.

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)

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]

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. [See Chapter 12]

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

4 12 CFR §1026.43(g)(3)
5 Calif. Civil Code §2954.9(b)
6 **Williams** v. **Fassler** (1980) 110 CA3d 7
7 CC §2954.10

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.

Figure 1

Excerpt from Form 418-2

Prepayment of Principal Provisions

- the amount due, shown more prominently than other disclosures on the statement.[8]

*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] [See Chapter 10]*

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.

---

8 12 CFR §1026.41(d)(ii)

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 balloon payment

When a consumer or business mortgage is arranged by a broker and contains a due date for a *balloon payment*, a **late charge** may be assessed if the balloon payment is not received within ten days after the due date.

13 CC §2954.4

14 Bus & P C §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 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 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] [See Chapter 10]

**grace period**
The time period for the mortgage holder's receipt of a payment following its due date after which the missed payment is delinquent and subject to a late charge. [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.**<br>Date: ______________, 20____<br>Payor's Name ______________________<br><br>Signature ______________________<br>Payor's Name ______________________<br><br>Signature ______________________ | **Payee: I agree to the terms stated above.**<br>Date: ______________, 20____<br>Payee's Name ______________________<br><br>Signature ______________________<br>Payee's Name ______________________<br><br>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. [See Chapter 11]

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); CC §2957(b),(c)

21 CC §2924i(c); CC §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 **RPI** 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]

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 in Chapter 12]

**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]

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

An *exculpatory clause* in a note converts a mortgage holder's **recourse paper** into **nonrecourse paper**. [See Chapter 41]

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]

**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]

23 California Code of Civil Procedure §580b

24 12 CFR §1026 Supplement I Official Interpretation to 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. [See Chapter 43]

## 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 Chapter 41; 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 5 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 5 Key Terms



**Quiz 2 Covering Chapters 3-8 is located on page 620.**

*Notes:*

# Chapter 6

# Adjustable rate mortgages

## Learning Objectives

After reading this chapter, you will be able to:

- review the history of the adjustable rate mortgage (ARM) in the United States;
- understand how ARMs work;
- know the different ARM products that influenced the real estate and financial markets in the last decade;
- recognize recent ARM developments in the consumer mortgage market; and
- identify disclosure requirements for mortgage loan originators (MLOs) and lenders originating an ARM.

## Key Terms

**adjustable rate mortgage (ARM)**
**conversion adjustable rate mortgage (ARM)**
**fully indexed rate**
**hybrid adjustable rate mortgage (ARM)**
**index**
**initial interest rate cap**
**interest-only adjustable rate mortgage (ARM)**
**introductory interest rate**
**lifetime interest rate cap**
**margin**
**negative amortization**
**option adjustable rate mortgage (ARM)**
**payment cap**
**periodic interest rate cap**
**prepayment penalty**

## The birth of the ARM

The most common type of home financing in the United States is the 30-year fixed rate mortgage (FRM) initiated in the 1930s to provide home sellers a method for cashing out of their current home to buy another home. Up until the early 1980s, the fixed rate mortgage was just about the only type of mortgage available to finance home sales.

After the 1974 recession, California authorized and some mortgage lenders adopted inflation-proof variable interest rate provisions, their interest rate range limited by statute. Federal de-regulation did not authorize **adjustable rate mortgages (ARMs)** until early 1982.

**adjustable rate mortgage (ARM)**
A variable interest rate note, often starting out with an introductory teaser rate which resets in a few months or years based on a particular index.

At the time, the main sources of mortgage funds were numerous financial entities known as **savings-and-loans (S&Ls)**. *S&Ls* operated by offering depositors interest on their deposits (that's the "savings" part), and in turn using the deposits to lend mortgage money at slightly higher interest rates (the "loans" part) than those paid to the depositors.

For instance, the S&Ls would pay a 5.5% interest rate to depositors, then turn around and charge 8.0% to a mortgaged homebuyer for a 30-year fixed rate mortgage, a 2.5% operating margin over their cost of funds. The S&Ls kept the **spread** between the two interest rates to cover expenses and provide a profit.

The arrangement was a simple business model, one that was perhaps too boring. And so the S&L cycle continued until it collapsed and disappeared in the late 1980s, consumed by a poisonous cocktail deregulation by Congress in late 1982.

## S&Ls dependent on depositors

Prior to the 1980s, federal housing policy prohibited S&Ls from dabbling in other types of consumer finance, so their sole source of income was mortgage lending. (The one-stop-shop mega-banks we are so familiar with today were unlawful then, too.) Thus, by their very structures, S&Ls were highly dependent on depositors as a source of funds to make mortgages and stay in business.

However, again, the mortgages made were 30-year FRMs. A lender making a 30-year FRM is making a commitment to lend money at a fixed interest rate over a long period of time. Depositors, on the other hand, were being paid interest rates at current market rates during the life of the S&Ls mortgages. Further, depositors had the right to withdraw their money at any time, except for those in certificates that paid higher rates where withdrawal without penalty required a one- to three-year holding period.

Everything worked fine for the S&Ls while their expenses (the interest paid on deposits) were less than their income (interest rate charged on mortgage mortgages). This business model left S&Ls highly vulnerable to interest rate fluctuations — mortgages at fixed rates for 30 years and rates on savings changing from day to day, and trended upward during the 30-year period prior to 1980.

## Caps placed on interest paid

Congress mitigated this vulnerability in 1966 by placing caps on the amount of interest an S&L was able to pay to depositors in exchange for guaranteed savings for depositors up to $10,000. By 1982, the average deposit account in an S&L was $8,300.

The interest rate cap on S&L savings accounts was set higher than the cap placed on commercial banks. Thus, depositors were encouraged to place their money with S&Ls, to ensure the mortgage money continued to flow. With excess funds, construction financing became a lucrative but riskier part of S&L portfolios. Each recessionary period over the past 70 years has brought on massive losses for these lenders for reason of *over-lending*, producing an excess supply of housing for the moment.

Then, economic conditions and monetary policies in the '70s allowed **inflation** to run sky-high. S&Ls remained restricted in their competition for deposits by the interest rate cap (until 1978 when money market rates were introduced). Other financial companies not subject to interest rate caps set by the federal government paid true market level interest. S&L depositors began pulling funds from the S&Ls in droves, to place their funds in higher-yield investments as protection against the Federal Reserve's failure to control inflation. [See Chapter 1]

## A Hail Mary attempt

In an attempt to save the moribund S&Ls, Congress and regulatory agencies did several things in the late 1970s and early 1980s:

- allowed S&LS to diversify by making other than 30-year FRMs;
- removed interest rate caps on depositor funds; and
- adopted regulations allowing S&Ls and banks to offer ARMs.

In contrast to FRMs, ARMs allow lenders to float interest rates they charge to match market rates they paid to obtain funds. By allowing mortgage rates to fluctuate with market rates, ARMs shifted inflationary and economic risk from the S&Ls to the *homebuyer*. Thus, a risk the S&Ls were unable to manage was now to be managed by far less informed homeowners. Regulators hoped this would equalize the expenses and incomes of S&Ls, and pull them out of the insolvency they faced.

It didn't. Ultimately, S&Ls went the way of the dodo, but the risky ARMs remained on the books. From the early 1980s onwards, the ARM has remained available to homebuyers. It has largely been as damaging to low- and mid-income homebuyers as it was ineffective in rescuing the S&Ls. The Millennium Boom is a pertinent example of the local and global destruction ARMs can wreak.

*Editor's note — The impact of ARMs on homebuyers has been memorialized in some colorful language over the years. Veteran mortgage loan brokers from the 1980s remember when ARMs were called "topless mortgages" as it seemed their ceiling rates were set so high as to be meaningless. Other equally colorful names included the "Reverse Interest and Principal for*

*Optimum Fast Foreclosure (RIPOFF) mortgage" and the "Zero Ability to Pay (ZAP) mortgage." All titles were instructive, but none were heeded until 2010, too late to avoid the financial crisis of 2007.*

## ARMs in the Millennium Boom

The face of the ARM has changed over the years, most dramatically during the Millennium Boom.

20 years after ARMs became part of the American mortgage landscape of constantly declining interest rates, the housing market was experiencing an unprecedented pricing boom, which became known as the *Millennium Boom*. Fueled by ever lower interest rates, no down payment ownership, the financial accelerator effect from Wall Street funds and speculative momentum fever, housing prices skyrocketed. [See Chapter 1]

Further, mortgage lending standards were fully relaxed. Part of the blame for this lax attitude was due to demand from bond market investors for ever more securitized mortgages (based in large part on the rating agency's conflicted miscalculation of risks). But also largely to blame was the widespread belief that home prices always rise, and therefore the collateral (the property), rather than the homebuyer, would carry the mortgage on a default.

When demand for mortgages peaked in mid-2005, Wall Street had perfected its vertically expanded business model for originating, gathering, bundling and reselling mortgages from loan application through to the **mortgage-backed bond (MBB)** market bought up by millions of investors worldwide, who kept none themselves while betting on a crash. Of course, meeting all this investor demand for MBBs was dependent on even more new mortgages.

The most infamous of these new mortgage products were "subprime mortgages" and "no-doc mortgages." When the homebuyer could not afford a mortgage, it was the fault of the lender's underwriters, not the homebuyer's.

## ARM popularity

In the history of ARMs, we discussed that FRMs guarantee a rate over a long period of time. Lenders necessarily build into the FRM interest rate the cost of keeping an interest rate "locked-in" at that interest rate for 30 years. ARMs tended to have a lower initial "fixed rate" (if any) because the lender's cost of short-term funds was lower — a matter of a few months to one or two years, rather than 30 years. Thus, otherwise unqualified homebuyers were able to make monthly payments — but only at the time of origination. ARMs offered low initial interest rates to qualify and very low payment schedule options for up to ten years. Declining interest rates from their peak in 1980 to the zero-lower-bound range by 2010 made the rate and payment adjustments calculus look benign.

Since the Great Recession of 2008, ARM use for funding home purchases has remained relatively low. However, by 2014 their use was rising as home prices increased far faster than supporting wages and inflation. While interest rates lingered near historic lows in 2015 and into 2016, home prices again became significantly higher than the **mean price trendline** (a range to which home prices eventually return).

Unlike the 30 years preceding 2010, homebuyers who later take out ARMs will be at the mercy of inevitably rising interest rates over the next few decades. Their ARM payments will increase with rising interest rates, cutting into disposable income and standards of living for the massive *debtor class* of job-holding homeowners, as distinguished from the *rentier class* who have no debt and hold income producing assets.

In order to adequately inform homebuyers of the consequences ARMS will have on their payments going forward, mortgage loan originators (MLOs) need to be aware of the not-so-benign workings of these ARM products.

## The purpose and popularity of ARMs

An ARM calls for periodic adjustments to both the interest rate charged and the dollar amount of scheduled payments. ARMs allow homebuyers to leverage the lower initial interest rate into a higher purchasing price through greater mortgage amounts when FRM rates rise before the Federal Reserve (the Fed) raises short-term rates. The reverse of this interest movement was experienced in early 2016 as the short-term Fed controlled rate moves up and the FRM bond controlled rate was flat to down in comparison.

In addition to the greater purchasing power an ARM initially provides a homebuyer, ARMs may attract homebuyers who plan to:

- sell the mortgaged home prior to the first adjustment on the ARM;
- refinance the ARM into a lower FRM and keep the home after they improve their credit; and/or
- use the money saved by the lower ARM interest rates to speculate in higher-yield investments.

Unfortunately, these plans didn't always bear out. During the Millennium Boom, many MLO brokers fell into the trap (more fees coming) of advising their homebuyers to obtain a short-term ARM with the expectation FRM refinancing would be available when the fixed rate period ended.

But when it came time to refinance, the house securing the property had lost value, or the homeowner had lost their job. Additionally, the terms on some of the more "creative" ARMs also contained financial time bombs built of interest-only payments, or less. When a refinance was not available, the resulting **re-amortization** often doubled monthly payments.

## Basic ARM elements

All ARMs contain five components:

- an introductory interest rate;
- a ceiling and a floor rate;
- an index figure;
- an operating margin; and

- adjustment intervals for rates and payments.

## Introductory interest rates

**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. Also known as a teaser rate.

**fully indexed rate**
The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.

The **introductory interest rate** is the initial rate on the ARM. The introductory interest rate is sometimes called a *teaser rate*. The introductory interest rate stays fixed for a set amount of time, called the **introductory period.** The introductory period can be anywhere from a month to ten years, depending on the terms of the ARM.

The lender may set the introductory interest rate however it chooses, depending on whether it wants to attract homebuyers into ARMs.

In the past (and certainly during the Millennium Boom), most lenders qualified homebuyers' mortgage applications based on the low introductory interest rate payment. When the introductory interest rate adjusted, homebuyers were too often unprepared with sufficient income increases to cover the increase in payments, a phenomenon known as *payment shock*.

However, post-2010 ability-to-repay (ATR) rules require lenders to underwrite homebuyers based on a **fully indexed rate** (discussed shortly), or the highest rate possible on the ARM during the first five years of its term.[1] [See Chapter 2]

## 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 **index** is the primary of two components which determine the adjusted interest rate after the introductory period. An ARM is said to be "tied" to an index. The index is basically a moving rate, called the *index figure*, which sets the periodic adjustment in the mortgage rate charged. As the index figure rises and falls, so does the ARM's interest rate in an equal degree.

ARM interest rate adjustments may be tied to any one of a variety of indexes. Each index adjusts based on different criteria, set by the "owner" of the index. Common indexes for ARMs are the:

- 11th District Cost-of-Funds Index (COFI);
- 12-month Treasury Average; and
- Secured Overnight Financing Rate (SOFR).

The COFI is compiled monthly based on the previous month's cost of funds actually incurred by lenders. Since the COFI is set monthly, it is appropriate for ARMs. The COFI is a short-term benchmark and tracks the lender's costs to be passed on to the homebuyer.

The **12-month Treasury Average** is released as a weekly average 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 amount paid by winning bidders on Treasury Securities in the over-the-counter stock market.

1 12 Code of Federal Regulations §1026.43(c)(5)(A)

The SOFR replaced the London Interbank Offered Rate (LIBOR). LIBOR was an international benchmark for setting interest rates commonly used with ARMs. It was a common index from the 1980s until it began to be phased out in 2021, and then became replaced by the SOFR in 2023.

The Federal Reserve Bank of New York sets and publishes the SOFR daily. The rate is based on completed transactions, specifically on overnight funds collateralized by Treasury Securities, not what the individual bankers might wish to report as their best estimate of a day's transactions.

Thus, the SOFR is more reliable than LIBOR and is not susceptible to fraud by the bankers involved. As a result, it provides an index without manipulation by mortgage bankers to increase profits which better protects homeowners with ARMs.

Regardless of which index is used, the purpose of the index is the same: it is meant to be a proxy of the change in the cost of lending that is passed on to those homebuyers who insist on an ARM.

**Regulation D** requires the index used to be:

- readily available and verifiable by the homebuyer, and beyond the control of the creditor;[2] or
- based on a formula or schedule for the amount the interest rate may increase, and when a change in the rate may be made.[3]

Basically, the lender may not arbitrarily and opaquely make changes to a consumer's interest rate on an ARM. Changes are made in a transparent, agreed-to fashion set forth in the mortgage note.

## The margin

The **margin** is the second component of the mortgage rate. When added to the index figure, it determines the interest rate charged after the introductory period, called the *note rate*. The margin consists of the interest points the lender adds to the index to cover its operating expenses and provide a profit. The margin varies with each lender, but unlike the index figure, it stays fixed for the life of the mortgage.

**margin**
The interest points added to an index by a lender as profit on the adjustment of an adjustable rate mortgage (ARM).

The ARM's interest rate, after the introductory period, is determined by adding the margin to the index figure (at set intervals, and subject to any caps), called a **fully indexed rate**.

For instance, an ARM with an index figure of 4%, and a margin of 2% has a fully indexed rate of 6% (the *note rate*). If the index figure later fell to 2%, the fully indexed rate would be 4%.

## The adjustment interval

The adjustment interval is the time period between changes in the ARM's interest rate and the monthly payments. ARMs may be scheduled to adjust every month, every year, every three years, etc. At the end of each adjustment

2 12 CFR §1004.4(a)(2)(i)
3 12 CFR §1004.4(a)(2)(ii)

interval, the interest rate on the mortgage will adjust to the current index figure plus the margin. For continued amortization of principal over the remaining term of the mortgage, monthly payment changes each time the ARM rate adjusts.

An ARM with payments scheduled to adjust every year is a 1-year ARM. An ARM with payments scheduled to adjust every three years is a 3-year ARM.

## Rate caps and other ARM features

Some ARMs have other features which will impact how the interest rate or payments adjust. These features include:

- an initial interest rate cap;
- periodic interest rate caps;
- a lifetime interest rate cap and floor;
- periodic payment caps;
- conversion features; and
- prepayment penalties.

A "cap" is a ceiling on the amount of the interest rate, or payment adjustment. The "floor" is the rate below which the mortgage rate will not drop.

## Interest rate caps

**initial interest rate cap**
A limit on the amount the interest rate may change on the first adjustment of an adjustable rate mortgage (ARM).

**periodic interest rate cap**
A limit on the amount the interest rate can increase with each future adjustment of an adjustable rate mortgage (ARM).

**lifetime interest rate cap**
A limit on the amount the interest rate can increase over the life of an adjustable rate mortgage (ARM).

The **initial interest rate cap** sets a limit on the amount the interest rate may change on the first adjustment. A **periodic interest rate cap** places a ceiling on the amount the interest rate can increase with each future adjustment. A **lifetime interest rate cap** is the maximum amount the lender can increase the interest rate throughout the life of the mortgage.

The **base rate** is the rate used to determine interest rate caps. For both the initial interest rate cap and the lifetime interest rate cap, the base rate is set at the *introductory interest rate*. For the periodic interest rate cap, the base rate is the interest rate from the prior interest rate charged, as it changes from period to period.

In response to the potential for never-ending future interest rate increases during the life of an ARM, all consumer-purpose ARMs now have lifetime interest rate caps (thus, regulations now defy the derogatory "topless mortgage" term predictive from the '80s). It is the lender who actually sets the caps. No regulations or guidelines set minimum or maximum allowable caps as was the case with the California 1970's variable rate mortgages (VRMs).[4]

The most common rate cap arrangements are 5/2/5 or 2/2/6. The first number refers to the initial rate increase cap over the base rate, the second number is the future periodic rate increase cap over the prior rate charged, and the third number is the lifetime rate increase cap over the base rate.

For instance, for the 5/2/5 rate cap arrangement:

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4 12 United States Code §3806(a)

- the initial rate increase cannot exceed 5% over the introductory interest rate;
- future periodic rate increases cannot exceed 2% from one adjustment period to another; and
- the lifetime rate increase cannot exceed 5% over the introductory interest rate.

## Payment caps

Another type of cap for an ARM is known as a **payment cap**. As the name suggests, this caps the total payments due on the mortgage at each adjustment. So, if your homebuyer had a mortgage payment of $1,000, and the mortgage has a payment cap of 10%, the maximum the payment can increase with the adjustment is $100, for a total payment of $1,100 — regardless of interest rate changes.

**payment cap**
A limit on the amount of increase in the borrower's monthly principal and interest at the payment adjustment date on an adjustable rate mortgage (ARM).

However — and here is the rub — with payment caps the additional interest due above the 10% payment cap is not simply forgiven. It is actually added to the mortgage balance and becomes part of the principal which bears interest. Thus, payment caps can cause **negative amortization** as unpaid interest is added to principal and thereafter bears interest — a deleterious compounding. Some ARMs have both interest rate caps, and payment caps.

*Editor's note — Mortgages with the potential for negative amortization are only allowed under general ATR requirements. They are not permissible for any type of qualified mortgage.*[5] *[See Chapter 2]*

## Conversion ARMs

Some ARMs allow them to be converted to an FRM during the mortgage term. The rules for exercising a conversion are set out in the mortgage documents. However, **conversion ARMs** have some drawbacks:

**conversion adjustable rate mortgage (ARM)**
An adjustable rate mortgage (ARM) which may be converted to a fixed rate mortgage (FRM) during the mortgage term.

- the interest rate when converted may be higher than the average FRM rate offered by other lenders;
- the lender may charge a higher interest rate during the ARM portion of the mortgage than for other mortgages without conversion features; and/or
- the lender might charge a fee for the conversion.

Conversion is not mandatory for the homebuyer. For example, a homebuyer who takes out a conversion ARM may either adopt a fixed interest rate five years into the mortgage term, or may choose to adhere to the traditional ARM terms, including periodic adjustments to the interest rate and monthly payment. The bet depends on whether interest rates are expected to move up or down.

However, lenders might charge a higher interest rate on a conversion mortgage. Thus, a homebuyer should be aware before they take on an ARM

5 12 CFR §1026.43(c)

whether or not a conversion option affects the ARM interest rate. As always, when opting to exercise the conversion, the homebuyer is best served by inquiring into refinancing with another lender, which likely will be cheaper.

## Prepayment penalties

**prepayment penalty**
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

**Prepayment penalties** are fees charged by a mortgage holder when a homeowner pays off a mortgage early.

For business mortgages, prepayment penalties are usually limited to prepayments during the first three to seven years of the mortgage. When analyzing whether an investor may want to refinance, the prepayment penalty is taken into consideration by the investor and their agent.

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. When an ARM is secured by one-to-four residential units, the mortgage holder may not bar the owner's voluntary prepayment within 90 days of notification of a change in the rate.[6]

Additionally, under Regulation Z (Reg Z), consumer ARMs may not contain a prepayment penalty provision.[7] [See Chapter 7]

*Editor's note — State laws may restrict the charging of prepayment penalties. For example, in California a prepayment penalty may not be charged on a mortgage secured by an owner-occupied single family residence unless the homebuyer pays more than 20% of the unpaid balance in any 12-month period.*[8]

*Prepayment penalties on consumer mortgages secured by one-to-four unit residential properties are only allowed on qualified mortgages.*[9]

## Different types of ARMs

A plethora of ARMs, each with different terms, existed for 30 years before 2010. Reg Z now sets parameters for future consumer ARM originations. Common types of ARMs popular during the Millennium Boom included:

- hybrid ARMs;
- option ARMs;
- conversion ARMs; and
- interest-only ARMs.

6 Calif. Civil Code §1916.5(a)(5)
7 12 CFR 1026.43(g)
8 CC §2954.9
9 12 CFR §1026.43(g)

ARM adjustment examples

*Let's say your homebuyer started with a 3.25% fully-indexed interest rate on an adjustable rate mortgage (ARM) for $200,000. The ARM adjusts annually, and has a 5/2/5 cap structure. At the first adjustment, the index figure rises 3%. At the second year, the index figure rises another 3%. (NOTE: No impounds are included in this example.)*

*What is the interest rate on the mortgage after the second adjustment?*

*The interest rate after the second adjustment is 8.25%. The breakdown goes like this:*

| ***ARM Interest Rate*** | ***Monthly Payment (Rounded to nearest dollar)*** |
|---|---|
| *1st year @ 3.25%* | *$ 870* |
| *2nd year @ 6.25%* | *$ 1221* |
| *3rd year @ 8.25%* | *$ 1478* |
| *3rd year @ 9.25% (without lifetime cap)* | *$ 1614* |

*The first adjustment (the 2nd year rate) is within the 5% initial interest rate cap. With a 3% rise in the index figure, the interest rate increases to 6.25%. The second adjustment, also with a 3% rise in the index figure, is limited by the lifetime interest rate cap.*

*Here, the lifetime cap avoids the homebuyer paying an additional $136 monthly after the third year.*

*Additionally, some ARMs with interest rate caps have a **carryover** feature. The carryover feature is contained in the mortgage note, and allows lenders to "carryover" interest rate increases which exceed the periodic interest rate increases to the next adjustment.*

*Now consider a homebuyer with a 3.25% fully-indexed interest rate on an ARM for a $200,000 mortgage. The ARM adjusts annually, and has a carryover provision in the mortgage documents. 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 figure goes up 3%. At the second year, the index figure goes down 1%. (NOTE: no impounds are included in this example.)*

*What is the interest rate on the mortgage after the second adjustment?*

*The interest rate after the second adjustment is 5.25%. The breakdown goes like this:*

| ***ARM Interest Rate*** | ***Monthly Payment (Rounded to nearest dollar)*** |
|---|---|
| *1st year @ 3.25%* | *$ 870* |
| *2nd year @ 5.25%* | *$ 1098* |
| *3rd year @ 5.25%* | *$ 1098* |

*The index figure 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 figure. Thus, the interest rate remains 5.25%.*

*These examples are based on a fully-indexed initial interest rate, not the teaser rate. Most ARMs will start with discounted interest rates (ones which are not fully-indexed). If an ARM has a very low teaser rate – below the fully-indexed rate – and a 5/2/5 ceiling structure, the interest rate can increase by up to 5% over the introductory rate on the first adjustment — a payment shock for most homebuyers. Here, mortgage loan originators (MLOs) with homebuyers set on an ARM may search for other ARM products with a lower initial interest rate cap – say a 2/2/6, structure, which allows for more gradual interest rate increases.*

## Hybrid ARMs

**hybrid adjustable rate mortgage (ARM)**
A type of adjustable rate mortgage (ARM) which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

The **hybrid ARM**, also known as a "Canadian rollover," is a fusion of an FRM and an ARM. It's the "traditional" type of ARM in which the interest rate is fixed during an initial time period, then adjusts periodically afterward. Some hybrid ARMs are named after the initial fixed period and following adjustment periods.

For example, one of the most common types of hybrid ARMs is the **5/1 ARM**. With this type of mortgage, the interest rate is fixed for the first five years of the mortgage, typically at a low teaser rate. Then, the mortgage adjusts once a year after that initial period expires.

Other common hybrid ARMs using this naming convention include:

- 3/1 (fixed for three years, then adjusts annually);
- 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 initial rate is lower than market. This allows the homebuyer to qualify for a mortgage. The homebuyer's intention is to improve their credit and refinance out of the hybrid ARM before the initial fixed rate period expires. Common hybrid ARMs named under this convention included:

- 2/28 (fixed for two years, adjustable for 28 years); and
- 3/27 (fixed for three years, adjustable for 27 years).

Both 2/28 and 3/27 ARMs adjust every six or twelve months.

Hybrid ARMs can be qualified mortgages if they otherwise meet qualified mortgage requirements. Thus, this is one of the only types of consumer ARMs which survived introduction of the Reg Z ATR requirements.

The remaining ARM mortgages discussed below have been relegated back to their rightful place as niche products for extremely well-qualified homebuyers under ability to pay rules.

## Interest-only ARMs

With an **interest-only ARM**, the homebuyer's monthly payments are only for the amount of interest due, there being no payment towards the reduction of principal. The interest-only payment schedule typically lasts for three to ten years.

**interest-only adjustable rate mortgage (ARM)**
A type of adjustable rate mortgage (ARM) which features an initial period of interest-only payments.

After the interest-only period expires, the homebuyer's monthly payments are adjusted to include both interest and principal. However, because the homebuyer did not make any principal payments during the first years of the mortgage term, the principal payments are amortized over a shorter period of time.

For example: a homebuyer enters into a 30-year ARM, payable interest-only for the first three years. After three years, the interest rate is adjusted to the new index figure and the margin agreed to in the mortgage. On the **recast,** the principal is re-amortized to set the monthly payments for the ARM's remaining 27-year term. (Note: some interest-only mortgages also have periodic adjustments to the interest rate during the interest-only period.)

The longer the interest-only period, the greater the payments will be when the mortgage recasts.

Consider a homebuyer taking out a 30-year ARM with a five-year interest-only feature. The homebuyer's monthly payment during the first five years of the mortgage is $625. However, after the initial period runs, the mortgage is recast. The interest rate is reset at 5% and monthly payments increased to amortize the principal over the remaining 25 years of the mortgage. The homebuyer's monthly mortgage payment jumps to $1,461 in the sixth year of the mortgage, more than double the amount of the homebuyer's initial payments.

## Option ARMs

**Option ARMs** were among the most insidious type of mortgage offered during the Millennium Boom. Option ARMs are so named because the homebuyer may choose any one of several different payment options each month. Also called *pick-a-pay ARMs*, option ARMs typically begin with a very low teaser rate. However, this rate only holds for a month or so before increasing with the index figure from month to month.

**option adjustable rate mortgage (ARM)**
An adjustable rate mortgage (ARM) giving the borrower the choice of a full monthly payment, an interest-only payment, and a minimum payment typically less than the interest due.

Each month, the homebuyer may choose to pay:

- principal and interest under a traditional amortization schedule for the full term of the mortgage (some option ARMs allowed the homebuyer to choose the amortization schedule for the payment — 15, 30 or even 40 years);
- interest-only; or
- a minimum payment, amounting to less than the interest due.

If the homebuyer chooses to pay the minimum amount, the unpaid interest due is added onto the total principal amount. This process in which accrued unpaid interest tacks on to the principal balance is called **negative amortization**.

**negative amortization**
The addition of unpaid interest to the principal balance of a mortgage due to insufficient monthly interest payments.

When the homebuyer chooses this payment option, their mortgage is recast after an agreed number of years (typically every five years) according to the new principal balance due — an amount now greater than the original mortgage. Payments caps do not restrict a recast needed to fully amortize the principal.

Some lenders placed **negative amortization caps** on mortgages which had the potential for negative amortization. The negative amortization cap places a ceiling on how high the principal balance was able to grow before a recast. A recast of payments occurred at this principal ceiling regardless of any pre-set recast time period. The typical negative amortization cap was set at 110% or 125% of the original mortgage amount. And, as with other recasts, the payment caps did not apply.

Option ARMs were often a lure for under-qualified homebuyers during the years leading up to the 2007 financial crisis. Low-income homeowners consistently paid the minimum amount due each month. As a result, their debt quickly snowballed. When their mortgages were recast, owners became overwhelmed with their adjusted payments and defaulted.

## Recent developments

In 1996-2002 the ARM-to-loan ratio moved parallel with FRM rates. This displayed ideal conditions for financing a stable housing market. Real estate prices rose at a sustainable rate for the duration of this period.

However, beginning in 2002, FRM rates dropped continuously for two years. In the meantime, the ARM-to-loan ratio began to rise. This inverse movement was brought on by **deregulation** of mortgage lenders. The unanchored rise in the ARM-to-loan ratio and the financial accelerator conditions that followed led directly to hugely excessive home price increases, which continued for nearly three years.

The ARM-to-loan ratio peaked in early 2005, and sales volume turned down in mid-2005. Home pricing reached its apex one year later in early 2006; sales volume tanked in 2007. No surprise for anyone aware of the triggering effect of periods with greater than inflation price rises, sales volume peaks and price peaks to bring prices crashing down.

Between 2005 and 2009, FRM rates remained flat while the ARM-to-loan ratio reversed course and dropped significantly. The declining ratio in ARMs to all loans alongside a flat FRM rate, an abnormal sequence, presaged a further decline in home prices.

In 2014, ARMs made up roughly 11% of mortgage originations in California. This is extremely low compared to the 77% peak ARM-to-total-loan ratio experienced at the height of the Millennium Boom. For comparison, the national peak ARM-to-loan ratio was only 36% during the Boom.

## ARM-use backfires

The disparity between the 2004 and 2014 ARM-to-loan ratios is due to the type of homebuyer demand unique in 2004. During that time, many under-qualified homebuyers were anxious to purchase property in the frenzied real estate market. However, these homebuyers lacked sufficient income to make monthly payments on a 30-year FRM.

Because they did not qualify for FRMs, many homebuyers opted for high-risk ARMs. They expected — based on what they had experienced at the time — the value of their collateral to only increase over the next few years, allowing them to either refinance or resell the property before their ARMs reset based on projections, not forecasts.

However, the value of a California homebuyer's collateral did not increase over the next five years. Instead it dropped drastically beginning in 2006 when pricing had reduced sales volume for over 12 months, decelerated in

2007 being about a price bottom in early 2009. This prevented homebuyers from escaping the obligations of their ARMs by refinancing after the initial period of the ARM.

The 50% implosion of real estate pricing was not just a shock to the real estate market, but to homebuyers as well. (Wall Street had already sold the mortgages and lost nothing, until they settled mortgage fraud cases with the government.) Homebuyers in turn reacted with greatly reduced favor toward ARMs in the years following the Millennium Boom and bust.

Hybrid ARMs remained the most popular type of ARM in 2024, with the 5/1 ARM leading the market, followed by the 7/1, 3/1 and 10/1 ARMs.

However, the vast majority of homebuyers still prefer FRMs to ARMs. The share of residential mortgages originated with ARMs is 19% as of 2023.

Under Reg Z guidelines, lenders must disclose that homebuyers are not guaranteed the ability to refinance to a lower rate after their mortgage adjusts. Additionally, lenders are required to plainly state the maximum interest rate possible on the mortgage — a kind of "worst case" rate previously buried deep in the rarely read mortgage jargon and formulas of prior ARM documents.

## Disclosures required and other regulations

Disclosures lenders are now required to provide to ARM homebuyers include:

- the Consumer Handbook on Adjustable Rate Mortgages;
- notice that the mortgage terms are subject to change, including:
    - the interest rate; and
    - the mortgage payments;
- 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 to the homebuyer to request additional information about the current margin value and current interest rate;
- notice that the current interest rate is discounted;
- a recommendation to the homebuyer to 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;
- either:
    - a historical example of an ARM, which illustrates the effect of interest rate changes on the homebuyer's payments and mortgage balance. This example must be based on a $10,000 mortgage amount

and the past 15 years' index values. A description of negative amortization, interest rate carryover, interest rate discounts and payment caps must be integrated into this example; or

- the maximum interest rate and payment for a $10,000 ARM under the current mortgage terms. This must also disclose the fact that the homebuyer's payments may increase or decrease significantly;

- instructions for calculating mortgage payments;
- notice of the mortgage's demand provision;
- a description of notices of adjustments, and the schedule for these notices; and
- a notice that the homebuyer may access disclosure forms for the lender's other ARM programs.[10]

These avuncular-styled regulations are among the most user-friendly and socially effective amendments to the Truth in Lending Act (TILA). Throughout the past history of our government, Congress demanded the government refrain from this brand of hand-holding consumer protection from lenders. But the parameters set for the playing field for consumer mortgages has been made level for lenders and consumers for the first time in U.S. history. Lenders, expectedly, are unhappy with the changes designed to prevent another social disruption like the 2007 financial crisis and the Great Recession of 2008.

## Changes from Fannie Mae

Fannie Mae has tightened standards on the mortgages they purchase, requiring higher credit scores and more documentation of income for ARMs.

Changes to ARM transactions included:

- an increase in the minimum FICO score from 620 to 640;
- the maximum loan-to-value ratio (LTV) for one-unit, principal residence, purchase and limited cash-out refinances became 90% for both desktop underwriting (DU) and manually underwritten mortgages (reduced from 95% and 97%, respectively); and
- the majority of ARM transactions were required to have maximum LTVs of 10 percentage points less than previously, not falling below 60%.

The buyer's total debt obligation, including front-end and back-end **DTI** maximum was revised to 36%, unless the mortgage meets credit score and reserve requirements (found unchanged in Fannie's Eligibility Matrix), then it may be as high as 45%.

10 12 CFR §1026.19

## Chapter 6 Summary

Up until the early 1980s, the fixed rate mortgage (FRM) was just about the only type of mortgage available to homebuyers. Then, Congress and regulatory agencies adopted regulations allowing savings-and-loans (S&Ls) to offer adjustable rate mortgage (ARMs).

The face of the ARM has changed over the years, most markedly during the Millennium Boom. During this time, otherwise unqualified homebuyers were able to afford mortgages. Currently, ARM use is relatively low, but climbing. However, in the next few years, any homebuyers who take out ARMs will be at the mercy of the rising interest rates of the next few decades.

All ARMs contain four items:

- an introductory interest rate;
- an index;
- a margin; and
- an adjustment interval.

Some ARMs have other features which will impact how the interest rate or payments adjust. These features include:

- an initial interest rate cap;
- periodic interest rate caps;
- a lifetime interest rate cap;
- periodic payment caps;
- conversion features; and
- prepayment penalties.

Prepayment penalties are usually limited to the prepayments made in the first few years of a mortgage (incidentally, the same period of time in which interest is paid to the lender). When analyzing whether a homebuyer should refinance or allow an ARM to adjust, the prepayment penalty needs to be considered.

A plethora of ARMs exist, each with different terms. Common types of ARMs, or ARMs popular during the Millennium Boom include:

- hybrid ARMs;
- option ARMs;
- conversion ARMs; and
- interest-only ARMs.

The mortgage industry and rule makers have also acknowledged the need for regulation of ARMs. The Truth in Lending Act (TILA) and its Regulation Z require that all features of an ARM mortgage, including the existence of a carryover feature, be disclosed to a homebuyer at the time of the homebuyer's mortgage application. Fannie Mae has also tightened standards on the notes they purchase, requiring higher credit scores and more documentation of income for ARMs.

## Chapter 6 Key Terms



**Quiz 2 Covering Chapters 3-8 is located on page 620.**

# Chapter 7

# Modifying the mortgage note

## Learning Objectives

After reading this chapter, you will be able to:

- distinguish between different scenarios for typical modifications of a note; and
- understand the process of modifying a note.

## Key Terms

**allonge**
**consumer mortgage**
**due-on clause**
**exculpatory clause**
**nonrecourse debt**
**novation**
**prepayment penalty**
**recourse debt**
**subordination**

## Modifying provisions in a note

During the life of a mortgage, the mortgage holder and owner of the mortgaged property may agree to **modify**, **add** or **rescind** one or more note provisions. Any change in the terms of a note requires:

- **mutual agreement** between the property owner and the mortgage holder; and
- **consideration** given in exchange for the modification, with the exception of bankruptcy. [See **RPI** Form 426]

**Modifications** of a mortgage usually arise out of a financial necessity experienced by the owner of the mortgaged property. Conversely, a carryback seller incurs profit taxes on receipt of a payoff of the mortgage which may prompt the seller to bargain for a modification to extend the time for payoff, and thus payment of profit taxes.

## Negotiating to modify mortgage terms

The modification of a note is controlled by California **contract law**. Thus, a written contract — in this example the note evidencing a debt — is modified by:

- a *written agreement*; or
- an *oral agreement*.[1]

However, for an oral modification to be enforceable, both the mortgage holder and the property owner need to *execute* the oral agreement by taking action on it. To be certain of the terms as modified, they need to memorialize the modification in writing.

A property owner best initiates a written modification process by filling out a form submitted to the mortgage holder as an **offer to modify** the note. As with all forms, the form functions as a checklist of issues a well-informed agent considers when negotiating a modification, a malpractice risk-reduction issue.

When filled out, the agreement sets forth the terms sought by the person initiating the modification effort. A real estate agent traditionally facilitates negotiations with the mortgage holder on behalf of the owner. [See **RPI** Form 426]

Once the agreement to modify has been negotiated to set the new terms for payment and rates, the agent, broker or escrow officer prepares a **Modification of the Promissory Note** form. It is the *modification form*, a sequel to the *offer to modify* form, which actually changes the terms of the existing mortgage from those in the original note. [See **RPI** Form 425]

**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.

Provisions in the modification form:

- identify the note which is being modified;
- name the parties to the mortgage; and
- identify the trust deed and the mortgaged property involved.

To complete the paperwork called for in the agreement, the signed modification form is attached to the note as an **allonge**. The terms of the modification then become part of the original note.

## Common reasons for a modification

**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.

Foreclosure prevention was one of the most common reasons for **consumer mortgage** modification during the 2000s. However, property owners and mortgage holders may agree to a mortgage modification for many reasons.

Common modifications include:

- a due date extension;
- interest rate changes;
- temporary or permanent changes in installment payment amounts or schedule;
- cash advances or accrued interest added to principal; and
- the addition of special provisions.

1 Calif. Civil Code §1698

*Editor's note — Persons offering foreclosure consultant services to* ***distressed homeowners*** *are subject to the federal Mortgage Assistance Relief Services (MARS) rule requiring special disclosures, advertising rules and fee restrictions.*

*Very broadly, the rule only applies to mortgage brokers, real estate brokers and agents, attorneys and companies who offer consumer-mortgage relief plans, programs or services as part of their business. Mortgage holders who modify mortgages to assist struggling homeowners are not subject to the rule.*[2]

## Extending the due date

Consider an owner of real estate who executes a business mortgage with a five-year due date.

Later, with the due date of the final/balloon payment approaching, the owner realizes they will be unable make the final payoff. The owner contacts the mortgage holder to negotiate a due date extension for the payoff of the mortgage.

The mortgage holder offers to extend the payoff date if the owner agrees to:

- a higher interest rate with increased monthly payments; and
- a credit check for any change in the owner's financial status since originally entering into the mortgage. [See Form 302 in Chapter 29]

## A change in the interest rates and payment terms

Consider a buyer and carryback seller who become entangled in a dispute following the close of escrow concerning the seller's **representations** of the property's condition. [See **RPI** Form 304]

The carryback seller offers to modify the mortgage, reducing the principal balance and the monthly payments to compensate the buyer for an over-valuation of the property based on undisclosed property facts. In exchange, the buyer releases the seller from any further claims concerning the condition of the property and the purchase transaction.

The buyer accepts the seller's offer to modify the mortgage and agrees to *release* the seller and *waive* the buyer's rights to any future claims. [See **RPI** Form 526]

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

Now consider an owner whose income-producing property is located on an earthquake fault. The existing business mortgage encumbering the property is a **recourse debt**.

The owner is concerned about their future liability exposure in the event an earthquake renders the property valueless. If disaster reduces the property's value below the amount owed on the mortgage and the mortgage holder forecloses judicially, the owner is personally liable for the difference, called a **deficiency.** The owner wishes to eliminate this risk of loss. [See Chapter 40]

2 12 Code of Federal Regulations §1015

**Form 425**

**Modification of the Promissory Note**

**MODIFICATION OF THE PROMISSORY NOTE**

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

**NOTE:** This form is used by a holder of a mortgage, their servicing agent or broker when a modification of the debt has been negotiated, to evidence the modification of the original note and state the change in terms of the note.

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

**FACTS:**

**1.** This is a modification of a promissory note

1.1 executed by ________________________________________, as the Payor,

1.2 in which ________________________________________, as the Payee,

1.3 dated ________________, at ________________________________________, California,

1.4 in the original amount of $________________.

**2.** The promissory note is secured by a deed of trust of the same date

2.1 executed by ________________________________________, as the Trustor,

2.2 in which ________________________________________ is the Beneficiary,

2.3 recorded on ______________________, as Instrument No. ______________________,
in the records of ________________________________ County, California.

**3.** regarding real estate referred to as ________________________________________
________________________________________________________________.

**AGREEMENT:**

**4.** The above mentioned promissory note is modified as follows: ______________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________
________________________________________________________________

**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20____
Payee's Name: ______________________________

Signature: ______________________________

Signature: ______________________________

**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20____
Payor's Name: ______________________________

Signature: ______________________________

Signature: ______________________________

**FORM 425** 03-11 

**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]

The mortgage calls for the owner to carry **earthquake insurance** which shifts the risk of loss from the owner to the insurance carrier. However, the premium for the insurance policy has become too expensive.

The owner seeks a mortgage modification with the mortgage holder, increasing the interest rate in exchange for:

- the elimination of the earthquake insurance provision; and
- a release of the owner from liability in the event circumstances beyond the owner's control impair the security, called an **exculpatory clause**.

## Adding a special provision

Now consider a seller who carries back a mortgage containing a five-year due date. By its terms, the mortgage will soon be due.

However, the seller does not want the mortgage paid off at this time since *depreciation recapture* and **capital gains taxes** will be due on the profit from the final payoff. Also, the current market interest rate is much lower than the interest rate on the carryback note.

The seller wants to negotiate an extension of the due date and include a **prepayment penalty** provision in the note, sufficient to cover any profit taxes if the buyer pays off the mortgage early. The seller will lower the interest rate — possibly below market rates — in exchange for the buyer agreeing to the extension and *prepayment penalty* provision.

**prepayment penalty**
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

*Editor's note — When the carryback mortgage in this scenario is a consumer mortgage, Regulation Z (Reg Z) rules govern the mortgage holder's ability to charge prepayment penalties. [See Chapter 8]*

## Insuring trust deed priority

Most real estate-related debts are secured by a **lien** on title to the real estate. Such *liens* typically take the form of a recorded trust deed which describes the mortgaged property and is insured by a **title company**.

Thus, the mortgage holder needs **title insurance** to be assured of the continued **priority** of their trust deed lien relative to the junior interests on title to the real estate. Any agreement to modify the mortgage needs to be conditioned on re-insuring the trust deed by obtaining:

- an additional *title insurance policy;* or
- an *endorsement* to the mortgage holder's existing policy.

A title insurance policy is obtained or endorsed for the modification of a mortgage to assure the mortgage holder that any junior trust deed liens (such as a second mortgage) will still be considered junior to the modification. The person seeking the modification generally pays the premium charged for the title insurance policy.

**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.

In turn, the title insurance company will require any junior mortgage holder to sign a *specific subordination agreement* before re-insuring the trust deed securing the modified mortgage, even when a *future subordination agreement* exists permitting the owner to later modify the senior mortgage.

## Junior lienholder is subordinated

When the modification of a senior mortgage puts a junior mortgage holder at a significantly greater risk of loss than already exists, the modified terms will not have *priority* to the pre-existing second. To avoid loss of priority on a significant modification, a junior mortgage holder needs to agree to take on the greater risk of loss, called **subordination**.

Consider the holder of a first mortgage and property owner who modify the mortgage. The modification agreement:

- shortens the due date;

- raises the interest rate; and
- increases the amount of principal balance.

Later, the holder of a second mortgage secured by the property claims the first mortgage lost its priority since the modification significantly reduced the value of the second mortgage holder's security interest in the property.

The first mortgage holder claims only the modification agreement lacks priority to the second mortgage, not the mortgage's original note and trust deed, since only the modifications have the potential to impair the secured position of the second mortgage.

Here, the *modifications* to the first mortgage do not have priority over the second mortgage and thus cannot be enforced against the second mortgage holder. However, the *original terms* of the first mortgage note retain their priority. Thus, the second mortgage remains unimpaired by the modifications made to the first trust deed note and retains its original financial and legal position. The terms of the modification are essentially a third trust deed lien.[3]

## Seller's breach of the due-on clause

Now consider a seller who carries back a second mortgage on the sale of their property. The property sold is subject to a first mortgage which contains a **due-on clause**. The holder of the first mortgage is not advised of the sale. [See Chapter 19]

> **due-on clause**
> A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

Later, the first mortgage holder learns of the sale and calls the mortgage due and immediately payable. To avoid the call, the buyer *assumes* the mortgage and modifies the note to shorten its due date.

On discovering the modifications, the carryback seller claims their second mortgage now has priority over the first since the first mortgage modification increases the risk of default, substantially impairing the seller's security interest.

In this example, the modification of the first mortgage without the junior carryback seller's consent does not result in a change in trust deed priorities. The mortgaged property was sold (and the seller accepted a second mortgage) without the first mortgage holder's written consent. Thus, the seller breached the *due-on clause* in the first mortgage holder's trust deed. Due to the breach, the first mortgage holder has no duty to avoid impairment of the owner's second trust deed lien.[4]

However, the modification of an *existing* junior mortgage does not trigger the due-on clause in senior trust deed liens on title to a property. Only the act of creating a *new security interest* — such as recording a mortgage — triggers the due-on clause.

The same rules apply to the modification of an existing lease on any type of property, with the exception of extensions beyond three years.

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3 **Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576

4 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869

## Modification to change priority

In some instances, a mortgage modification may be made to accommodate the deliberate change of lien priority.

Consider a seller who carries back a mortgage on the sale of a parcel of vacant land. Later, the buyer asks the carryback seller to *subordinate* their mortgage to a construction loan.

Subordinating their mortgage lien to a construction loan with priority inherently increases the seller's risk of loss. As a result, the **nonrecourse** carryback mortgage is automatically converted to *recourse debt*.

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

In exchange for the seller's subordination to the construction loan, the buyer agrees to:

- modify the carryback mortgage to increase the interest rate and monthly payments;
- record a **Request for Notice of Delinquency**; and
- serve a copy of the *Request for Notice of Delinquency* on the construction lender. [See Form 412 in Chapter 45]

*Editor's note — Interest rate modifications on carryback notes are not subject to usury laws.*[5]

*When a modification or replacement note restructures a carryback debt and the debt remains secured solely by the property sold, the debt remains outside the usury law interest rate limits. Also, the debt retains its original nonrecourse, anti-deficiency character since the modified or replacement note evidences a continuation of the original carryback debt.*[6] *[See Chapter 38]*

## Assumption

Mortgage modifications are also made when the mortgage is assumed by a buyer of the encumbered property. Here, the buyer arranges with a seller and the mortgage holder to take over the mortgage. Often on an assumption, a mortgage holder will seek a modification increasing their portfolio yield based on current factors such as:

- changes in market interest rates;
- the new owner's creditworthiness; or
- consideration for permitting the assumption.

Consider a buyer who is willing to cash out the seller's equity and assume the existing business mortgage which encumbers the property, called a **cash-to-loan (CTL)** transaction. The seller, however, is unwilling to remain liable for the recourse mortgage, even though the buyer agrees to assume it.

**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.

The seller's agent negotiates an arrangement agreeable to the mortgage holder, buyer and seller. The buyer assumes the existing mortgage and the mortgage holder releases the seller from further liability, a series of activities called a **novation**.

5 **DCM Partners** v. **Smith** (1991) 228 CA3d 729; CCP §580b
6 **Ghirardo** v. **Antonioli** (1994) 8 C4th 791; CCP §580b

## Modification accompanies the novation

The *novation agreement* is accompanied by a separate agreement to modify the mortgage. The modification is the *consideration* the mortgage holder demands for releasing the seller from liability for the mortgage. The modification agreement calls for:

- an increased interest rate and monthly payments; and
- an assumption fee paid to the mortgage holder.

Remember, special rules apply to assumptions of a *consumer mortgage*. An assumption triggers new consumer mortgage disclosures and adherence to the **ability-to-repay (ATR)** rules when:

- the mortgage is assumed by a buyer who will occupy the property as their principal residence;
- the mortgage holder expressly agrees to accept the buyer as the primary obligor; and
- the assumption agreement is in writing.

Thus, the assumption of an existing consumer mortgage on a property owner's principal residence is considered a new mortgage transaction whether or not its terms are modified.[7] [See Chapter 20]

## Refinancing

On a mortgage modification, the note itself is not cancelled or rewritten as it is secured by a trust deed. When a new note is executed to replace the original note, the dates of the new note and trust deed will differ, even though the debt evidenced by the new note remains the same with only a change in its terms for repayment.

Mismatched dates cause difficulty on **foreclosure** or **reconveyance** of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date."

Additionally, on a consumer mortgage, cancelling and replacing an existing note with a new note is deemed a **refinance**, even when the new terms are substantially similar to the original terms. A *refinance* requires a Reg Z mortgage holder to provide new disclosures and apply ATR rules.[8]

A few exceptions to Reg Z exist for modifications to existing consumer mortgages. When a consumer mortgage modification meets the criteria of a refinance, it is exempt from new disclosures and ATR rules if it is:

- a *renewal* of a single-payment obligation with no change in the original terms;
- a *reduction* in the annual percentage rate (APR) with a corresponding change in the payment schedule;
- an agreement involving a *court proceeding*, such as a bankruptcy or settlement;
- a *pre-foreclosure workout* agreement (unless the interest rate or principal balance is increased); or

7 12 CFR 1026.20(b); Official Interpretation of 1026.20(b)

8 12 CFR §1026.20(a)(1)

- a renewal of *optional insurance*, as long as required disclosures were provided at the original purchase of the optional insurance.[9]

However, the modifications above are only exempt from Reg Z disclosure requirements when undertaken by the mortgage holder who originated the mortgage. A refinancing by an assignee of the mortgage triggers new disclosures and application of the ATR rules, even when the refinancing falls into one of the exempt categories above.[10]

9 12 CFR §1026.20(a)(1-5)
10 12 CFR §1026.20

## Chapter 7 Summary

The modification, addition or rescission to one or more note provisions requires:

- mutual agreement between the property owner and the mortgage holder; and
- consideration given in exchange for the modification, with the exception of bankruptcy.

The modification of a note is controlled by California contract law. Thus, a note evidencing a debt is modified by a written or oral agreement. However, for an oral modification to be enforceable, both the mortgage holder and the property owner need to execute the oral agreement by taking action on it. To be certain of the terms as modified, the modification needs to be memorialized in writing.

Once the agreement to modify has been negotiated to set the new terms for payment and rates, the agent, broker or escrow officer prepares a Modification of the Promissory Note form.

The terms of the modification then become part of the original note when the signed modification form is attached to the note as an allonge.

Most real estate-related debts are secured by a lien on title to the real estate in the form of a recorded trust deed which describes the mortgaged property and is insured by a title company. Title insurance assures the mortgage holder of the continued priority of their trust deed lien relative to the junior interests on title to the real estate.

When the modification of a senior mortgage puts a junior mortgage holder at a significantly greater risk of loss than already exists, the modified terms will not have priority to the pre-existing second. To avoid loss of priority on a significant modification, a junior mortgage holder needs to agree to take on the greater risk of loss, called subordination.

In some instances, a mortgage modification may be made to accommodate the deliberate change of lien priority. Mortgage modifications are also made when the mortgage is assumed by a buyer of the encumbered property.

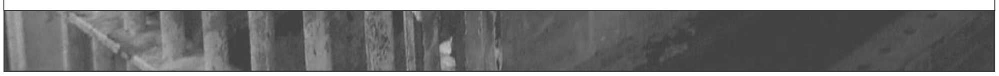
On a mortgage modification, the note itself is not cancelled or rewritten as it is secured by a trust deed. When a new note is executed to replace the original note, mismatched dates will cause difficulty on foreclosure or reconveyance of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date."

## Chapter 7 Key Terms



**Quiz 2 Covering Chapters 3-8 is located on page 620.**

# Prepayment penalties



Chapter
8

## Learning Objectives

After reading this chapter, you will be able to:

- understand how prepayment penalties were historically used by lenders to prevent their loss of interest on a mortgage;
- identify the limitation of prepayment penalties on consumer mortgage payoffs;
- determine the limited circumstances when a prepayment penalty is allowed; and
- advise on the applicability of a prepayment penalty provision in a mortgage containing a due-on clause.

## Key Terms

**average prime offer rate**
**conforming loan**
**cost basis**
**due-on clause**
**liquidated damages provision**
**lock-in clause**
**prepayment penalty**
**secondary mortgage market**

## The privilege of becoming debt-free when able

A buyer negotiating to acquire a parcel of real estate generally needs additional capital to pay the purchase price. The capital will be raised through mortgage financing.

The purchase-assist financing will be arranged by either:

- borrowing funds from a mortgage lender; or
- entering into an **installment sale** with the seller.

Either way, a **note** will be prepared and signed to evidence the debt created. [See Chapter 3]

As with any arrangement for debt, provisions in the note set out a payment schedule for the return of principal, typically through amortized reduction of the mortgage balance and final payoff.

The note's *payment schedule provision* contains an "or more" clause. The "or more" wording allows for payment of unscheduled principal reductions by the buyer – unless otherwise restricted in provisions added to the boilerplate copy of the note. [See **RPI** Form 420 §2]

The buyer may **deleverage** by voluntarily reducing principal using the "or more" wording, either periodically or in one payment. Here, the mortgage holder may not force an increase in principal reduction by a *call* so long as the buyer:

- pays no less than the scheduled payments; and
- does not trigger an incurable breach.

## Managing the premature receipt of principal

On the flip side of the buyer's use of the "or more" clause is the mortgage holder's various desires not to have the principal prepaid.

Two methods exist for meeting this objective:

- the removal of the "or more" clause from the payment schedule provision; or
- the inclusion of a **prepayment penalty provision** to recover costs and losses due to any principal reduction beyond the scheduled payments.

To strike and remove the "or more" clause from the note *locks in* the buyer to paying only the principal as scheduled. Without an "or more" clause, the buyer is barred from voluntarily prepaying any portion of the principal other than by the installments set in the note's payment schedule. As a result, the owner's inability to pay off mortgage debt becomes a restraint on their ability to sell or further encumber their property.

Thus, the mortgage holder's most practical method for managing their premature receipt of principal is to include provisions for a charge on a prepayment of extra principal. The amount of the charge is based on the amount of principal prepaid, and continues for a sufficient number of years to justify originating the mortgage. Such an arrangement is called a **prepayment penalty provision.**

**prepayment penalty**
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

However, **Regulation Z (Reg Z)** sharply curbs the use of *prepayment penalties* for **consumer mortgages**, limiting the charge amount during the first three years of the mortgage, as reviewed later in this chapter.

As for **business mortgages**, prepayment penalty and lock-in negotiations between the buyer and the mortgage holder are not controlled by *Reg Z*. Further, business mortgage originations are considered arms-length transactions arising out of relatively equal bargaining positions. Thus, prepayment provisions in business mortgages are not currently subject to legislation or regulation—just judicial review for unreasonable charges.

When preparing a note and trust deed to document a consumer or business mortgage, the prepayment penalty provision is included in the note. The provision is not included in a trust deed since a trust deed is a security device and relates to the care, maintenance and foreclosure of the mortgaged property, not the terms of the debt. [See Chapter 4]

## Debt reduction: deleveraging inhibited

The unscheduled prepayment of any mortgage principal before it is due is ironically considered a *privilege*. When an owner of a mortgaged property is able to deleverage by paying off the mortgage holder early, they typically need to pay a premium to become debt free.

When a prepayment penalty provision exists in the note, the mortgage holder is able to charge the owner on each exercise of the principal reduction privilege, whether the reduction is a portion or all of the remaining principal balance on the debt. [See Form 418-2 accompanying this chapter]

Historically, lenders and mortgage holders used prepayment penalties to prevent the loss of **interest income** until the funds were re-lent to another borrower. That is no longer the reason for a loss caused by a premature principal reduction.

## Weak repayment rationale

Over the years, California courts have embraced a number of rationales which support mortgage holder enforcement of the prepayment penalty, including:

- **Administrative costs**: The net costs and the loss of profit a mortgage holder incurs on the unscheduled reduction of principal;[1]
- **Lag time**: The loss of interest income due to money sitting idle between payoff and re-lending;[2]
- **Mortgage holder profitability**: Use of the prepayment penalty as a mortgage *portfolio yield* maintenance device;[3]
- **Mortgage holder expectations**: Disruption of a mortgage holder's commitment to a long-term placement of funds;[4] and
- **Loss due to falling market rates**: Income lost due to prepaid funds being re-lent at lower interest rates than originally bargained with the borrower.[5]

1 **Hellbaum** v. **Lytton Savings and Loan Association** (1969) 274 CA2d 456

2 **Lazzareschi Investment Company** v. **San Francisco Federal Savings and Loan Association** (1971) 22 CA3d 303

3 Lazzareschi Investment Company, *supra*

4 Lazzareschi Investment Company, *supra*

5 **Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142 (Disclosure: the legal editor of this publication was the attorney of record in this case for the borrower.)

## Economic reality

A counter-argument exists for each justification mortgage holders offer in support of prepayment penalties:

1. **Administrative costs**: Penalties allow mortgage holders to recoup costs they will incur when making new mortgages with prepaid funds *up-front*. Income such as mortgage origination fees and charges always offset costs incurred to re-lend principal to fund new mortgages.
2. **Lag time**: Cash on hand does not sit idle in today's lending institutions. Lenders used to have a saying: "Lettuce rots if it sits on the shelf." Unlike lettuce, prepaid funds are promptly re-invested in short-term securities until placed again in long-term mortgages.
3. **Mortgage holder profitability**: When mortgage holders call or modify mortgages on the transfer of the mortgaged property using the *due-on clause*, they do so only because they can re-lend the money at higher rates.

   They welcome the prepayment of fixed rate mortgages (FRMs) in markets of rising interest rates (as we will experience through 2020 and the decades beyond). Principal prepaid and re-lent during periods of rising mortgage rates increases mortgage holders' portfolio yield and maintains or increases their profitability. Thus, the prepayment penalty charge becomes bonus windfall earnings.

   It is argued mortgage holders have the right to collect prepayment penalties in a market characterized by declining interest rates. However, this argument is inapplicable when interest rates are rising, as will occur well into the 2030s. Prepayment penalty provisions are enforced on premature principal payments in both rising and falling interest rate markets, an asymmetric application of their purpose. If penalties are justified at all, it is only during periods of falling interest rates.

4. **Mortgage holder expectations**: The belief that when making long-term commitments mortgage holders can expect long-term benefits is stressed in the *Hellbaum* and *Lazzareschi Investment Company* decisions.

   When viewed against *adjustable rate mortgage (ARM)* lending objectives and the portfolio yield claims made regarding the *due-on clause* controversy, this argument fails to withstand analysis. [See Chapter 6 and Chapter 19]

   Mortgage holders expect mortgages to be paid prior to maturity. Mortgage holders consider the risk of prepayment when setting interest rates or assessing the value of a mortgage portfolio, especially for *servicing agreements*. The industry-standard long-term projection shows the average mortgage prepays by its twelfth year.

   In California in the 1990s, the average was a mere five years due to several periods of increased mortgage refinancing as rates constantly

**PREPAYMENT OF PRINCIPAL PROVISIONS**
Penalties and Discounts

**NOTE:** This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to include prepayment 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 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 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 commercial 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.

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______.

| | |
|---|---|
| Payor's name: _______________________________ | Payor's name: _______________________________ |
| Signature: __________________________________ | Signature: __________________________________ |
| Payor's name: _______________________________ | Payor's name: _______________________________ |
| Signature: __________________________________ | Signature: __________________________________ |

FORM 418-2 03-11 

Form 418-2

Prepayment of Principal Provisions

declined. That low average was seen again in the mid-2000s as home values soared and refinancing conditions converted real estate equities into proverbial ATMs.

Such turnover generates profits from mortgage origination fees, points and interest rate adjustments. It is reasonable to assume prudent mortgage holders base their annual profit projections on portfolio turnover.

Further, with the predominant **secondary mortgage market**, many mortgage lenders pool and sell their mortgages to other mortgage holders on an advantageous change in interest rates. They generally do not own mortgages with the intent of obtaining long-term income; rather, they *service* them for that income and not the occasional prepayment penalty revenue.

**secondary mortgage market**
A market where mortgages are sold by originators to bundlers who aggregate them into pools which become collateral for bonds sold to investors, called mortgage backed securities (MBS).

5. **Loss due to declining market rates**: For the declining market argument to succeed, penalties are appropriate only when market rates drop below that of the prepaid mortgage, and only when the various *front-end charges,* points accruing over the life of the mortgage and the mortgage holder's *cost of funds* at the time of the prepayment are also taken into consideration.

Thus, in all but the rarest situations — such as a catastrophic fall in long-term interest rates without an immediate corresponding decrease in the cost of funds — mortgage holders are unable to show they experience losses due to an early payoff.

## Consumer mortgages and diminishing returns

Prepayment penalties were a popular tactic mortgage holders used in the **Millennium Boom** era to lock inexperienced owners into dangerously expensive mortgages. Inadequate disclosures left many owners unaware of the potential for their interest rates and payments to increase dramatically.

When deceptively low **teaser rates** expired or **negative amortization** swelled their principal balance, owners soon found themselves trapped in mortgages they were never able to afford to begin with. Prepayment penalties only increased an owner's inability to refinance into a more reasonable arrangement. Defaults and foreclosures exploded in 2007, setting the cascade of the financial crisis in motion.

**average prime offer rate**
An annual percentage mortgage interest rate derived from average interest rates, points and other pricing terms offered by lenders on consumer mortgages which have low-risk pricing characteristics and are used to fund a higher-priced mortgage loan. These rates are published weekly by the Consumer Financial Protection Bureau (CFPB).

**conforming loan**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

In response to those abuses and the resulting toxic economic ripple effect of the 2008 Financial Crisis and ensuing Great Recession, prepayment penalties on **consumer mortgages** were re-regulated in 2010, along with enhanced disclosure requirements and other consumer protections added to an expanded **Reg Z**. [See Chapter 2]

In the renewed regulatory era, prepayment penalties on consumer mortgages are now prohibited unless the mortgage is a **qualified mortgage** meeting Reg Z's **ability-to-repay rules** (together, **ATR-QM**) and does not include the following terms:

- an *adjustable rate of interest* (an ARM); or
- an *annual percentage rate (APR)* greater than the **average prime offer rate** (published by the Consumer Financial Protection Bureau [CFPB]) for a comparable residential mortgage loan by:
  - **1.5%** on a first mortgage with a principal within **conforming loan** limits set by the Federal Home Loan Mortgage Corporation (Freddie Mac);
  - **2.5%** on a first mortgage with a principal above conforming loan limits set by Freddie Mac; and
  - **3.5%** on a second or other subordinate mortgage.

*Editor's note – As of 2024, Freddie Mac's baseline limits for conforming loans are:*

- *$766,550 for a single family residence;*

- *$981,500 for a two-unit property;*
- *$1,186,350 for a three-unit property; and*
- *$1,474,400 for a four-unit property.* [6]

Prepayment penalties are also prohibited for **Section 32 high-cost consumer mortgages**.[7] [See Chapter 2]

## Prepayment penalty on QMs

When a prepayment penalty is allowed on fixed rate consumer mortgages classified as QMs, the penalty period is limited to **three years** after origination.

Further, the amount of the prepayment penalty may not exceed:

- **3%** of the outstanding balance during the 1st year;
- **2%** of the outstanding balance during the 2nd year; and
- **1%** of the outstanding balance during the 3rd year.

A mortgage lender who intends to include a prepayment penalty provision when offering to make a qualified fixed rate consumer mortgage is also required to offer a comparable, alternative mortgage arrangement without a prepayment penalty provision.

Thus, when a prepayment penalty is involved in a consumer mortgage it will be a QM with a fixed rate. The mortgage lender or mortgage loan originator (MLO) seeking a prepayment penalty needs to offer two comparable mortgages: one with the prepayment penalty, and one without.[8]

## Enforceable penalties for business and consumer carryback mortgages

This rule also applies to all consumer carryback mortgages. If a carryback seller wishes to include a prepayment penalty provision in their consumer carryback mortgage the seller needs to comply with QM requirements, including verification of the buyer's ability to repay, caps on points and fees, maximum debt-to-income ratio and more.

Business mortgages secured by owner-occupied, one-to-four unit residential property are required to permit prepayment of 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 a 12-month period, the penalty on the excess is limited to six months' advance interest at the note rate.[9]

For business mortgages not secured by owner-occupied, one-to-four unit residential property, a prepayment penalty is enforceable if the amount is **reasonably related** to money losses actually suffered by the mortgage holder on prepayment. *Reasonably related* money losses include the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff.[10]

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6 FHFA News Release, "Loan Limit Values for 2024," 12/14/2023
7 12 CFR §§1026.43(g)(1); 1026.32(d)(6)
8 12 CFR §1026.43(g)(3)
9 Calif. Civil Code §2954.9(b)
10 **Williams** v. **Fassler** (1980) 110 CA3d 7

## Due-on clause and prepayment penalties

**due-on clause**
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

A mortgage holder may not collect a prepayment penalty on a mortgage secured by owner-occupied, one-to-four unit residential property when the mortgage holder:

- calls the mortgage due for a transfer in breach of the **due-on clause**;
- starts foreclosure to enforce a call under the *due-on clause*; or
- fails to approve an *assumption* of the mortgage during the pendency of a sale of the mortgaged property within 30 days of receipt of the qualified buyer's completed *credit application*.[11]

However, a seller carrying back a mortgage secured by a one-to-four unit residential property is only able to **bar prepayment** for the calendar year of the sale when they have not already carried back four or more such mortgages in the same calendar year.[12] [See Chapter 2]

If the holder of a mortgage on one-to-four residential units intends to collect a prepayment penalty on a call triggered by a due-on clause, the owner needs to have agreed in a prepayment penalty provision that they waive their right to prepay without a penalty.[13] [See Chapter 24 and Chapter 25]

## Prepayment penalty due on a call

Consider a prepayment penalty clause in a mortgage that calls for a penalty payment on the **voluntary** or **involuntary** prepayment of the debt.

The property owner defaults on the mortgage. The mortgage holder records a **Notice of Default (NOD)**, automatically calling the debt due. The owner tenders full payment of the debt excluding the prepayment penalty, which the mortgage holder refuses. [See Chapter 42]

The property owner claims the prepayment penalty clause is only enforceable when the property owner voluntarily prepays the debt, not when the mortgage holder calls the debt due.

Is the prepayment penalty clause enforceable on a full payoff when the mortgage holder calls the debt due?

Yes! The clause permits the mortgage holder to demand a prepayment penalty on an *involuntary prepayment* resulting from the mortgage holder's **acceleration** of the balance due on the debt.[14]

## Voluntary or involuntary payoff

Further, consider a property in foreclosure. The mortgage holder records a **Notice of Trustee's Sale (NOTS)** which states the amount to pay off the loan includes:

- unpaid principal balance;
- accrued and unpaid interest;
- late charges;

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11 12 CFR §591.5(b)(2), (3)
12 CC §2954.9(a)(3)
13 CC §2954.10
14 **Biancalana** v. **Fleming** (1996) 45 CA4th 698

- foreclosure costs (including attorney and trustee's fees); plus
- a prepayment penalty.

At the trustee's sale, is the mortgage holder able to demand and collect a prepayment penalty charge?

Yes! The mortgage holder's right to collect a prepayment penalty is set by the provisions of the note, unless prohibited. Since the note provides for a prepayment charge when the loan is either **voluntarily or involuntarily** prepaid, the mortgage holder's **full credit bid** at the trustee's sale may include the prepayment penalty charge.[15]

Conversely, when the mortgage limits a prepayment penalty to only **voluntary payoffs**, the mortgage holder is not permitted to include the penalty when the property is redeemed or bid on at the trustee's sale.[16]

## Tax advantages for the carryback seller

Consider a seller of real estate who is willing to carry back a mortgage for the portion of the purchase price remaining after a 20% down payment and the buyer's takeover of the seller's existing mortgage. The seller financing is classified as a business mortgage since the property sold is not a one-to-four unit residence or, if it is, will not be occupied by the buyer's family or serve as the buyer's vacation home.

The seller is aware the profit on the carryback note will not be taxed until principal is received or they *assign* it in a sale of the note or as collateral for other debt.

The seller's remaining **cost basis** for the property is less than the balance of the mortgage on the property. Thus, the entire amount of the carryback note will be profit, subject to taxes as principal is paid, due to the seller's **mortgage-over-basis** situation. [See Chapter 51]

**cost basis**
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

If the seller receives all cash, and thus is taxed on all profit in the year of the sale, they will pay a combination of federal and California state income tax on the profit depending on the seller's income bracket. [See Chapter 51 and Chapter 52]

If deposited in an interest-bearing account, the balance of the sale proceeds remaining after the payment of taxes will produce interest earnings on less than 66% of the net sales proceeds for the highest income bracket (the other 33% being disbursed to pay taxes).

However, with taxes deferred in an installment sale, the seller will earn interest at the carryback **note rate** on the full amount of the equity remaining unpaid after the down payment. Profit tax on the amount of "mortgage over basis" debt relief will need to be paid, unless covered by the seller carrying back an *all-inclusive trust deed (AITD)*. [See Chapter 30]

15 **Golden Forest Properties, Inc.** v. **Columbia Savings and Loan Association** (1988) 202 CA3d 193

16 **Tan** v. **California Federal Savings and Loan Association.** (1983) 140 CA3d 800 (Disclosure: the legal editor of this publication was the attorney of record in this case for the borrower.)

Thus, the seller is motivated to **defer taxes** on their profit until the carryback note is due. Meanwhile, the seller earns interest on the amount of the deferred profit tax they retain as principal in the carryback note.

## A carryback seller's compensation for an early payoff

Two alternatives exist for the carryback seller of a business mortgage to earn interest income on the portion of the sales price which will eventually be paid in profit taxes:

- *lock* the buyer into payments of no more than the scheduled installments by eliminating the "or more" provision in the note and to prevent early payoff of additional principal [See **RPI** Form 420 §2]; or
- include provisions for a prepayment penalty to be due on the payoff of any principal exceeding scheduled installments.

**lock-in clause**
A promissory note provision limiting repayment to no more than the regularly scheduled installment amount, in contrast to an "or more" clause.

Consider a seller carrying back a business mortgage who selects the prepayment penalty alternative after their broker voices concern over the enforceability of a **lock-in clause**. Deletion of the "or more" clause prohibits principal reductions except under regular monthly payments and the *final/balloon payment*. [See Chapter 9]

The seller wants to include a prepayment penalty of 25% to cover most of the taxes incurred on payoff.

For the carryback business mortgage, a *reasonableness standard* applies to any prepayment penalty. If the carryback business mortgage is secured by an owner-occupied, one-to-four unit residential property, any prepayment penalty is limited to six months' advance interest on prepaid principal exceeding 20% of the original balance per calendar year.

Is the carryback business mortgage holder able to enforce a prepayment penalty in the amount of the estimated tax they will pay on their profit if the buyer prematurely pays additional principal?

Yes! A prepayment penalty on a carryback business mortgage is enforceable if the penalty amount is reasonably related to the seller's **anticipated money losses** in the form of profit taxes on prepaid principal. Since the anticipated profit tax rate for an unscheduled principal reduction is 33% in the highest income bracket, a penalty in that or a lesser amount when principal is prepaid is reasonable.[17]

QM prepayment penalties are limited to:

- 2% in the first two years following origination;
- 1% in the third year; and
- 0% thereafter.[18]

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17 **Williams** v. **Fassler** (1980) 110 CA3d 7

18 12 CFR §1026.43(g)(2)

## Reasonableness of the penalty

The reasonableness of the carryback seller's penalty amount is tested at the time the mortgage is entered into, not at the time of payoff. In the intervening years, interest and tax rates will likely go through major fluctuations, either up or down.[19]

Although a prepayment penalty inhibits conveyancing and reconveyancing, it is considered a reasonable **restraint on alienation** and the owner's use of the property's title.[20]

An *exorbitant* or *unconscionable* penalty is unreasonable and thus unenforceable.[21]

## Prepayment penalty triggered by late payments

Now consider the holder of a business mortgage encumbering real estate other than an owner-occupied, one-to-four unit residential property. The note contains a prepayment penalty provision calling for payment of six months unearned interest on any principal prepaid within six months after origination.

Further, the prepayment penalty is due on a principal prepayment after the first six-month period if any previous regularly scheduled payment was delinquent. The owner makes a regular payment after the **grace period** for its payment expired, resulting in a delinquency. [See Chapter 10]

After the initial six months and before the final/balloon payment is due, the owner prepays the principal together with the prepayment penalty demanded by the mortgage holder. The owner later makes a demand on the mortgage holder for a return of the penalty payment, which the holder rejects.

The owner claims the prepayment penalty is an unenforceable **liquidated damages** penalty since it was triggered by a late payment of a regular installment, not an early payoff of the mortgage, and thus was unrelated to losses the mortgage holder incurred on prepayment of principal.

**liquidated damages provision**
A provision stating the maximum money losses a buyer owes a seller in the event the seller incurs losses on a buyer's breach.

Is the business mortgage holder permitted to enforce a prepayment penalty on a final payoff which was triggered by a prior late payment of a monthly installment?

No! The prepayment provision here is structured to trigger payment of a penalty for having paid a regular installment late, not an early payoff of principal. Thus, the purported prepayment provision becomes an unenforceable *liquidated damages* provision since the charge bore no relation to the mortgage holder's losses due to the prior late payment.[22]

19 Williams, *supra*

20 Sacramento Savings and Loan Association, *supra*

21 Hellbaum, *supra*

22 **Ridgley** v. **Topa Thrift and Loan Association** (1998) 17 C4th 970

## Chapter 8 Summary

The unscheduled prepayment of any mortgage principal before it is due is ironically considered a privilege. When an owner of a mortgaged property is able to deleverage by paying off the mortgage holder, they generally are required to pay a premium to become debt free.

A mortgage holder's most practical method for managing their premature receipt of principal is to include provisions for a charge on a prepayment of extra principal. The amount of the charge is based on the amount of principal prepaid, and continues for a sufficient number of years to justify originating the mortgage.

Regulation Z (Reg Z) sharply curbs the use of prepayment penalties for consumer mortgages, limiting the charge amount during the first three years of the mortgage.

As for business mortgages, prepayment provisions are not currently subject to legislation or regulation—just judicial review for unreasonable charges.

Prepayment penalties on consumer mortgages are prohibited, unless the mortgage is a qualified mortgage meeting the Reg Z ability-to-repay rules (together, ATR-QM) and does not include:

- an adjustable rate of interest (an ARM); or
- an annual percentage rate (APR) greater than the average prime offer rate (published by the CFPB) for a comparable residential mortgage loan by a percentage threshold.

QM prepayment penalties are limited to:

- 2% in the first two years following origination;
- 1% in the third year; and
- 0% thereafter.

Prepayment penalties are also prohibited for Section 32 high-cost consumer mortgages.

Thus, when a prepayment penalty is involved in a consumer mortgage it will be a QM with a fixed rate. The mortgage lender or mortgage loan originator (MLO) seeking a prepayment penalty will offer two comparable mortgages: one with the prepayment penalty, and one without.

If a carryback seller wishes to include a prepayment penalty provision in their consumer carryback mortgage, the seller needs to comply with QM requirements.

Business mortgages secured by owner-occupied, one-to-four unit residential property are required to permit prepayment of up to 20% of the original principal balance in any 12-month period without penalty, and the penalty on prepayment in excess of 20% is limited to six months' advance interest at the note rate. For business mortgages not secured by owner-occupied one-to-four unit residential property, a prepayment penalty is enforceable if the amount is reasonably related to money losses actually suffered by the mortgage holder on prepayment.

Prepayment penalty provisions in all mortgages containing a due-on clause secured by owner-occupied, one-to-four unit residential property are unenforceable if the mortgage holder:

- calls the mortgage due for a breach of the due-on clause;
- starts foreclosure to enforce a call under the due-on clause; or
- fails to approve an assumption of the mortgage property within 30 days of receipt of the qualified buyer's completed credit application.

A prepayment penalty on a carryback business mortgage is enforceable if the penalty amount is reasonably related to the seller's anticipated money losses in the form of profit taxes on prepaid principal. If the carryback business mortgage is secured by an owner-occupied, one-to-four unit residential property, any prepayment penalty is limited to six months' advance interest on prepaid principal exceeding 20% of the original balance.

## Chapter 8 Key Terms



**Quiz 2 Covering Chapters 3-8 is located on page 620.**

*Notes:*

# Chapter 9

# Mortgage lock-in clauses

## Learning Objectives

After reading this chapter, you will be able to:

- identify how lock-in clauses are addressed differently by contract law and real estate law; and
- determine when mortgage lock-in clauses are unenforceable.

## Key Terms

| | |
|---|---|
| **lock-in clause** | **real rate of return** |
| **prepayment penalty** | **restraint on alienation** |

## Restraints on rights of alienation

A builder obtains a long-term permanent mortgage from a lender. The mortgage is called a **takeout loan** since it funds the payoff of a construction or bridge loan. The builder's mortgage finances a business purpose — the continued ownership of nonresidential or residential income producing real estate. The *takeout loan* is evidenced by a note and is secured by a trust deed on the property, collectively called a **mortgage**, or more specifically, a **business mortgage** in this case.

The note contains a **lock-in clause** prohibiting prepayment of the debt for the initial seven years after origination. The note also contains a **prepayment penalty** which applies to any principal paid off during or after the seven-year lock-in period other than through regular amortization by scheduled payments.

**lock-in clause**
A promissory note provision limiting repayment to no more than the regularly scheduled installment amount, in contrast to an "or more" clause.

During the seven-year *lock-in* period, interest rates drop significantly. Wanting to take advantage of the lower market rates to refinance the property, the builder requests a payoff demand from the lender and a reconveyance of the mortgage lien.

However, the lender refuses to allow a payoff and reconveyance. The lender claims the builder is locked in for the first seven years of the mortgage. This contract *bars prepayment and reconveyance* at any time during the lock-in period.

**prepayment penalty**
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

The builder claims the lock-in clause and the prepayment penalty are in conflict with one another. Thus, the builder believes they are able to pay off the mortgage, as long as they pay the prepayment penalty called for *on a default* during the lock-in period.

Is the builder prohibited from prepaying the mortgage evidenced by a note containing a lock-in clause?

Yes, by the application of contract law theories. Here, the builder agreed to be locked into the mortgage for the seven year period agreed to in the note. The provision prohibiting prepayment and the duration of the prohibition was part of the mortgage documents. Thus, the builder was fully aware of the provision barring prepayment when they entered in the mortgage transaction, and are bound by its terms.[1]

## Enter real estate law for the greater good

A real estate matter of public concern exists in the above *Trident Center* fact situation which was not addressed. The lock-in provision contained in the mortgage documents completely restricts an owner's ability to *freely reconvey and reencumber* their interest in a parcel of real estate.

**restraint on alienation**
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

When applying real estate law, a lock-in clause becomes viewed as a **restraint on alienation**. It prohibits prepayment of debt and reconveyance of the mortgage lien from title. This is an absolute interference with the right to clear the builder's title and transfer a security interest in real estate to another lender. Here, use of an ownership right commercially marketed is barred.

When a provision which functions as a *restraint on alienation* is unnecessary to protect the lienholder's security interest in the property against the risk of loss, it is unreasonable and unenforceable under real estate law. Here, a payoff eliminates any risk of loss of principal and any need for the lender to protect its security interest in the property.[2]

Also, an owner's right to a reconveyance can be significantly *inhibited* by the financial impact of a prepayment penalty. However, the monetary penalty for prepayment is not considered in real estate law to be an unreasonable restraint. Under a prepayment penalty, the owner has the ability to obtain a reconveyance and clear title of the lender's security interest in the property, albeit at a high cost in terms of money expended.

A prepayment penalty does not bar the reconveyance which clears title of the lender's security interest. It only makes an owner's payoff more difficult financially.

1 **Trident Center** v. **Connecticut General Life Insurance Company** (9th Cir. 1988) 847 F2d 564

2 Calif. Civil Code §711

## The lock-in clause and prepayment penalty distinguished

Unlike a lock-in clause, the monetary *prepayment penalty*, though an economic constraint, still allows for the *voluntary use* of the property by the owner. This is true whether the owner intends to further encumber the property or sell it.[3]

Conversely, the lock-in clause absolutely bars the owner from obtaining a reconveyance to clear their title and re-encumber or sell the property. Thus, the lock-in clause is void under real estate law since the lender experiences no risk of loss on a payoff, by either impairment or default. Lenders claim that without the lock-in provision they lose the expectation of the interest to be earned on the note, but this expectation is covered by a prepayment penalty. [See Chapter 8]

Some judicial decisions, such as those in the above *Trident Center* case, have attempted to resolve restraints on alienation based solely on *general theories* of contract law. The historic judicial preference applies more *specific rules*, not an underlying general rule, to control interference with an owner's interest in real estate.

## Public policy breach

*Trident Center* rests solely on the *contract doctrine* that a restraint on alienation provision is valid only if it is *willingly* entered into between an owner and a lender *of relatively equal and sophisticated bargaining power*.

However, *real estate law*, which is the foundation for marketable real estate rights, prohibits unreasonable restraints on alienation. Unreasonable restraints on alienation are prohibited no matter how they are contracted, or how aggressively the lender bargains to achieve an agreement from the borrower or owner consenting to the restraint.

The lock-in, as a contractual provision, attempts to trample ancient public policy, which demands property titles remain:

- unfettered; and
- available to the real estate marketplace.

The prohibition of restraints on transfers of real estate interests gives property owners the right to voluntarily use or convey the many ownership rights and interests they hold in their real estate. These rights are subject to lender interference only when it is necessary for the lender to protect itself from an increased risk of loss and interference by third parties holding involuntary liens, such as the Internal Revenue Service (IRS).[4]

The owner's right to use their ownership interests is historically ingrained and long-standing. This public policy principle prevails in spite of contractual provisions to the contrary. Court decisions imposing contract law theories to override the pre-existing statutory rights of owners to alienate real estate interferes with owners' right to *freely transfer* encumbered property in the real estate marketplace.

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3 **Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142

4 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423

## Contract law vs. real estate law

Consider a seller who carries back a note secured by a trust deed on the sale of their income-producing property.

A boilerplate provision in the mortgage allows for prepayment of the mortgage, subject to a prepayment penalty.

Further, the mortgage includes an additional typewritten provision which states the buyer is locked in to making monthly installments, and is prohibited from prepaying the mortgage prior to its due date. Also, the clause allowing prepayment remains unstricken from the boilerplate provisions in the mortgage.

Thus, the carryback mortgage includes *conflicting provisions*:

- two in the printed form which prohibited prepayment and a reconveyance of the property; and
- one added to the printed note form which permitted prepayment and reconveyance without penalty.

The buyer, after making payments on the mortgage, attempts to pay off the mortgage prior to its due date.

The seller claims the addition of the typewritten lock-in clause prohibits prepayment since the buyer agreed to the provision, which has authority over conflicting preprinted provisions.

The buyer claims the lock-in clause is unenforceable since the boilerplate provisions in the mortgage express inconsistent activities, allowing prepayment and reconveyance limited only to the payment of a monetary penalty.

Can the buyer be completely prohibited from prepaying the mortgage, even though the boilerplate provision in the mortgage's note provides for prepayment?

Yes! Under contract law, the buyer can be prohibited from prepaying the mortgage.

When preprinted boilerplate provisions and additionally entered provisions in a set of documents are in conflict, the *added provisions control*. Thus, even if a provision allowing prepayment is located in the boilerplate provisions of a mortgage, the additionally entered lock-in clause, which is in conflict, controls under contract law.[5]

## Restraints vs. the need to protect

However, continuing our previous example, under the specific *real estate law*, any lock-in provision prohibiting the release of real estate interests is a *restraint on alienation*.

5 **Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636; CC §1651

The above *Gutzi* case agreed, but held the restraint was *reasonable* since the property owner failed to demonstrate the unreasonableness of the interference. The owner did not request a payoff demand from the lender and no interference actually occurred.

The lender is to weigh two factors in restraint of alienation challenges:

- the *quantum of restraint* on the sale or refinance of real estate necessary for the provisions in a mortgage to be rendered unenforceable under real estate law; and
- the lender's need to protect its investment from a legitimate risk of loss.

A contracted for lock-in clause becomes an unreasonable restraint on alienation if it causes transferable real estate rights to be unavailable to the marketplace under any present circumstance.[6]

A lock-in clause directly and absolutely bars the owner's ability to reconvey a lender's security interest while:

- concurrently encumbering the property by recording a mortgage to another lender with the same priority on title; or
- transferring the property to a cash buyer.

The lock-in clause is an unenforceable provision when:

- it imposes a restraint on an owner's right to reconvey and release liens of record, and;
- the cost of the restraint imposed by the clause is greater than that experienced by the lender due to an early payoff.

## Enforceable vs. unenforceable restraints

Prepayment of mortgages is allowed by statutes, regardless of provisions in a mortgage prohibiting early payoff, under each of the following situations:

- the mortgage is secured by one-to-four, owner-occupied residential units;[7]
- the mortgage has a variable interest rate and, on notification of a change in the rate, the borrower may prepay it within 90 days;[8]
- the debt is a land sales contract which provides for land to be subdivided into lots of four-or-less residential units;[9]
- the prepayment penalty clause is not sufficiently specific to allow enforcement;[10]
- the property subject to a mortgage is acquired for public use;[11]
- the mortgage holder calls the mortgage due for a transfer in breach of the due-on clause;[12]

6 **Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488

7 CC §2954.9(a)

8 CC §1916.5(a)(5)

9 CC §2985.6(a)

10 **Donahue** v. **LeVesque** (1985) 169 CA3d 620

11 Calif. Code of Civil Procedure §1265.240

12 12 Code of Federal Regulations §591.5(b)(2)

- the mortgage holder starts foreclosure to enforce a call under the due-on clause;[13] or
- the mortgage holder fails to approve an assumption of the mortgage during the pendency of a sale of the mortgaged property within 30 days of receipt of the qualified buyer's completed *credit application*. [See Chapter 8][14]

However, if the lender or carryback seller on a mortgage secured by a one-to-four unit residential property is a Regulation Z (Reg Z) consumer mortgage holder, the ability to charge a prepayment penalty is restricted to those consumer mortgages meeting the **qualified mortgage (QM)** criteria.[15] [See Chapter 2]

Conversely, a lock-in clause is enforceable in two limited **carryback situations** when necessary to assure installment sales profit tax treatment. These carryback situations are:

1. The buyer of up to four residential units *per calendar* year can only be locked into the mortgage and barred from prepayment during the calendar year of the carryback sale. After the lock-in period expires, the buyer has the right to pay off the mortgage at any time, subject to the prepayment penalty agreed to and as limited by law.[16] [See Chapter 8]

2. The lock-in clause is enforceable on the prepayment of a seller carryback documented as a *land sales contract* on four-or-fewer residential units. This can be prohibited for up to a 12-month period following the sale.[17]

## Carrybacks and lock-ins

A carryback seller's primary motivation for locking in the buyer is their desire to prevent the seller's premature payment of profit taxes which would be due on an early payoff of the note.

Carryback sellers *reporting profits* on installment sales limit their taxable profit in any one year to the pro rata share (contract ratio) of profit in the principal paid on the note. Similar to a traditional mortgage provided by a lender, the installments received each year on a carryback note typically include only a small amount of principal, with a majority of the payment going to interest. Thus, use of a lock-in clause bars early payoff of principal, one method for allowing the seller to take economic advantage of the tax deferral in *installment sales reporting*.[18]

## Lenders and lock-ins

For lenders, a lock-in clause is a portfolio tool to assure a consistent, long-term yield on a mortgage, regardless of actual market rate fluctuations during the life of the mortgage.

13 12 CFR §591.5(b)(2)
14 12 CFR §591.5(b)(3)
15 12 CFR §1026.43(g)(2)
16 CC §2954.9(a)(3)
17 CC §2985.6(a)
18 26 United States Code §453

*Editor's note — Lock-in clauses worked to the lender's advantage during the half cycle of declining interest rates from 1980 to 2012. However, the rising interest rates to be experienced during the coming 30-year half cycle in interest rates will work to the advantage of owners, not lenders. Under a lock-in clause, the fixed-rate mortgage (FRM) rate will remain level even as interest rates increase.*

Locking in the borrower to prevent early payoff of mortgages made during periods of high interest rates is the lender's long-term motive when interest rates will drop. Inevitable cyclical inflation is broken by the Federal Reserve's (the Fed's) monetary policy. As mortgage rates decline, the **real rate of return** to the lender, and thus real earnings, increases on the old FRM.

**real rate of return**
The nominal interest rate on a mortgage minus the rate of inflation.

The reverse will occur over the next few decades of steadily rising interest rates and favor owners.

As inflation abates, the lock-in clause protects the lender's now excessive *real rate* of return, an economic distortion delivering a *windfall profit* to the lender due solely to Fed monetary policy moves. The profit in the lender's portfolio yield is the spread between the rate of inflation (its cost of funds) and the underlying mortgage rate.

As an exaction to enforce a right to protect a mortgage from loss, interference for the purpose of increasing a lender's portfolio yield has been denounced in California as beyond the legitimate purpose of a mortgage lien on real estate.[19]

19 **Wellenkamp** v. **Bank of America** (1978) 21 C3d 943

## Chapter 9 Summary

When applying real estate law, a lock-in clause becomes an unenforceable restraint on alienation. It prohibits prepayment of debt and reconveyance of the mortgage lien from title. This is an absolute interference with the right to clear the owner's title and transfer a security interest in real estate to another.

This right is subject to lender interference only when it is necessary for the lender to protect itself from an increased risk of loss and interference by third parties holding involuntary liens, such as the Internal Revenue Service (IRS).

Court decisions imposing contract law theories to override the pre-existing statutory rights of owners to alienate real estate now jeopardize the property owners' right to freely transfer encumbered property in the real estate marketplace.

## Chapter 9 Key Terms



**Quiz 3 Covering Chapters 9-12 is located on page 621.**

# Chapter 10

# Late charges and grace periods

## Learning Objectives

After reading this chapter, you will be able to:

- determine the provisions and conduct needed to establish a mortgage holder's right to collect a late charge;
- distinguish between allowable late charges on consumer mortgages versus business mortgages;
- differentiate late charge arrangements based on the type of property mortgaged, and whether the mortgage was arranged by a broker; and
- understand how late charges are calculated and enforced.

## Key Terms

| | |
|---|---|
| **balloon payment** | **impound account** |
| **default rate provision** | **late charge provision** |
| **grace period** | **material breach** |
| **high-cost consumer mortgage (Section 32 mortgage)** | **pyramiding** |

## Elements for a delinquency

Promissory notes typically contain a **late charge provision**. The *late charge provision* calls for an additional charge if payment is not received by the mortgage holder when due or within a **grace period** after which the payment is delinquent.

**late charge provision**
A provision in a promissory note which calls for an additional charge if payments are not received when due or during a grace period.

To establish the right to collect a late charge, the following conditions need to exist:

- a *late charge provision* is contained in the note [See Form 418-1 accompanying this chapter];

- a scheduled payment is *delinquent*;
- a *notice of amounts due* is delivered by the mortgage holder assessing the late charge and requesting its payment, if the delinquency is the first; and, for a subsequent delinquency, notice is given or *accounting requirements* for semi-annual and annual reports have been met; and
- the *dollar amount* of the late charge is within the limits set by statutes or **reasonableness standards**.

**material breach**
Failure to perform significant obligations called for in an agreement, such as a promissory note.

An owner's failure to pay a late charge when demanded is not a **material breach** of the note and trust deed. As a *non-material breach*, the failure to pay a late charge alone is not grounds for the mortgage holder's initiation of foreclosure by recording a *notice of default (NOD).* [See Chapter 42]

## The negotiation of a late charge provision

Late charge provisions included in notes used by **institutional lenders** are generally non-negotiable. This non-negotiable status is due primarily to adherence to established uniformities, such as ceilings set by statute or *pooling arrangements* in the secondary mortgage market. All too often, retaliation becomes the basis for setting the charge. When excessive, it becomes windfall earnings for the mortgage holder.

However, late charge provisions in **private money** or **carryback transactions** are not automatic or boilerplate. Instead, late charges are left to negotiations between the participants in the transaction and judicial oversight.

A late charge provision in a mortgage needs to be *agreed to* by inclusion in the note. When a late charge on a seller carryback debt is agreed to in a purchase agreement, escrow is instructed to include a late charge provision in the note they prepare. [See **RPI** Form 150 §8.1; see Chapter 4]

## The complete late charge provision and amount

A complete **late charge provision** includes:

- the *amount* of the late charge;
- the *duration of any grace period* following the due date before a payment is considered delinquent; and
- a *requirement for notice* from the mortgage holder to impose the late charge and demand its payment on a delinquency. [See Form 418-1]

**grace period**
The time period for the mortgage holder's receipt of a payment following its due date after which the missed payment is delinquent and subject to a late charge. [See **RPI** Form 550 §4.3 and 552 §4.7]

To be enforceable, a late charge amount imposed for a delinquent payment on a debt secured by real estate must be **reasonably related** to money losses incurred by the mortgage holder due to the delinquency. The charge may not be punitive in amount, as in an effort to coerce timely payment.[1] [See Form 418-1 §2.1]

While late charge provisions are triggered by the delinquency of a payment, the agreed-to charge is not automatically due. Unless the **first delinquency** is immediately preceded or followed by a notice imposing the charge and demanding its payment, the charge is **waived**.

1 Calif. Civil Code §1671

For all following delinquencies, lack of notice and demand does not automatically waive the late charge. Instead, after the first notice and demand, the mortgage holder has the option to either:

- provide the notice and demand payment of the late charge; or
- assess the charge automatically, and account for assessed late charges semi-annually.[2]

Special periodic accounting rules apply to consumer mortgages, which are discussed later.

## Collectable losses

Reasonable **monetary losses** collectible as a late charge include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the lost use of the *principal and interest (PI)* portion of the delinquent payment until paid.

*Money losses* incurred in a reasonable effort to collect a late payment include the cost of:

- forms;
- envelopes and postage for mailing the notice; and
- the administrative time spent by individuals in the collection effort prior to recording an NOD.

A late charge provision constitutes a **penalty amount** when the charge is excessive and not reasonably related to the money losses incurred by the mortgage holder. Here, the borrower is still liable for the mortgage holder's out-of-pocket money losses resulting from the delinquency, if assessed and payment demanded—but is not liable for any amount beyond that which is deemed excessive.[3]

When a scheduled payment is not received prior to becoming delinquent, a late charge provision calls for either or both:

- an additional one-time fixed fee stated as a dollar amount; or
- the accrual of interest on the amount of the delinquent PI payment from the due date until the date payment is received. [See Form 418-1]

## Late charge notice

To collect a late charge for the *first* delinquent payment on a mortgage encumbering any type of real estate, the mortgage holder needs to first notify the owner in a **timely manner** of the charge and *make a demand* for its payment.

2 CC §2954.5

3 **Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731

Form 418-1

Late Payment Provisions

**LATE PAYMENT PROVISIONS**
Addendum to Promissory Note

**NOTE:** This form is used by a loan broker or escrow officer when originating a mortgage with a lender or carryback seller, to include a late payment provision 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 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.

| | |
|---|---|
| Payor's name: ________________________________ | Payor's name: ________________________________ |
| Signature: ___________________________________ | Signature: ___________________________________ |
| Payor's name: ________________________________ | Payor's name: ________________________________ |
| Signature: ___________________________________ | Signature: ___________________________________ |

**FORM 418-1** 03-11 

Mortgage holders give notice and make a demand for the late charge by providing the borrower either:

- a *billing statement* or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or
- a *written statement* or notice of the late charge amount sent concurrent with or within ten days of mailing a notice to cure a delinquency.[4]

4 CC §2954.5(a)

The notice of amounts due or the billing statement addressing the first late charge needs to include either:

- the exact amount of the late charge; or
- the formula used to calculate the charge.[5]

If the mortgage holder fails to initiate collection of the *first late charge* by a demand for its payment, the mortgage holder **waives** its right to collect a late charge on that individual payment. However, failure to give notice and demand a late charge on a particular delinquency does not waive the mortgage holder's right to enforce the late charge provision and collect a fee on future delinquencies.[6]

For all subsequent delinquent payments, after the first notice and demand for a late charge, the mortgage holder is not compelled to notice and demand the late charge to enforce the late charge provision. Instead, it has the option to provide notice and demand payment, or to provide at least a semi-annual accounting of the total amount of late charges assessed during the accounting period.[7]

Further, overriding **consumer mortgage** rules for late charges and grace periods which provide greater consumer protection apply. These additional rules, which illustrate the federal preemption of less stringent state law, are discussed below.

## Late charges on high-cost consumer mortgages

Late charge limits are unique for **high-cost consumer mortgages (Section 32 mortgages).** Section 32 mortgages are:

- first trust deed consumer mortgages;
- secured by the owner's principal residence; with
- an original principal balance exceeding $50,000; and
- an annual percentage rate (APR) exceeding the average *prime offer rate* for comparable mortgages by 6.5% or more.

To be enforceable, *Section 32 mortgage* late charges are:

- *specifically agreed* to in the note;
- not incurred if payment is received within a 15 day grace period after the due date;[8]
- limited to *4%* of the amount of the delinquent principal and interest payment; and
- imposed *once* for any single delinquent payment that remains unpaid.[9]

**high-cost consumer mortgage (Section 32 mortgage)**
A class of Regulation Z (Reg Z) consumer mortgage characterized by an annual percentage rate (APR) charge which exceeds the average prime offer rate for a comparable mortgage by various percentage spreads set by the mortgage's priority on title and principal balance, and subject to consumer protection rules.

5 CC §2954.5(a)
6 CC §2954.5(e)
7 CC §2954(b)
8 12 CFR §1026.34(a)(8)(ii),(iii)
9 12 CFR §1026.34(a)(8)(i)

Further, holders of consumer mortgages on the owner's principal residence, including Section 32 mortgages, may not charge a late fee for the owner's failure to pay a previously demanded late fee, a practice known as **pyramiding**.[10] [See Chapter 10]

## Grace period and late charge controls

**pyramiding**
The practice of assessing a late charge for the delinquent payment of a previously assessed late charge.

On consumer mortgages other than high-cost Section 32 mortgages, Regulation Z (Reg Z) does not control late charges. However, state law does control the amount of a late charge. Several specific rules apply to different mortgage situations.

The late charge on any mortgage (consumer or business) secured by an owner-occupied single family residence (SFR) is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5.[11] [See Form 418-1 §2.1]

Also, the **minimum grace period** before a mortgage encumbering a one-to-four unit, owner-occupied residential property is delinquent is *ten days* after the due date without receipt of the payment—even if the borrower agrees to a shorter grace period or no agreed-to grace period is stated.[12]

Consider a lender who originates a purchase-assist mortgage encumbering residential real estate the buyer acquires as their principal residence. The mortgage calls for monthly installments of **principal and accrued interest (PI)** to be paid on the first day of each month. The mortgage is not made or arranged by a broker.

The note contains a **late charge provision** allowing:

- a ten-day grace period after the due date for each monthly payment before it is delinquent; and
- a late charge of 6% of the delinquent PI installment on written notice and demand for its payment. [See Form 418-1 §2.1]

A monthly payment is not received by the mortgage holder on the eleventh day of the month.

The lender sends the buyer a *written notice* of amounts due and demands payment of the delinquent installment and the agreed-to 6% late charge.

The buyer makes the delinquent payment but refuses to pay the late charge.

Is the lender's demand for the late charge enforceable?

Yes! The installment was not received by the expiration of the ten day grace period following the due date of the installment. Thus, the payment is *delinquent* and a late charge is collectible on notice and demand.

10 12 CFR §1026.36(c)(2)
11 CC §2954.4(a), (e)
12 CC §2954.4(a), (b)

## Mailed monthly payment

What if a late mortgage payment is post-marked within the grace period but is physically received by the mortgage holder after the grace period expires?

Mailing the installment within the grace period does not qualify the payment as *timely paid*.

The payment needs to be **actually received** by the mortgage holder or servicing agent no later than the last day of the grace period.[13]

The mortgage holder and buyer may negotiate for the buyer to tender payment by a particular method, such as by mail. When mail is agreed as the method for transmission of payment, the payment is considered received when the owner complies with the method of payment, such as placing the payment in the mail — even if the mortgage holder never receives it.[14]

## Late charge for a mortgage made or arranged by a broker

When a licensed real estate broker makes or arranges a mortgage, the owner-occupied SFR late charge limitation of 6% does not apply. Further, reasonableness standards do not apply either. Instead, statutes control.[15]

For all mortgages secured by **any type of real estate** which are made or arranged by a **real estate broker —** other than Section 32 mortgages—the maximum late charge permitted on delinquent monthly payments is the greater of:

- 10% of the delinquent principal and interest payment; or
- $5.[16] [See Form 418-1 §2.2]

Consider a borrower who enters into a consumer purposes mortgage arranged by a broker. The security for the consumer mortgage is a one-to-four unit residential property, which is the borrower's principal residence. Additionally, the mortgage exceeds $50,000 and has an interest rate in excess of the average prime offer rate by more than 6.5%.

In this situation, late charge provisions are governed by Section 32 of Reg Z since the debt meets the criteria for a **Section 32 high-cost consumer mortgage**.

Thus, the maximum late charge on a delinquent Section 32 mortgage payment is limited to 4% of the delinquent principal and interest installment. In this situation, the 10% late charge for all other broker-made or arranged mortgages does not apply since the federal rule is more protective of the consumer and therefore controls.[17] [See Chapter 10]

13 **Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995
14 CC §1476
15 CC §2954.4(e)
16 Bus & P C §10242.5(a)
17 12 CFR §1026.32 (a); 12 CFR §1026.34(a)(8)

## Balloon payments untimely paid

**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]

**default rate provision**
A note provision increasing the note rate on the remaining principal when the final/balloon payment becomes delinquent.

Mortgages with a **balloon payment** provision—when allowed—may demand an agreed to late charge on the *final/balloon payment* if not received within ten days after its due date. [See Form 418-1 §2.4; see Chapter 11]

*Editor's note — Balloon payments for consumer mortgages are rare. Qualified mortgages (QMs) provide lenders with the security of presumed compliance with ability-to-repay (ATR) rules. However, balloon payments are limited in use to mortgages originated by small lenders operating in rural or underserved areas. Non-QM consumer mortgages may contain balloon payment provisions subject to ATR rules. [See Chapter 2]*

On the delinquency of a balloon payment to pay off the mortgage, the mortgage holder may enforce a **default rate provision** which increases the note rate on the remaining principal.[18]

However, if the mortgage is secured by an owner-occupied SFR or is a brokered loan, the default rate provision is unenforceable as the late charge is limited to:

- the greater of $5 or 6% of the delinquent PI installment, in the case of an owner-occupied SFR not made or arranged by a broker; or
- the greater of $5 or 10% of a regularly scheduled PI installment, in the case of a brokered loan.[19]

Additionally, any late charge on a balloon payment may be charged for *each month* the payment remains delinquent. Interest at the default rate accrues and is payable with the final/balloon payment.

However, the default rate of interest is limited by reasonableness standards and triggered only by the expiration of any grace period for delivery of the final payment.[20] [See Form 418-1 §2.5]

## One charge per delinquency

For consumer mortgages secured by the owner's one-to-four unit principal residence, the mortgage holder is not permitted to assess more than one late charge per delinquent monthly installment, no matter how many months the payment remains delinquent.

Additionally, *pyramiding* is prohibited. Thus, a late charge on a consumer mortgage may only be charged on principal and interest payments, not on unpaid late charges.[21]

Consider a homeowner who fails to make the January and February installments on their consumer mortgage.

The mortgage holder charges the homeowner a late fee for each of the following months the payment remains unpaid, demanding two late charges for the January payment and one for the February payment.

18 **Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701
19 Bus & P C §10242.5(b), (c); CC §2954.4
20 Bus & P C §10242.5(c); CC§1671
21 12 CFR §1026.36(c)(2)

The homeowner pays one installment in March before the 10-day grace period expires.

The mortgage holder's accounting program applies the payment to the delinquent principal and accrued interest (PI) installment due in January, and demands payment of additional late charges for the failure in March to timely pay the February and March installments.

Here, the mortgage holder is only permitted to collect **two late payment charges**, no matter how many months pass before catching up the missed payments:

- *one* for the unpaid January installment;
- *one* for the unpaid February installment; and
- *none* for March, since the March installment was timely paid.[22]

A payment received in the month following an unpaid, delinquent installment is applied toward the *most recent payment* due for late charge purposes, not the most outstanding delinquent installment. The charge is for the one missed installment which still remains unpaid by the homeowner.[23]

However, for accounting purposes, funds from the most recent payment are applied to the interest accrued for the month of the oldest delinquency.

## Impound accounts

An **impound account** is a money reserve funded by the property owner and maintained by the mortgage holder, also called an **escrow account**.

**impound account**
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

The money in the *impound account* consists of funds the property owner advanced to the mortgage holder as an initial deposit, followed by regularly scheduled further deposits made with monthly principal and interest payments. The impound funds belong to the owner and are disbursed by the mortgage holder for periodically recurring property expenses, such as taxes. [See Chapter 14]

*Editor's note: Reg Z mandates impound accounts for first trust deed consumer mortgages classified as higher-priced (not to be confused with a Section 32 high-cost mortgage). A* ***higher-priced consumer mortgage*** *is secured by the borrower's principal residence and has an annual percentage rate exceeding the average prime offer rate by 1.5% for comparable conforming loans or 2.5% for mortgages exceeding the* ***conforming loan limit*** *set by Freddie Mac. By default, Section 32 high-cost mortgages need to conform to the higher-priced mortgage rules.[24] [See Chapter 2]*

From the impounded funds, the mortgage holder pays specified obligations the owner periodically owes on the property, such as:

- property taxes;
- insurance premiums;

22 CC §2954.5
23 CC §2954.4(b); Bus & P C §10242.5(b)
24 12 CFR §1026.35

- assessments for common area or easement maintenance;
- water stock; or
- bonded improvements.

To fund the impound account, a *pro rata* amount of anticipated costs for annual taxes and insurance premiums (known as TI) is collected with each monthly PI payment (collectively known as **PITI**).

The TI portion of the owner's monthly PITI payment is **excluded** from the computation of any late charge amount.

## Enforcement of the late charge

A borrower's refusal to pay a late charge when demanded does not justify a **call** of the mortgage or initiation of foreclosure by itself.[25]

A mortgage holder is not entitled to foreclose on an owner who has tendered all installments which are due, but has failed to pay outstanding late charges. Collection of late charges, when no other monetary breach exists, is not a material breach and is enforced by means other than foreclosure.

## Periodic mortgage statements

Holders and servicers of consumer mortgages provide the property owner with a **periodic mortgage statement** each **billing cycle**—the regular interval between the scheduled due date of each payment. If the *billing cycle* is shorter than 31 days, such as a bi-weekly payment schedule, the mortgage holder provides one statement for all cycles occurring in the 31-day period.[26]

The *periodic mortgage statement* details amounts due and any fees and charges incurred, as well as a breakdown of how the last payment was applied to the principal balance and interest and how payments have been applied year-to-date. A breakdown of any late charges paid and owed is also included.[27] [See Chapter 10]

Small consumer mortgage holders (those who hold fewer than 5,000 mortgages), carryback sellers and business mortgage holders are not required to give periodic mortgage statements under Reg Z.[28]

However, even though small lenders, business mortgage holders and carryback sellers are exempt from Reg Z mortgage statement requirements, they are still required to account for assessed late charges if they do not notify the borrower of late charges at the time they are incurred.[29]

25 **Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818
26 12 CFR §1026.41(a)(2)
27 12 CFR §1026.41(d)(2), (3)
28 12 CFR §1026.41(e)(4)
29 12 CFR §1026.41(a)(2); §1026.41(d)(1)(ii)

## Chapter 10 Summary

Promissory notes typically contain a late charge provision calling for an additional charge if payment is not received when due or within a grace period after which the payment is delinquent.

To be enforceable, a late charge imposed for a delinquent payment a mortgage must be reasonably related to money losses incurred by the mortgage holder due to the delinquency, and may not be punitive.

To collect a late charge for the first delinquent payment on a mortgage encumbering any type of real estate, the mortgage holder needs to first notify the owner in a timely manner of the charge and make a demand for its payment wither either:

- a billing statement or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or
- a written statement or notice of the late charge amount sent concurrent with or within ten days of mailing a notice to cure a delinquency or within ten days after mailing the notice.

The notice or billing statement needs to include either the exact amount of the late charge or the formula used to calculate it.

For all subsequent delinquent payments, the mortgage holder is not compelled to notice and demand the late charge to enforce the late charge provision.

Consumer mortgage holders are not permitted to charge a late fee for an owner's failure to pay a previously demanded late fee, a practice known as pyramiding.

The late charge on any mortgage (consumer or business) which is not a Section 32 mortgage or a brokered loan and is secured by an owner-occupied single-family residence (SFR) is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5.

The minimum grace period before a mortgage encumbering a one-to-four unit owner-occupied residential property is delinquent is ten days after the due date without receipt of the payment.

For all mortgages secured by any type of real estate which are made or arranged by a real estate broker—other than Section 32 mortgages—the maximum late charge permitted on delinquent monthly payments is the greater of:

- 10% of the delinquent principal and interest payment; or
- $5.

Additional late charge limits exist for high-cost consumer mortgages (Section 32 mortgages).

Mortgages with a balloon payment provision may demand an agreed to late charge on the final/balloon payment if not received within ten days after its due date. Any late charge on a final/balloon payment may be charged for each month the payment remains delinquent.

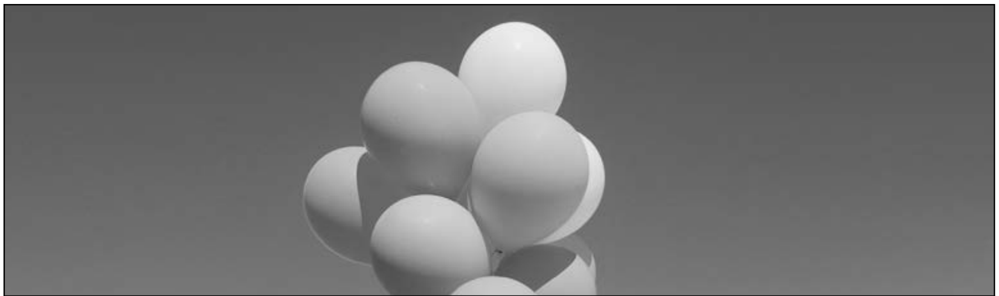
Holders and servicers of consumer mortgages provide the property owner with a periodic mortgage statement each billing cycle detailing amounts due and any fees and charges including assessed late charges, as well as a breakdown of how the last payment was applied and how payments have been applied year-to-date.

## Chapter 10 Key Terms

**balloon payment** .......... **pg. 132**
**default rate provision** .......... **pg. 132**
**grace period** .......... **pg. 126**
**high-cost consumer mortgage (Section 32 mortgage)** .......... **pg. 129**
**impound account** .......... **pg. 133**
**late charge provision** .......... **pg. 125**
**material breach** .......... **pg. 126**
**pyramiding** .......... **pg. 130**

**Quiz 3 Covering Chapters 9-12 is located on page 621.**

# Chapter 11



# Balloon payments — risks and notices

## Learning Objectives

After reading this chapter, you will be able to:

- understand the risks inherent in a balloon payment on a mortgage;
- determine when balloon payments are permitted on consumer mortgages and which rules apply;
- calculate the amount of a balloon payment;
- prepare and deliver a Carryback Disclosure Statement in a carryback sales transaction; and
- advise on the requirements for the contents and delivery of a final/balloon payment notice.

## Key Terms

**balloon payment**

**balloon-payment qualified mortgage**

**call provision**

## Notes containing a balloon payment

A **balloon payment** is any final payment on a mortgage more than twice the amount of any of the six regularly scheduled payments immediately preceding the balloon payment date.[1]

*Balloon payment* mortgages contain due date provisions calling for final payment of the principal balance in a *lump sum* before the principal is fully amortized through periodic payments.

1 Calif. Civil Code §§2924i(d)(1), 2957(b)

Further, a mortgage has a balloon payment if it contains a **call provision** giving the mortgage holder the right to demand a final payment at any time or after a specified time.[2]

## Limitations on balloon payments in consumer mortgages

**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]

**Consumer mortgages** are contrasted with **business mortgages** based on the purpose for which the funds are intended to be used.

A *consumer mortgage* both:

- funds a personal, family or household purpose; and
- is secured by a one-to-four unit residential property, whether or not occupied by the borrower or their family.[3]

Balloon payments in consumer mortgages have become rare due to **Regulation Z (Reg Z)** rules. Mortgage lenders making consumer mortgages are mandated by Reg Z to qualify the borrower under **ability-to-repay (ATR)** rules.

If the mortgage complies with Reg Z **qualified mortgage (QM)** standards the mortgage is *presumed compliant* with ATR rules.

However, to be classified as a QM, the mortgage needs to be fully amortized in *substantially equal* regular installments, a rule eliminating the inclusion of a balloon payment provision.

## Small lender exemptions

**Small lenders** operating in rural or underserved areas, however, are exempt from Reg Z balloon payment rules. Small lenders are mortgage holders who:

- originate 2,000 or fewer consumer mortgages in a calendar year; and
- have total assets of $2.640 billion or less at the end of the preceding calendar year.[4]

**balloon-payment qualified mortgage**
A type of qualified mortgage which allows small lenders to include a balloon feature.

Small lender **balloon-payment QMs** are not limited by the QM rules for *debt-to-income ratio (DTI)* caps. However, like a general qualified mortgage, a small lender balloon-payment QM:

- has a fixed interest rate and periodic payments calculated using an amortization period not longer than 30 years;
- does not result in negative amortization;
- has a term of at least five years and no more than 30 years;
- has total points and fees equal to no more than 3% of the mortgage amount;
- requires the lender to verify all income, assets and debt of the borrower according to the general QM rule; and
- may not be sold after origination to an entity other than another small lender eligible to make balloon-payment QMs.[5]

2 CC §§2924i(d)(2), 2957(c)
3 12 Code of Federal Regulations §1026.2(a)(19)
4 12 CFR §1026.35(b)(2)(iii)(B),(C)
5 12 CFR §1026.43(f)(1)(i)-(vi)

Mortgage lenders and carryback sellers may make balloon payment consumer mortgages if they choose to do so — they simply will not enjoy the safe harbor of presumed compliance with the *ATR rules*. Lenders making consumer mortgages with balloon payments need to document their *good faith effort* to determine the borrower's ability to actually repay the mortgage—the underlying intent of the ATR rules.

## Higher-priced consumer mortgages

For compliance with the ATR rules, selection of the proper repayment ability calculation depends on whether the consumer mortgage is considered *higher-priced*. A **higher-priced consumer mortgage** has an annual percentage rate (APR) which exceeds the *average prime offer rate* for a comparable transaction by a percentage threshold — for instance, exceeding a 1.5% spread for a senior mortgage with a principal balance over $50,000.[6] [See Chapter 2]

Calculations for the borrower's ability to repay a consumer mortgage containing a balloon payment provision take into consideration:

- the maximum amount of any payment scheduled during the **first five years** of a consumer mortgage which is not higher-priced; or
- the maximum amount of any payment during the **life of the mortgage** including the balloon payment for higher-priced consumer mortgages.[7]

## The consumer's ability to repay a balloon payment mortgage

Consider a borrower who obtains a consumer mortgage secured by their principal residence. The APR on the mortgage exceeds the average prime offer rate (calculated and published by the Consumer Financial Protection Bureau [CFPB]) for similar transactions by 0.8%. The principal balance of the mortgage is $60,000.

The consumer mortgage terms include regular monthly payments and a balloon payment due in six years.

Is the lender required to consider the balloon payment amount when calculating the borrower's ability to sustainably repay the consumer mortgage?

No! The due date for the balloon payment is beyond the first five years of the mortgage and the transaction is not a higher-priced consumer mortgage. Here, the lender does not need to take the balloon payment amount into account when determining the borrower's ability to repay the mortgage.[8]

Now consider a similar scenario, only in this case, the repayment term is five years instead of six. A small change of circumstance yields significantly different considerations for the lender's ability-to-repay calculation. Here, the maximum payment in the first five years of the mortgage now *includes* the balloon payment.

6 12 CFR §1026.35(a)(1)(i)

7 12 CFR §1026.43(c)(5)(ii)(A)(1), (2)

8 Supplement I to 12 CFR §1026.43(c)(5)(ii)(A)

Finally, consider the six year balloon payment consumer mortgage situation, except the mortgage's APR now exceeds the average prime offer rate for a comparable transaction by 3.0%. Here, the transaction is a higher-priced consumer mortgage. Even though the balloon payment is due more than five years after origination, the lender needs to include the balloon payment amount in their ATR calculations.

## Final/balloon payment notice and due dates

**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 **RP**I Form 418-3 and 419]

Some mortgages with due dates require a *final/balloon payment* notice.

A **90/150-day due date notice provision** is required in mortgages with terms exceeding one year and containing a balloon payment provision, if:

- the mortgage is carried back by a seller and secured by a one-to-four unit residential property whether or not the buyer occupies the property; or
- the mortgage is a loan secured by an owner-occupied, one-to-four unit residential property. [See Form 419 accompanying this chapter]

A due date notice is not required, unless agreed to, on transactions including:

- carryback mortgages secured by any type of real estate other than a one-to-four unit residential property, whether or not owner-occupied;
- lender mortgages secured by any type of real estate other than owner-occupied, one-to-four residential units;
- open-ended credit secured by any type of real estate, such as a *home equity line of credit (HELOC)*; and
- construction loans for any type of improvements.[9]

The due date notice is used to remind the owner of the secured property of a mortgage's balloon payment. The notice, while a reminder, gives the owner an opportunity to **refinance** or pay off the remaining principal balance before the balloon payment becomes due. [See Form 419]

## Delivery and contents of the notice

Mortgage holders need to **deliver** the due date notice to the owner of the property:

- personally; or
- by first-class certified mail to the property owner's last known address.

The notice needs to be delivered *at least* 90 days, but *not more than* 150 days, before the due date (hence the term 90/150).[10] [See Form 419]

If the notice is not timely delivered, the due date of the balloon payment is **extended until 90 days** after proper notice is delivered. No other terms of the note are affected. Thus, the accrual of interest and the schedule of periodic payments remain the same during the extended due date period.[11]

9 CC §2924i(b)(1), (3)
10 CC §§2924i(c), 2966(a)
11 CC §§2924i(e), 2966(b)

For example, consider a mortgage which calls for the final/balloon payment to be due and payable no later than June 1st. The mortgage holder fails to deliver the final/balloon payment due date notice at least 90 days before it is due—in this case, March 3rd.

Instead, the mortgage holder delivers the mandatory notice on March 15th. This delay triggers the extension of the balloon payment due date to 90 days after the delivery date of the due date notice.

Thus, the new due date for the final/balloon payment becomes June 13th.

The failure to deliver the notice does not affect the owner's obligation to continue making the regular periodic payments. Non-delivery of the notice merely extends the date by which the owner is obligated to pay off the remaining balance.

If the owner defaults on a payment during the due-date extension period, the noteholder may initiate foreclosure. [See Chapter 44]

## Consequences of non-delivery

The dollar amount of the *final/balloon payment* in a carryback mortgage secured by a one-to-four unit residential property needs to be computed and disclosed to the buyer twice:

- first in a **Seller Carryback Disclosure Statement** handed to both the buyer and seller as an attachment to the purchase agreement, or for further approval before the close of escrow which subjects the transaction to cancellation on reasonable disapproval by either the buyer or the seller [See **RPI** Form 300];[12] and
- a second time in a written due date notice delivered to the property owner at least 90 days, but not more than 150 days, before the balloon payment is enforced.[13] [See Form 419]

Additionally, the carryback note prepared by escrow includes a statutory provision calling for the balloon payment due date notice.[14] [See **RPI** Form 418-3 §2.1]

## Carryback notice of final/ balloon payment amount

The broker preparing a purchase offer or counteroffer calling for a balloon payment in a carryback mortgage on any sale of one-to-four unit residential property discloses the dollar amount of the final/balloon payment in a *Carryback Disclosure Statement*. [See **RPI** Form 300]

In contrast, mortgage **lenders** are only required to make the balloon payment calculation and disclosure on mortgages secured by one-to-four residential units when the secured property is owner-occupied.

Specifically, the Carryback Disclosure Statement advises the buyer of:

- the existence of the balloon obligation;

12 CC §2956

13 CC §2966(a)(1-4)

14 CC §2966 (d)

Form 419

Notice of Balloon Payment Due

**NOTICE OF BALLOON PAYMENT DUE**

**NOTE:** This form is used by the holder of a mortgage or their servicing agent when the mortgage note has a due date, to notify the owner making payments of the final/balloon payment date at least 90 but not more than 150 days before the payoff is due.

**DATE:** _______________, 20______, at ______________________________________________________, California.

**TO:** ______________________________________________________________________________, the owner of real estate referred to as ___________________________________________________________________________

______________________________________________________________________________________________,

securing a promissory note dated __________________, in the original face amount of $________________.

**NOTICE:**

**1.** A final/balloon payment on this promissory note is due on _______________, 20______.

**2.** The approximate amount due (including all principal and interest and any other charges due between the date of this notice and the due date) is $________________.

**3.** Payment is to be made to (Name and address) ______________________________________________________

______________________________________________________

______________________________________________________

**4.** You have a contract right with the undersigned to refinance this final/balloon payment in accordance with the following terms:

4.1 Origination or modification fee $_____________.

4.2 Principal amount $____________.

4.3 Interest rate _______%.

4.4 Installment payments payable monthly in the amount of $____________.

4.5 Due date extended to ____________, 20_____.

Date: ___________, 20_______

Trust Deed Holder: ____________________________________

Signature ___________________________________________

Address: ___________________________________________

____________________________________________________

Phone: _____________________________________________

Fax: _______________________________________________

Email: ______________________________________________

**FORM 419** 03-11 

- the amount of the final/balloon payment;
- any negative amortization; and
- the fact the buyer may not be able to refinance the balloon payment when it is due.[15] [See Form 419]

## Failure to give notice

Further, if the carryback seller begins foreclosure when the owner fails to make the final/balloon payment when the seller has not first given the due date notice, they are liable to the owner for any money losses incurred due to the seller's foreclosure efforts, including attorney fees.[16]

If the carryback seller fails to give proper notice of the final/balloon payment and successfully takes title to the property as the highest bidder at the trustee's sale, the owner is able to **void** the trustee's sale. [See Chapter 44]

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15 CC §2963

16 CC §§2924i(f), 2965

However, if an unrelated third-party purchases the property at the trustee's sale, the owner is not able to set aside the sale. In this instance, the owner is limited to the recovery of money from the carryback seller in the amount of the owner's *lost equity*.[17]

17 CC §2966(c)

## Chapter 11 Summary

Balloon payment mortgages contain due date provisions calling for final payment of the principal balance in a lump sum before the principal is fully amortized through periodic payments.

Balloon payments in consumer mortgages have become rare due to Regulation Z (Reg Z) rules, as they are prohibited in most qualified mortgages (QMs).

Small lender balloon-payment QMs are not limited by the QM rules for debt-to-income ratio (DTI) caps, but must comply with many of the other standards of a general QM.

Mortgage lenders and carryback sellers may make balloon payment consumer mortgages if they choose to do so—they simply will not enjoy the safe harbor of presumed compliance with the ability-to-repay (ATR) rules.

Calculations for the borrower's ability to repay a consumer mortgage containing a balloon payment provision take into consideration:

- the maximum amount of any payment scheduled during the first five years of a consumer mortgage which is not higher-priced; or
- the maximum amount of any payment during the life of the mortgage including the balloon payment for higher-priced consumer mortgages.

A 90/150-day due date notice provision is required in mortgages with terms exceeding one year and containing a balloon payment provision, if:

- the mortgage is carried back by a seller and secured by a one-to-four unit residential property whether or not the buyer occupies the property; or

- the mortgage is a loan secured by an owner-occupied, one-to-four unit residential property.

The due date notice is used to remind the owner of the secured property of a mortgage's balloon payment.

The notice needs to be delivered to the owner by the mortgage holder personally or by certified mail at least 90 days, but not more than 150 days, before the due date (hence the term 90/150). If the notice is not timely delivered, the final due date is extended until 90 days after proper notice is delivered.

Mortgage lenders are only required to make the balloon payment calculation and disclosure on mortgages secured by one-to-four residential units when the secured property is owner-occupied.

## Chapter 11 Key Terms



**Quiz 3 Covering Chapters 9-12 is located on page 621.**

# Chapter 12

# Trust deed characteristics

## Learning Objectives

After reading this chapter, you will be able to:

- understand how a trust deed voluntarily imposes a lien for a debt on an ownership interest in real estate;
- identify the three participants and their roles under a trust deed; and
- take steps to have a trust deed lien released from title to a property.

## Key Terms

| | |
|---|---|
| **beneficiary** | **promissory note** |
| **deed-in-lieu of foreclosure** | **reconveyance** |
| **guarantor** | **trustee (on a mortgage)** |

## A security device, a lien and a mortgage

Financing involves a borrower or buyer who, as the payor, signs and delivers a **promissory note** to a lender or seller as *evidence of the debt* owed for money lent or an installment sale of property sold.

However, the *promissory note* itself is only a promise to pay as agreed. It is not a guarantee or other assurance the debt evidenced by the note will actually be repaid.

A *guarantee* is a separate agreement entered into by a person who is not the payor under the note, known as a **guarantor.** The guarantee agreement obligates the *guarantor* to be responsible for the borrower's performance. In essence, the guarantor agrees to *buy the note* in the event the borrower defaults. [See **RPI** Form 439]

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

**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** From 439 and 553-1]

In real estate loan and carryback sales transactions – mortgages – lenders and sellers want assurance the debt to owed them will be repaid as agreed. Thus, lenders and carryback sellers require borrowers and buyers to give them a lien on the real estate involved as **collateral** to secure the performance of their promise to pay if they default on repayment.

To secure payment of the debt by a parcel of real estate, the *security device* used is a **trust deed**. The *trust deed* is always the preferential method used to impose a **lien** on real estate. [See Figure 1, **RPI** Form 450]

The *lien* gives the lender or carryback seller the right to foreclose on the real estate if the borrower defaults.

## The trust artifice

The trust deed, by its words, purports to convey legal title to a neutral person, called a **trustee**. In law, the title is not transferred. Instead, a lien is created to encumber the owner's title and establish the property as security for the debt.

By the use of the trust artifice, title to the property is theoretically held by a *trustee* as a middleman. In other words, title is held *in trust* on behalf of the owner and for the benefit of the lender or carryback seller.

If the property owner defaults on the note, the trustee is instructed by the lender to sell the property at a public auction to satisfy the debt.

**trustee (on a mortgage)**
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.

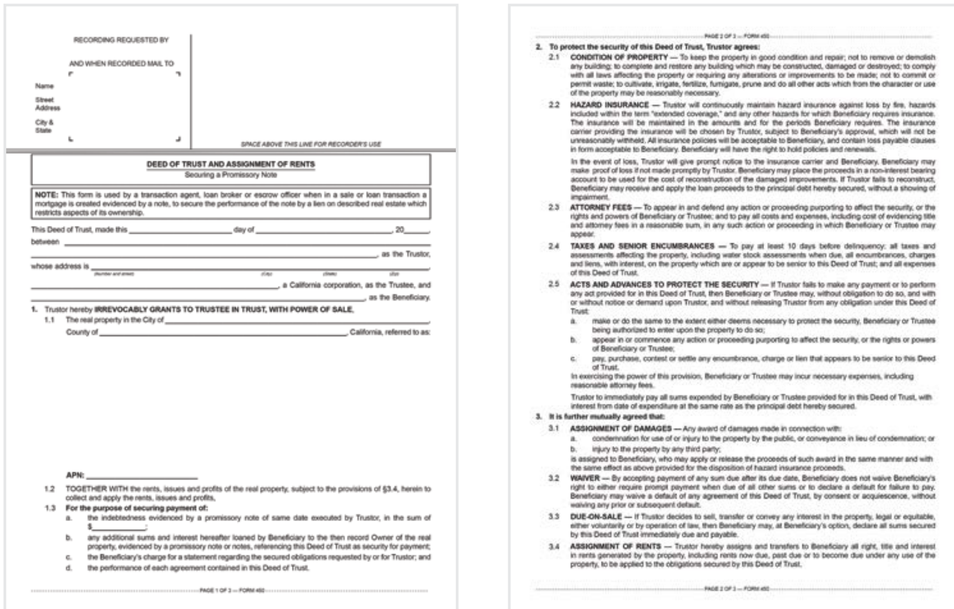
A *trust deed lien* arrangement consists of:

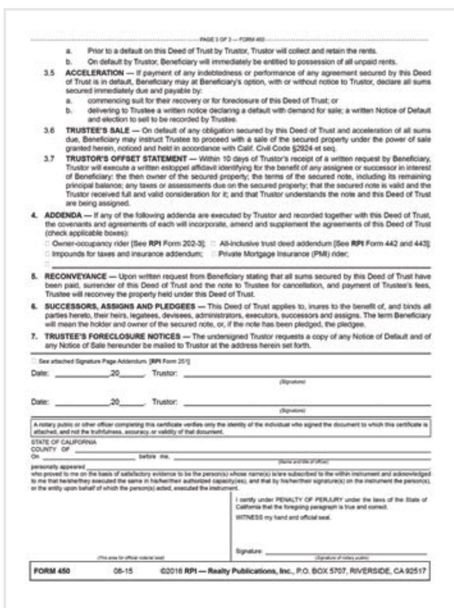
- an identification of the parties;
- a description of the real estate liened as security;
- an identification of the primary money obligation, usually evidenced by a note, which brought about the need for security;
- the terms of the note holder's security interest which is established by the trust deed lien on the property, limited to setting out the rights and obligations of the owner and the note holder solely in regard to the real estate; and
- the property owner's signature and notary acknowledgments. [See Figure 1]

## Parties to the trust deed

The trust deed identifies three parties, each of whom has distinctly separate roles in the mortgage transaction:

- the borrower/owner (*trustor)* who voluntarily encumbers their property with the trust deed lien;
- the middleman (*trustee)* who holds the power of sale to auction the property; and
- the lender or carryback seller (*beneficiary)* who benefits from the trust deed lien encumbering the property, also known as the noteholder.





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

Figure 1

Form 450

Trust Deed and Assignment of Rents

The trustor who signs and delivers a trust deed to a lender or carryback seller is the *owner* of the real estate interest encumbered. Delivery is accomplished by recording the trust deed with the **county recorder**, which *perfects* its priority on title.

The owner creating a trust deed encumbrance on real estate usually is the borrower of money or buyer of the property in an installment sale.

However, an owner can impose a trust deed lien on the title to their property to provide security for:

- the performance of any lawful act they may have agreed to; or

- as security for another person's debt, including:
    - other individuals;
    - a corporation;
    - limited liability company (LLC); or
    - partnership debt.[1]

## Fractional interest encumbered

The owner's real estate interest which is encumbered can be less than the entire *fee interest*, such as:

- a fractional co-ownership;
- leasehold interest;
- life estate in the property;
- beneficial interests of creditors in existing trust deeds;
- equitable ownership rights under land sales contracts; and
- purchase rights under options to buy.

For example, a condominium owner can encumber their long-term leasehold interest, even though some other person is the fee owner of the real estate.[2]

The trust deed lien created by the owner of a fractional interest in the real estate attaches only to the owner's interest in the property. It does not attach to the interests of any co-owners.[3]

If *community property* is encumbered, both spouses need to consent to the encumbrance of the community real estate interest, with the exception of attorney fee agreements in divorce proceedings.[4]

## The trustee's authority

Despite the wording in the trust deed stating the trustor "hereby grants and conveys to trustee...the following real property...", the trustee receives no ownership or security interest in the real estate. Further, the trustee holds no legal right to any interest in the property.

The trustee merely receives the *authority* to carry out the activities vested in the trustee by the **power-of-sale provision** in the trust deed lien held by the beneficiary (lender).[5]

Under the trust deed, the trustee's sole responsibilities concerning the property are to:

- *auction* the property at a public sale on notice from the beneficiary; and
- *reconvey title* to the trustor (owner) and release the beneficiary's lien on instructions from the beneficiary or the trustor on the repayment of debt evidenced by a note.

---

1 **Everly Enterprises, Inc.** v. **Altman** (1960) 54 C2d 761
2 Calif. Civil Code §§783, 1091, 2947
3 **Caito** v. **United California Bank** (1978) 20 C3d 694
4 Calif. Family Code §1102
5 **Lupertino** v. **Carbahal** (1973) 35 CA3d 742

Thus, the owner's *possessory right* to the property is never transferred to the trustee under a trust deed. The trustor, as the owner of the real estate, remains free to occupy, sell, lease or further encumber their property, subject to the existing trust deed lien.

## Who may be trustee?

Any person other than the owner of the real estate may serve as trustee. This includes the beneficiary of the trust deed, be they the lender or carryback seller.[6]

Some private lenders name their attorney or broker as the trustee. Frequently, title and escrow companies intentionally, but unknowingly, play the role of trustee in a particular transaction by virtue of the use of general trust deed forms distributed by these companies.

The key difference between the trust deed's legal fiction as a trust and a genuine trust is the trustee under a trust deed is designated without their knowledge or consent. A true trustee needs to consent to their appointment.[7]

Under a trust deed lien, the trustee is *non-existent* until the beneficiary elects to foreclose or release its security interest in the property. The trustee's conduct is (in nearly all aspects) completely controlled by statutes.[8]

When the trustee is called on by the beneficiary to carry out its duty to foreclose or reconvey, the trustee is required to act impartially.

Thus, a trust deed lien does not create a trust relationship between the parties to the trust deed. The trustee is regarded as a *common agent* and bears a responsibility to both the beneficiary and the trustor to absolutely follow the strict statutory foreclosure scheme.[9]

## The beneficiary is the lienholder

The **beneficiary**, such as a lender or carryback seller, is the person entitled to performance of the promised activities referenced in the trust deed. This is generally the repayment of debt evidenced by a note.

**beneficiary**
The holder of a note secured by a trust deed and entitled to the performance of the provisions in the trust deed.

The *beneficiary*, like the trustee, receives no ownership interest in the property. But unlike the trustee, the beneficiary *holds an interest* in the property in the form of a lien, called a **security interest**.

Thus, the beneficiary has the power to instruct the trustee (who may be the beneficiary) to sell the secured property on behalf of the beneficiary. In turn, the trustee has authority from both the trustor (owner) and the beneficiary (lender or carryback seller) under the power-of-sale provision in the trust deed to sell the property in conformance with the statutory scheme at the request of the beneficiary.[10]

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6 **More** v. **Calkins** (1892) 95 C 435

7 Calif. Probate Code §15600

8 **Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268; CC §2924 et seq.

9 **Kerivan** v. **Title Insurance and Trust Company** (1983) 147 CA3d 225

10 Prob C §§16000, 16420(a)(1)

## Extinguishing the relationship

A trust deed ceases to exist when its purpose as security for a debt ends.

Thus, once the beneficiary (lender or carryback seller) receives the full amount of money they are entitled to under the note and trust deed, any later claim of a security interest by the beneficiary is invalid.

Removing the trust deed from the title to the property on ending the debt relationship between the owner and the creditor is accomplished in one of three ways:

- *foreclosure* by issuance of a trustee's deed or sheriff's deed [See **RPI** Form 475];
- *full repayment* by reconveyance [See **RPI** Form 472]; or
- *mutual agreement* by a deed-in-lieu of foreclosure. [See **RPI** Form 406]

*Foreclosure* of the trust deed lien is accomplished by a public auction at a trustee's sale or sheriff's sale, the proceeds of which are applied to the debt. [See Chapter 44]

The foreclosure sale terminates the trust deed lien on the property whether or not the price bid at the foreclosure sale is sufficient to fully satisfy the note. The foreclosure sale cancels the trust deed lien on issuance of the trustee's or sheriff's deed to the successful bidder.

## Reconveyance of the trust deed

*Full repayment* of the debt requires the beneficiary to cause the trust deed to be *reconveyed*. Once the debt is fully repaid by the trustor, the beneficiary delivers the original note to the trustee, together with a request for a reconveyance of title. In turn, the trustee records a **reconveyance** of the trust deed. [See **RPI** Form 472]

**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]

A trustee who erroneously reconveys when the trustor is not entitled to a release of the beneficiary's lien on the property is liable for the beneficiary's resulting money losses. However, the beneficiary's recovery from the trustee is limited to the market value of the secured property.[11]

On a request for reconveyance, the trustee will demand identification of the beneficiary and require the original note be marked as paid. After recording the reconveyance, the trustee will deliver the note to the owner at the owner's request.

Unless the recorded trust deed lien expires earlier, the lien expires and is no longer enforceable by any means after the later of:

- ten years after the final maturity date contained in the recorded trust deed; or
- 60 years after the recording of the trust deed if the final maturity date cannot be ascertained from the recorded trust deed.[12]

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11 **Jeanese, Inc.** v. **Surety Title & Guaranty Co.** (1959) 176 CA2d 449
12 CC §882.020

## Failure to reconvey on payoff

Failure of the beneficiary or trustee to comply with mandatory reconveyance requirements results in liability for:

- the owner's actual money losses;
- a penalty of $500; and
- criminal liability punishable by a fine of $400 and six months imprisonment.[13]

When the beneficiary refuses to reconvey on full satisfaction of the debt or cannot be located, the owner, as trustor, can obtain and record a *corporate bond* in the county where the encumbered property is located.

The trustor sends a notice by certified mail to the trustee and the last beneficiary of record stating the trustor has recorded the bond and a declaration. The notice states the trustee may record a written objection to the release of the obligation.[14]

Also, the creditor and property owner may *mutually agree* to terminate the security interest evidenced by the trust deed lien with:

- a **deed-in-lieu of foreclosure** and reconveyance of the trust deed; or
- a *substitution of security* and reconveyance of the trust deed without first paying the debt in full.

**deed-in-lieu of foreclosure**
A grant deed conveying the mortgaged real estate to a mortgage holder which is accepted from the property owner in exchange for cancelling the mortgage debt to avoid foreclosure. [See **RPI** Form 406]

Under a deed-in-lieu of foreclosure, the owner conveys their entire interest in the property to the beneficiary. In exchange, the beneficiary cancels any remaining debt and reconveys the trust deed. Thus, the trustor/beneficiary relationship between the owner and the creditor under the trust deed is terminated. [See Chapter 47]

13 CC §§2941, 2941.5
14 CC §2941.7(b)(5)

## Chapter 12 Summary

To secure payment of the debt by a parcel of real estate, a security device is used in the form of a trust deed agreement. The trust deed is the preferential method used to impose a mortgage lien on real estate. In the event the owner defaults on the note or trust deed, the trustee can be instructed by the lender to sell the property at a public auction to satisfy the debt.

The trust deed identifies three parties, each of whom has distinctly separate roles in the secured transaction:

- the owner (called the trustor);
- the middleman (called the trustee); and
- the lender or carryback seller (called the beneficiary).

Under the trust deed, the trustee's only responsibilities concerning the property are to auction the property at a public sale on notice from the lender of a default and election to sell and reconvey title to the owner and release of the lender's lien on instructions from the beneficiary or trustor.

Unlike the trustee, the beneficiary holds an interest in the property, a security interest called a lien.

The modern California trust deed gives the beneficiary a lien as a security interest in the real estate. The trust deed authorizes the sale of the property by a trustee's sale under the power-of-sale provision to enforce the collection of secured debt. The trust deed ceases to exist when its purpose as security for a debt ends. Failure of the beneficiary or trustee to comply with mandatory reconveyance requirements results in liability for the owner's actual money losses.

## Chapter 12 Key Terms



**Quiz 3 Covering Chapters 9-12 is located on page 621.**


# Chapter 13

# 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** | **dragnet clause** |
| **adhesion contract** | **eminent domain** |
| **alienation clause** | **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.

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 19];

- 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**.

**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.

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

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.

**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.

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
- 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.

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

Form 450

Trust Deeds and Assignment of Rents

Page 1 of 3

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.

---------- PAGE 1 OF 3 — FORM 450 ----------

## 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's** Form 450 — Deed of Trust and Assignment of Rents. [See Form 450 accompanying this chapter]

## 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.

Form 450

Trust Deeds and Assignment of Rents

Page 2 of 3

**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.

PAGE 2 OF 3 — FORM 450

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 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

3 Calif. Civil Code §2929

PAGE 3 OF 3 — FORM 450

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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Form 450

Trust Deeds and Assignment of Rents

Page 3 of 3

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]

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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. [See Chapter 48]

## 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. The government pays the owner the fair market value of the property taken.

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] [See Chapter 46]

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 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 19]

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.

*Editor's note — For assignment of rents clauses recorded before 1997, the rules regarding the distinctions between the two types of rent clauses still govern their perfection and enforcement. [See Chapter 15]*

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 mortgage or extension of credit by a 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.

21 CC §2938(a)
22 CC §2938(b)

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
- violations of law affecting the value of the real estate. [See Chapter 42]

## 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] [See Chapter 44]

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] [See Chapter 44]

## 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];
- agreements for impound accounts [See **RPI** Form 455 in Chapter 14];
- owner-occupancy riders; and

23 CC §2924, et seq.

24 CC §2903

- 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 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 Form 471 in Chapter 42]

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]

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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 California Government Code §27321.5

31 CC §2924b(b)

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 45]

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 45]

32 CC §2924b(a)
33 CC §2924b(d)

## Chapter 13 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 13 Key Terms



**Quiz 4 Covering Chapters 13-17 is located on page 622.**

# Chapter 14

# Impound accounts: funds for taxes and insurance

## Learning Objectives

After reading this chapter, you will be able to:

- apply the federal and state schemes governing impound accounts for consumer and business mortgages;
- identify the components of an impound account;
- explain the procedures for establishing, managing and terminating an impound account; and
- calculate the appropriate initial and monthly deposits for an impound account.

## Key Terms

**computation period**
**impound account**
**impound account provision**

## Tax and insurance reserves

An **impound account** is a money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

The *impound account* is funded by the property owner making an initial deposit with the mortgage lender when the mortgage is originated. To maintain sufficient funds in the account, the owner makes further deposits monthly together with payments of principal and interest installments.

The funds impounded in the account maintained by the lender belong to the owner. However, the mortgage holder — not the property owner — disburses the funds to pay annually recurring property ownership expenses.

**impound account**
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

*Editor's note — Regulation Z mandates impound accounts for Section 35 higher priced consumer mortgages.*[1]

The property ownership expenses paid with the impound account include:

- property taxes;
- insurance premiums;
- bonded improvements
- water stock assessments; or
- maintenance assessments for common areas or easements.

To fund the impound account, a *pro rata* amount of anticipated costs for annual taxes and insurance premiums (known as TI) is collected on origination and with each monthly payment on principal and interest (PI) – collectively known as **PITI**.

The TI portion of the owner's monthly PITI payment is *excluded* from the computation of any late charge amount on a delinquent payment of the monthly installments of PITI.

## The purpose of an impound account

An owner of real estate encumbered by a mortgage is obligated by its terms to timely pay the taxes, bond assessments and insurance premiums, among other obligations. Timely payment protects the mortgage holder against **impairment** of their security interest in the property.

With an *impound account*, the mortgage holder's security interest in the property will not be impaired by defaults in the payment of property taxes, bond assessments and insurance premiums. An impound account is created when the property owner agrees to the terms of an **impound account addendum** attached to the mortgage holder's trust deed. [See Form 455 accompanying this chapter]

Mortgages that do not contain provisions for impounding obligate the owner to independently pay property taxes, insurance premiums, assessment liens and similar charges (the TI portion of the PITI payment) in a timely manner.

From the homeowner's perspective, impound accounts are useful to break up large, annual or semi-annual insurance and tax payments into more manageable monthly installments included with the mortgage. Thus, even if the mortgage does not require an impound account the homeowner may request one.

## Impounds mandated, required and elected

Depending on the mortgage type, an impound account may be mandatory, optional or prohibited.

Impound accounts are **mandatory** for Section 35 higher-priced consumer mortgages.[2]

1 12 Code of Federal Regulations §1026.35

2 12 CFR §1026.35(b)

On the flipside, a mortgage holder is **not permitted to require** an impound account at origination on a first mortgage secured by an owner-occupied one-to-four unit residential property when the loan-to-value ratio (LTV) is less than 90% (regardless of purpose).[3]

Besides those two rules, a mortgage holder **may require** an impound account on other mortgages secured by any type of real estate.

Rules for terminating enforceable impound accounts vary based on the mortgage holder's policies. There are no universal requirements for terminating an impound account that mortgage holders are required to follow.

After origination, the mortgage holder may demand and enforce the establishment of an impound account on a mortgage secured by a one-to-four unit residential property when the owner is delinquent on two or more consecutive property tax payments.[4]

At or after origination, the owner of any type of real estate may request the mortgage holder set up an impound account if the mortgage holder provides this service.[5]

## Components of an impound account

An **impound account provision** in a trust deed or attached addendum establishes rules for handling:

- **initial and monthly deposits** to be paid in amounts based on the owner's annually recurring obligations;
- **reserves** initially deposited as extra funds, used in the event monthly impound payments are insufficient to cover payment of a TI obligation;
- **interest** to be paid by the mortgage holder to the property owner on the impound account balance held by the mortgage holder;
- **surpluses** in an impound account when the balance is greater than necessary to satisfy TI disbursements and reserves, which are either returned to the owner or credited toward the next year's impound account payments;
- **deficiencies and shortages**, arising when the impound account balance is insufficient to pay upcoming TI obligations (a shortage) or the impound account has a negative balance after a TI payment (a deficiency); and
- **accountings**, statements and analyses prepared and delivered to the property owner at least once yearly.

**impound account provision**
A trust deed provision establishing a reserve of the owner's funds for the payment of annually recurring ownership expenses.

## Rules common to all impound accounts

When provisions in a mortgage encumbering **any type** of real estate establish an impound account for taxes and insurance premiums, the mortgage holder is required to:

- set the amount of the **initial deposit** and **monthly deposits** to be made into the impound account; and

3 Calif. Civil Code §2954(a)(1)(A)-(G)
4 CC §2954(a)(1)(C)
5 CC §2954(a); **Kirk** v. **Source One Mortgage Services Corporation** (1996) 46 CA4th 483

- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before they are cancelled.[6]

The **initial deposit** into an impound account on a mortgage secured by any type of real estate is capped at:

- the pro rata amount of annual property taxes and insurance premiums for the period beginning when they were last due and ending on the date of the first installment due on the mortgage; plus
- a reserve of **one-sixth** of this pro rata amount.

Further, the **monthly impound deposit** made with a principal and interest (PI) payment is capped at:

- one-twelfth of the estimated annual payments for taxes and insurance; plus
- any deficiency in the one-sixth reserve for the account.[7] [See Form 455]

However, the mortgage holder or servicer may call on an owner of any type of real estate to pay additional amounts to cover any **deficiency** that develops in the impound account.[8]

Further, the holder of a mortgage secured by an **owner-occupied single family residence (SFR)** may not increase the monthly payments to cover a deficiency until the mortgage holder delivers to the owner:

- an itemized accounting of the amount currently in the impound account;
- notice of the new monthly impound payment; and
- a statement of the reasons the increase is necessary.[9]

## Consumer mortgage deposits, reserves and interest

Consumer mortgages are a federal class of debts:

- incurred to fund a personal, household or family purpose; and
- secured by a one-to-four unit residential property.

The formulas for setting initial impound deposits, monthly TI payments and limits on reserves for any mortgage, consumer mortgages included, are set by California law.[10]

The consumer mortgage holder — like the holder of any mortgage secured by one-to-four unit residential property — is required to pay 2% annual **simple interest** on any balance in the impound account. The 2% *simple interest* accrues annually and is credited to the account balance when annual adjustments are made. When a deficiency exists, the mortgage holder may apply the interest to the deficient balance.

6 CC §2954.1
7 CC §2954.1(a); 12 CFR §§1024.2, 1024.17
8 CC §2954.1(c)
9 CC §2954(b)(3)
10 CC §2954.1(a); 12 CFR §1024.17

**IMPOUNDS ADDENDUM**
Taxes and Insurance

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

**NOTE:** This form is used by a transaction agent, loan broker or escrow officer when originating a mortgage for a lender or carryback seller with an impound account for taxes, insurance and other fixed ownership costs, to document as a trust deed addendum the additional impound payments to be made with the monthly installments of principal and interest.

**DATE:** ______________, 20______, at ________________________________________, California.
*Items left blank or unchcked are not applicable.*

**FACTS:**

**1.** This is an addendum of the Deed of Trust

1.1 ☐ of same date, or dated ________________, 20______, at ______________________________, California,

1.2 executed by ____________________________________________________________, as the Trustor,

1.3 naming ____________________________________________________________ as the Beneficiary.

**AGREEMENT:**

**2.** Trustor will pay Beneficiary, in addition to regular monthly installments on the Note secured by the Deed of Trust, a sum equal to one-twelfth ($^1/_{12}$) of the annual taxes levied on the property and the annual premiums for hazard insurance, mortgage insurance and other insurance required by the Beneficiary.

**3.** An initial deposit of $___________________ is required to establish the impound account.

**4.** Beneficiary will disburse money maintained in the impound account for the payment of taxes, assessments, and insurance premiums.

**5.** Any surplus amounts will be applied toward payment of the principal amount of the Note or future advances secured by the Deed of Trust.

| | |
|---|---|
| **I agree to the terms stated above.**<br>Date: ______________, 20_______<br>Trustor's Name: ______________________________ | Trustor's Name: ______________________________ |
| Trustor's Signature: ____________________________ | Trustor's Signature: ____________________________ |
| Trustor's Name: ______________________________ | Trustor's Name: ______________________________ |
| Trustor's Signature: ____________________________ | Trustor's Signature: ____________________________ |



Form 455

Impounds Addendum

To accrue, the interest will need to be determined for each month of the accounting period based on the account balance at the end of the month. To achieve the 2% annual rate, the minimum required interest is computed at 1/12$^{th}$ of 2% on each end-of-month balance. Any fee charged for maintaining the impound account may not cause the interest received on the account to fall below 2%.[11]

## Consumer mortgage surpluses, deficiencies and shortages

In the event the consumer mortgage holder discovers a surplus of funds during an initial, annual or disbursement analysis of the impound account, the mortgage holder needs to:

- refund the amount to the owner within 30 calendar days of the analysis when the excess is $50 or greater; or
- either refund the amount to the owner or credit the excess funds against the next year's impound payments, when the excess is less than $50.[12]

11 CC §2954.8(b)
12 12 CFR §1024.17(f) (2)(i)

However, when a scheduled payment is more than 30 days delinquent at the time of the account analysis and discovery of the surplus, the consumer mortgage holder may retain the surplus in the impound account if provided by the mortgage trust deed.[13]

When an impound account analysis reveals a *shortage* of less than one month's TI payment, the consumer mortgage holder may:

- allow a shortage to exist and do nothing;
- require the shortage be repaid within 30 days; or
- require the owner to repay the shortage amount in equal monthly payments over a period of 12 or more months.[14]

When the accounting reveals a shortage equal to or greater than one month's TI payment, the consumer mortgage holder has the option to:

- allow the shortage to exist and do nothing; or
- require repayment in equal installments over 12 or more months.[15]

When an impound account analysis confirms a deficiency, the consumer mortgage holder may:

- take no action, allowing the deficiency to exist;
- require the homeowner to repay the deficiency in at least two equal monthly payments; or
- require the homeowner to repay the deficiency within 30 days, when the deficient amount is less than one month's regular TI installment.[16]

When the consumer mortgage holder discovers a shortage in the impound account, they need to notify the homeowner at least once during the calendar year. This notice may be included with the annual impound accounting statement or it may be separate.[17]

## Consumer mortgage impound accounting

A consumer mortgage holder will complete an analysis of the initial and monthly impound deposit amounts and deliver an **initial impound account statement** to the homeowner within 45 calendar days after:

- the close of the escrow; or
- the establishment of the impound account, when the account is requested by the owner either at or after origination.[18]

The initial impound account statement includes:

- the total monthly mortgage payment;
- the portion of the total monthly payment going into the impound account;

13 12 CFR §1024.17(f)(2)(ii)
14 12 CFR §1024.17(f)(3)(i)
15 12 CFR §1024.17(f)(3)(ii)
16 12 CFR §1024.17(f)(4)(i), (ii)
17 12 CFR §1024.17(f)(5)
18 12 CFR §1024.17(g)(1), (2)

- an itemization of the estimated TI obligations the mortgage holder expects it will pay from the impound account; and
- the anticipated disbursement dates of those charges.

The initial impound account statement also indicates the amount of the one-sixth reserve, accompanied by a running trial balance for the account.[19]

## Consumer impound account analysis

A holder of a consumer mortgage with an impound account will conduct an annual impound account analysis. The mortgage holder uses the annual accounting to:

- determine the amount of the property owner's monthly impound account payments for the following year;
- determine whether any surplus, shortage or deficiency exists; and
- prepare and submit an annual accounting statement to the property owner.[20]

The annual accounting provides a detailed history of activity of the impound account as well as projected deposits and disbursements for the coming year. The consumer mortgage holder sends the statement to the homeowner within **30 days** after the end of the **computation year** for the account, along with a copy of the prior year's accounting statement.[21]

**computation period**
For impound account analysis, the 12-month period beginning on the date of the initial impound deposit during which monthly deposits, disbursements and any applicable interest occur.

The accounting statement itemizes:

- the current monthly mortgage payment amount;
- the portion of the monthly payment going into the impound account;
- the prior year's monthly mortgage payment and impound account amounts;
- the total amount paid into the impound account over the *computation year*; and
- the total amount disbursed over the computation year to pay for property taxes and insurance premiums, identified separately.[22]

The statement also shows:

- the current impound account balance;
- an explanation of how the mortgage holder is handling any surplus, shortage or deficiency and how the homeowner is to pay a shortage or deficiency; and
- if applicable, an explanation of why the estimated monthly balance given in the prior year's projection was not attained.[23]

19 12 CFR §1024.17(g)(1)(i)
20 12 CFR §1024.17(c)(3)
21 12 CFR §1024.17(i)-(1)
22 12 CFR §1024.17(i)(1)(i)-(iv)
23 12 CFR §1024.17(i)(1)(v)-(viii)

Figure 1

Impound account deposit

Largest shortfall for disbursements

| | pmt | disp | bal | |
|---|---|---|---|---|
| May | 0 | 0 | 0 | Close of escrow |
| June | 0 | 0 | 0 | |
| July | $400 | 0 | $400 | 1st installment due |
| August | $400 | 0 | $800 | |
| September | $400 | 0 | $1,200 | |
| October | $400 | 0 | $1,600 | |
| November | $400 | $2,050 | -$50 | |
| December | $400 | 0 | $350 | |
| January | $400 | 0 | $750 | |
| February | $400 | $2,050 | -$900 | |
| March | $400 | 0 | -$500 | |
| April | $400 | 0 | -$100 | |
| May | $400 | $700 | -$400 | |
| June | $400 | 0 | 0 | |

However, the holder of a consumer mortgage need not provide an annual impound account statement when:

- the owner is more than 30 days delinquent;
- the mortgage holder has begun the process of foreclosure; or
- the owner is in bankruptcy proceedings.

When the owner cures the default, the mortgage holder has 90 days to provide an accounting statement covering the period from the last annual accounting to the date the mortgage is brought current.[24]

24 12 CFR §1024.17(i)(2)

| | pmt | disp | bal | |
|---|---|---|---|---|
| May | $900 | 0 | $900 | Close of escrow |
| June | 0 | 0 | 900 | |
| July | $400 | 0 | $1,300 | 1st installment due |
| August | $400 | 0 | $1,700 | |
| September | $400 | 0 | $2,100 | |
| October | $400 | 0 | $2,500 | |
| November | $400 | $2,050 | $850 | |
| December | $400 | 0 | $1,250 | |
| January | $400 | 0 | $1,650 | |
| February | $400 | $2,050 | 0 | |
| March | $400 | 0 | $400 | |
| April | $400 | 0 | $800 | |
| May | $400 | $700 | $500 | |
| June | $400 | 0 | $900 | |

Figure 2

Adjusted balances

Lowest initial impound balance

**Business mortgages secured by one-to-four unit residential property**

Business mortgages are not covered by the federal rules for consumer mortgages. However, when a business mortgage (that is, any mortgage not intended to fund a personal, family or household use) is secured by a one-to-four unit residential property, California law controlling the use of impound accounts applies.

Generally, impound accounts are uncommon for business mortgages. However, the mortgage holder may elect to require one when a business mortgage has an LTV greater than 90% and is secured by an owner-occupied one-to-four unit residential property.[25]

Also, when a business mortgage is secured by a one-to-four unit residential property, the mortgage holder is required to pay at least 2% annual simple interest on funds held in an impound account.[26]

25 CC §2954(a)(1)(A)-(G)

26 CC §2954.8(b)

Figure 3

Initial deposit for impound account

Advance deposit to build reserves

| | pmt | disp | bal | |
|---|---|---|---|---|
| May | $1,700 | 0 | $1,700 | Close of escrow |
| June | 0 | 0 | $1,700 | |
| July | $400 | 0 | $2,100 | 1st installment due |
| August | $400 | 0 | $2,500 | |
| September | $400 | 0 | $2,900 | |
| October | $400 | 0 | $3,300 | |
| November | $400 | $2,050 | $1,650 | |
| December | $400 | 0 | $2,050 | |
| January | $400 | 0 | $2,450 | |
| February | $400 | $2,050 | $800 | |
| March | $400 | 0 | $1,200 | |
| April | $400 | 0 | $1,600 | |
| May | $400 | $700 | $1,300 | |
| June | $400 | 0 | $1,700 | |

Excess impound funds will be:

- refunded to the property owner within 30 days after the due date of the TI payment; or
- credited toward the next year's impound payments if previously agreed to.[27]

As with all mortgages secured by one-to-four unit residential property, an annual accounting of amounts deposited into and disbursed from an impound account is provided within 60 days after the end of the calendar year when the owner makes a written request for it. Instead of an annual accounting, the mortgage holder may provide an itemized monthly statement.[28]

27 CC §2954.1(b)
28 CC §2954.2

The homeowner is also entitled to more than one annual accounting, such as a monthly accounting, with a written request to the business mortgage holder and on payment in advance of a fee of:

- $0.50 per statement when requested in advance on a monthly basis for at least one year;
- $1 per statement when requested for only one month; and
- $5 for a single cumulative statement giving all the monthly information back to the last statement given.[29]

## Business mortgages

For business mortgages, including carryback business mortgages, impound accounts are optional requirements for the mortgage holder, but are neither common nor compulsory.[30] [See Chapter 23]

When a property owner agrees to an impound account provision, the impound account is only subject to the rules common to all California mortgages discussed previously.[31]

No requirement for interest on business mortgage impound deposits exist when not secured by a one-to-four unit residential property.

## Impounds and trust fund accounts

A holder of a mortgage on any type of real estate may deposit impound accounts in an out-of-state depository insured by the **Federal Deposit Insurance Corporation (FDIC)** when the mortgage holder is:

- Fannie Mae, Ginnie Mae, Freddie Mac, the Federal Housing Administration (FHA) or the U.S. Departments of Veterans Affairs (VA);
- licensed and certified under federal or state law to do business related to banking;
- a pension fund or profit sharing welfare fund worth $15,000,000 or more;
- a corporation with publicly traded securities;
- the California Housing Finance Agency (CalHFA) or any local housing authority;
- a **syndication** of the above investors organized to purchase promissory notes;
- a **real estate broker** selling all or part of the note to mortgage holders; or
- a licensed residential mortgage lender acting under the authority of its license.[32]

By contrast, on carryback transactions with no present transfer of legal title — called **land sales contracts** — the seller is required to hold the impounded

29 CC §2954(b)
30 12 CFR §1024.5(b)(2)
31 CC §2954.1(b); CC §2954.1(a)
32 CC §2955(b)

funds in a **trust account**. The carryback seller may only disburse trust funds for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise.[33]

## Calculating impound amounts

One method any mortgage holder may use to calculate an impound account balance is found in Appendix E to RESPA.[34]

Consider the origination of a business mortgage secured by any type of real estate. The business mortgage lender (or carryback seller) will also maintain an impound account.

The property owner will incur annual expenses totaling $4,800, consisting of:

- annual property taxes of $4,100, with the first half due on November 1st and the second half due on February 1st; and
- an annual hazard insurance premium of $700, due on May 15th.

The loan escrow will close on May 15th and the first payment is due to the mortgage holder (carryback seller) on July 1st.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month due to disbursements.

The initial deposit and monthly installments for the impound account are calculated based on:

- the mortgage holder making timely disbursements from the impound account; and
- the property owner making monthly installments into the impound account equal to **one-twelfth** of the total annual property taxes and insurance premiums due. [See Figure 1]

From the balances calculated monthly in the impound account in Figure 1, an amount equal to the lowest monthly balance — a deficiency — is to be **initially deposited** by the property owner to keep the impound account balance from dropping below zero during any one month. [See Figure 2]

In our example, February has the largest deficit of $900. [See Figure 1]

Also, a permissible **reserve balance** equal to one-sixth of the total annual disbursements is added to the impound account balance.

Here, the reserve is $800 — one-sixth of the $4,800 in taxes and insurance premiums. Thus, the initial deposit in the impound account is the $900 deficiency (Figure 1) and the one-sixth reserve, which equals $1,700 (Figure 3).

During the first year of mortgage payments, the property owner's monthly payment into the impound account is $400.

33 CC §2985.4

34 12 CFR §1024 Appendix E

## Chapter 14 Summary

The money in the impound account consists of funds the property owner advanced to the mortgage holder as an initial deposit, followed by regularly scheduled further deposits made with monthly principal and interest payments. The impound funds belong to the owner and are disbursed by the mortgage holder for periodically recurring property expenses, such as taxes.

Mortgages that do not contain provisions for impounding obligate the owner to independently pay property taxes, insurance premiums, assessment liens and similar charges in a timely manner.

The formulas for setting initial impound deposits, monthly tax and insurance payments and limits on reserves for any mortgage, including consumer mortgages and those carried back by sellers, are set by California law. Business mortgages are not covered by the rules for consumer mortgages. However, when a business mortgage is secured by a one-to-four unit residential property, California law controlling impound accounts applies.

When a consumer mortgage holder discovers a shortage or delinquency in the impound account, they are required to notify the homeowner at least once during the calendar year.

A holder of a consumer mortgage with an impound account conducts an annual impound account analysis, which provides a detailed history of activity of the impound account as well as projected deposits and disbursements for the coming year.

Monthly impound payments vary each year based on changes in property taxes and homeowners insurance. It’s good practice to review these annual impound statements for common loan servicing mistakes.

## Chapter 14 Key Terms

**computation period** .................................................. **pg. 173**
**impound account** ...................................................... **pg. 167**
**impound account provision** .................................... **pg. 169**

**Quiz 4 Covering Chapters 13-17 is located on page 622.**

*Notes:*

# Chapter 15

# Assignment of rents provisions

## Learning Objectives

After reading this chapter, you will be able to:

- use the uniform rules for a mortgage holder's enforcement of an assignment of rents provision on a default of the trust deed securing income property; and
- advise on how to collect rents and apply them to the mortgage.

## Key Terms

**absolute assignment of rents**
**assignment of rents provision**
**cash collateral**
**conditional assignment of rents**
**mortgagee-in-possession**
**one-action rule**
**self-help**

## The mortgage holder's collection of rent on a default

An **assignment of rents provision** is commonly placed in the trust deeds. This clause creates a lien on unpaid rents as additional security to the real estate described in the trust deed. Rents are property separate and different from the mortgaged real estate.

Following a default, the *assignment of rents provision* in a trust deed gives the mortgage holder the right to collect unpaid rental income from the income-producing real estate described in the trust deed.

The assignment of rents provision is legally referred to as an *assignment of rents, issues and profits clause*, but is limited to rent without concern for other issues or profits.

**assignment of rents provision**
A trust deed clause which creates a lien on unpaid rents as additional security to the real estate described in the trust deed.

**absolute assignment of rents**
A present transfer of all the owner's rights, title and interest in the rents generated by the real estate. Compare with conditional assignment of rents.

**conditional assignment of rents**
A trust deed provision which creates a lien on all rents in favor of the lender. The rents become additional security to the real estate which is also liened by the trust deed. Compare with absolute assignment of rents.

Two types of the assignment of rents provision exist:

- an **absolute assignment**; and
- a **conditional assignment**.

However, the distinction between the two types of assignment of rents provisions is not of concern to the holder of a trust deed recorded on or after January 1, 1997.

Either type of assignment of rents provision contained in a trust deed recorded on or after January 1, 1997, creates a *present security interest* in the rents from existing and future rental and lease agreements for possession of the mortgaged real estate, generally referred to as a **lien on rents**.[1]

The statutory scheme provides for *uniform enforcement* of all assignment clauses entered into on or after January 1, 1997, no longer leaving the terms of enforcement to the mortgage contract.

For those assignment of rents provisions in trust deeds recorded before 1997, the rules based on the distinctions between the two types of rent clauses still govern their *perfection and enforcement*. However, this is essentially a non-existent issue today.

*Editor's note — Unlike liens on real estate or personal property, enforcement of a security interest in rents had not been controlled by the state prior to 1997.*

*Like statutory schemes which control a trustee's foreclosure sale when enforcing a power-of-sale provision in a trust deed, and the creditor's sale of personal property when used as collateral for a loan, the statutory scheme for enforcement of assignment of rents provisions recorded on or after January 1, 1997, controls the procedures for enforcing the collection of rents.*

## Current assignment of rents scheme

A trust deed recorded on or after January 1, 1997 which contains any type of assignment of rents provision establishes a *present security interest* — a lien — on existing and future unpaid rents generated by the property encumbered by the mortgage lien.

This rule applies whether the assignment is defined as *absolute, absolute conditioned on default, additional security, a lien,* etc.[2]

The assignment of rents provision may be in a separate *lien agreement* but is usually placed in the trust deed describing the mortgaged real estate. [See Figure 1]

Once the assignment is recorded, it:

- gives *constructive notice* of the mortgage holder's security interest in the rents; and

1 Calif. Civil Code §2938(a)
2 CC §2938(a)

Figure 1

Excerpt from Form 450

Trust Deed and Assignment of Rents

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.

- is *fully perfected* even though the provision states the lien is unenforceable until a default occurs on the note or trust deed.[3]

Perfection by the recording gives priority to the mortgage holder's security interest in the rents over any security interest in the rents later acquired by other creditors or owners of the real estate.

## Default allows the mortgage holder to collect rents

A default under a trust deed triggers the assignment of rents provision, allowing the mortgage holder to collect the rents received from tenants occupying the property. On default, the mortgage holder may take any of several enforcement steps, including:

- delivering a written *demand for rents* to the *owner*, with a copy to all persons holding a recorded interest in the rents [See Form 456 accompanying this chapter];
- delivering a written *demand for rent* to the *tenants* with a copy to the owner and all persons holding a recorded interest in the rents, such as senior and junior mortgage holders [See Form 457 accompanying this chapter];
- having a *receiver* appointed judicially; or
- taking *possession* of the property and collecting rents nonjudicially, called **self-help**.[4]

**self-help**
One of several enforcement steps taken by a lender when an owner defaults on a post-1996 trust deed, in which the lender takes possession of the property and collects rents nonjudicially.

Whether the mortgage holder seeks the appointment of a receiver, takes possession of the property itself or delivers a notice demanding the rents, the mortgage holder has *commenced enforcement* of its right to the rents. From the moment the mortgage holder commences enforcement of its right to collect the rents by taking one of these actions, the mortgage holder is entitled to collect and receive all rents accrued and unpaid from the time enforcement was commenced.[5]

The written demand served on a tenant for collection of the rent needs to be prepared on a statutorily prescribed form and signed under penalty of perjury by the mortgage holder or their agent. [See Form 457]

3 CC §2938(b)
4 CC §2938(c)
5 CC §2938(c)

Whether the method of enforcement used is judicial or nonjudicial, a mortgage holder's enforcement of its collection rights under an assignment of rents provision does not constitute an action that triggers the **one-action rule**.

The *one-action rule* requires the mortgage holder to first resort to foreclosure on the real estate before pursuing other collection remedies. Thus, enforcement of the assignment of rents provision by collecting rents does not bar a mortgage holder from later foreclosing on the real estate or, on recourse loans, seeking a deficiency judgment against the owner after the property has been foreclosed.[6]

## Written demand on the tenant

**one-action rule**
The prohibition of more than one action to recover a mortgage debt, requiring the mortgage holder to first resort to foreclosure on the real estate before pursuing other collection remedies. The enforcement of the assignment of rents provision by collecting rents does not bar a mortgage holder from later foreclosing on the real estate and, if a recourse mortgage, seeking a deficiency judgment.

After a mortgage holder makes a written demand for rent on a residential or non-residential tenant, all unpaid rents due or becoming due in the future are paid to the mortgage holder, unless:

- the tenant has in good faith previously paid or, within 10 days following receipt of the demand, pays the rent to the owner;
- the tenant previously received a demand for the rents from a different mortgage holder;
- a court order directs the tenant to pay rent differently; or
- the mortgage holder cancels its demand for the rents.[7] [See **RPI** Form 458]

Payment of rent to the mortgage holder under the mortgage holder's demand fully satisfies the tenant's obligation to pay rent to the landlord under their lease or rental agreement. [See **RPI** Form 550 and 551]

The mortgage holder who makes a demand on a *residential tenant* to pay rents may concurrently make a demand on the owner to forward to the mortgage holder any rents collected by the owner after receiving the notice.

By serving a demand for rents on both the residential tenant and the owner, the owner becomes personally liable for those rents the residential tenant pays to the owner within 10 days after the tenant receives the demand notice.

Conversely, *nonresidential tenants* remain liable to the mortgage holder for rent if the nonresidential tenant disregards the mortgage holder's notice and continues to pay the rent to the owner.[8]

By also noticing the owner, the mortgage holder protects itself against the tenant's failure to comply with the demand.

A demand on the owner always imposes personal liability on the owner if they fail to pay the mortgage holder the rent the owner later collects.

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6 CC §2938(e)
7 CC §2938(d)
8 CC §2938(d)(2)

Further, when rent is collected under an assignment of rents provision without the appointment of a receiver (who then is the one to pay the operating costs), the owner may make a demand on the mortgage holder to pay the reasonable costs the owner has incurred to *preserve the property* — including the payment of taxes and insurance premiums — which the mortgage holder is then obligated to pay from whatever rents the mortgage holder collects.[9]

## Reasonable Costs

Costs which are considered reasonable to preserve and protect the property include:

- pool maintenance;
- *common area maintenance (CAM)* charges, whether paid through the rents or paid by the owner;
- repair costs, such as plumbing and roofing; and
- security patrols, if already provided by the owner before the default.

The mortgage holder's payment of costs on a demand from the owner does not make the mortgage holder a **mortgagee-in-possession**, or otherwise obligate the mortgage holder to operate or manage the property.

**mortgagee-in-possession**
A lender who possesses a property, receiving any income it produces, and is obligated to operate or manage the property.

The owner of property subject to a trust deed and assignment of rents lien has the *primary duty* to operate and manage the property when the mortgage holder receives the rents and pays some of the property's operating and ownership expenses, unless a receiver is appointed or the mortgage holder takes physical possession of the property.[10]

Further, the mortgage holder's obligation to pay reasonable property operating expenses on written demand from the owner remains until:

- a receiver is appointed by the court, in which case the receiver pays all further costs incurred to operate the property; or
- the mortgage holder ceases to enforce its assignment of rents clause.[11]

However, the mortgage holder is under no legal obligation to have a receiver appointed in order to enforce its assignment of rents provision.[12]

Also, no penalties exist when the mortgage holder fails to pay costs on the owner's written demand. However, the mortgage holder is liable to the owner for reimbursement of the costs.

*Editor's note — A court-appointed receiver essentially becomes a new owner-operator of the property, charged with the responsibility for the management and care of the property for the duration of the receivership.*

In practice, most mortgage holders secured by a rents clause on rental properties have neither the administrative expertise (staff) nor the will to enforce the clause or receive a voluntary tender of the rents from the owner.

9 CC §2938(g)(1)
10 CC §2938(g)(2)
11 CC §2938(g)(3)
12 CC §2938(g)(4)

**Form 456**

**Demand on Owner to Pay Rent to Lender**

**DEMAND ON OWNER TO PAY RENT TO LENDER**
Under Assignment of Rents

**NOTE:** This form is used by a mortgage holder or their servicing agent when a mortgage secured by an income producing property and its rents is in default, to notify the property owner to forward all rents received to the mortgage holder or servicing agent.

**DATE:** ______________, 20_____, at ____________________________________________, California.

**To Borrower:** ____________________________________________

**1.** ____________________________________________, as the Lender, is the Assignee of leases, rents, issues, and profits under

1.1 a document entitled ____________________________________________,
recorded on ______________, as Instrument No. _________________,
in ____________________________________________ County Records, California.

**2.** In accordance with Calif. Civil Code §2938(c)(4), Borrower is hereby directed to pay to Lender at ____________________________________________, all rents due Borrower under Borrower's leases or other rental agreements with Tenants

2.1 for the occupancy of the property at ____________________________________________
____________________________________________.

**3.** Rents due include rents which are past due and payable and rents which become due and payable on or after the date Borrower receives this demand.

**I declare under penalty of perjury that I have the authority to demand the rents, and that the assignment of leases, rents, issues or profits executed by Borrower or their predecessor in interest is being enforced pursuant to Calif. Civil Code §2938.**

Date: _____________________, 20______
Executed at: ____________________________________________, California.
Lender: ____________________________________________

By: ____________________________________________

**FORM 456** 03-11 

## The mortgage holder's risk when disrupting tenants

Serving tenants with a *statutory notice* to pay the rents to the mortgage holder seems to be an uncomplicated process for the mortgage holder.

While seemingly straight forward, notice to the tenant can lead to more involvement for the mortgage holder than may have occurred had it only made a demand on the owner or sought the appointment of a receiver.

Mortgage holders may view the statutory notice for demanding rents from tenants as a fast and easy way to force the owner into curing a default, and as a way to protect their secured position on the rents.

But before the demand is delivered to the tenants, the mortgage holder needs to, as a practical matter:

- obtain a list of tenant names and addresses; or
- hand deliver the demand to each tenant to get the tenant's name, and then insert the tenant's name on the form before handing it to the tenant.

Further, the mortgage holder needs to order a *title search* to gather the names and addresses of all owners of record and lienholders with a recorded interest in the rents. Title insurance companies will conduct this search for a fee.

## The mortgage holder dilemma

Here, the mortgage holder faces a dilemma: once the mortgage holder makes a demand on a tenant, the demand will adversely affect the income flow from the property, making the owner's cure of the default more difficult and unlikely.

For example, consider an owner who defaults on a mortgage additionally secured by an assignment of rents provision in a trust deed. The owner's default is on a regularly scheduled monthly payment and the result of an unintentional oversight.

The mortgage holder informs the owner of the delinquency.

However, before the owner cures the default, the mortgage holder serves a statutory notice on the tenants demanding the rents be paid to the mortgage holder.

When the tenants receive the demand for rent, the relationship between the owner and the tenants is adversely disrupted. The tenants' confidence in the owner is diminished by the demand for rent notice sent from the mortgage holder.

Many tenants believe a change of ownership is underway, which is a destabilizing event since it creates uncertainties. Some tenants relocate to other property since the demand for rent raises concerns about the owner's solvency and their ability to maintain the property and continue to provide security.

## Further tenant disruption

Continuing our previous example, when tenants leave, the mortgage holder experiences further deterioration in the flow of income from the property since replacement tenants will not be on notice to pay rent to the mortgage holder. The mortgage holder then makes a demand on the replacement residents and risks further disruption of the landlord/tenant relationship with the replacement tenants.

Instead of immediately serving the demand on the tenants, the mortgage holder is best served by first determining whether the owner's default was:

- merely an infrequent delinquency; or
- a serious default worthy of the collection of rents and foreclosure on the real estate, with all the associated disruptive activities.

To investigate the nature of the tenant's default on the rent payment, the mortgage holder contacts the owner *before* serving a statutory notice on the tenants demanding the rents be paid to the mortgage holder. This is prudent practice as the mortgage holder's collection effort requires staff, analysis and a pre-foreclosure workout ethic.

If the mortgage holder determines the default is more serious than an oversight or temporary cash-flow deficiency, the mortgage holder may then seek to work out the default or establish a period of time for the owner to

Form 457

Demand on Tenant to Pay Rent to Party Other than Landlord

**DEMAND ON TENANT TO PAY RENT TO PARTY OTHER THAN LANDLORD**
(California Civil Code §2938)

**NOTE:** This form is used by a mortgage holder or their servicing agent when a mortgage secured by income producing property and its rents is in default, to notify the tenants to forward all payments of rent to the mortgage holder.

**DATE:** ____________________, 20_____, at ______________________________________________, California.

**To Tenant:**______________________________________________
(Name of Tenant)

Property Occupied by Tenant ______________________________________________
(Address)

Landlord ______________________________________________
(Name of Landlord)

Secured Party ______________________________________________
(Name of Secured Party)

Address ______________________________________________
(Address for Payment of Rent to Secured Party and for Further Information)

**1.** The secured party named above is the assignee of leases, rents, issues, and profits under a document entitled ______________________________________________, dated ______________________, and

1.1 recorded on ____________________, as Instrument No. ______________________, in the Official Records of ______________________________________________ County, California.

1.2 You may request a copy of such assignment from the secured party at ________________________________.

**2.** THIS NOTICE AFFECTS YOUR LEASE OR RENTAL AGREEMENT RIGHTS AND OBLIGATIONS. YOU ARE THEREFORE ADVISED TO CONSULT AN ATTORNEY CONCERNING THOSE RIGHTS AND OBLIGATIONS IF YOU HAVE ANY QUESTIONS REGARDING YOUR RIGHTS AND OBLIGATIONS UNDER THIS NOTICE.

**3.** IN ACCORDANCE WITH SUBDIVISION (C) OF SECTION 2938 OF THE CIVIL CODE, YOU ARE HEREBY DIRECTED TO PAY TO THE SECURED PARTY, ______________________________________________ AT ______________________________________________, ALL RENTS UNDER YOUR LEASE OR OTHER RENTAL AGREEMENT WITH THE LANDLORD OR PREDECESSOR IN INTEREST OF LANDLORD, FOR THE OCCUPANCY OF THE PROPERTY AT ______________________________________________. WHICH ARE PAST DUE AND PAYABLE ON THE DATE YOU RECEIVE THIS DEMAND, AND ALL RENTS COMING DUE UNDER THE LEASE OR OTHER RENTAL AGREEMENT FOLLOWING THE DATE YOU RECEIVE THIS DEMAND UNLESS YOU HAVE ALREADY PAID THIS RENT TO THE LANDLORD IN GOOD FAITH AND IN A MANNER NOT INCONSISTENT WITH THE AGREEMENT BETWEEN YOU AND THE LANDLORD.

3.1 IN THIS CASE, THIS DEMAND NOTICE SHALL REQUIRE YOU TO PAY TO THE SECURED PARTY, ______________________________________________ ALL RENTS THAT COME DUE FOLLOWING THE DATE OF THE PAYMENT TO THE LANDLORD.

**4.** IF YOU PAY THE RENT TO THE UNDERSIGNED SECURED PARTY ________________________________, IN ACCORDANCE WITH THIS NOTICE, YOU DO NOT HAVE TO PAY THE RENT TO THE LANDLORD. YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY.

**5.** **FOR NONRESIDENTIAL TENANTS:** IF YOU PAY ANY RENT TO THE LANDLORD THAT BY THE TERMS OF THIS DEMAND YOU ARE REQUIRED TO PAY TO THE SECURED PARTY, YOU MAY BE SUBJECT TO DAMAGES INCURRED BY THE SECURED PARTY BY REASON OF YOUR FAILURE TO COMPLY WITH THIS DEMAND, AND YOU MAY NOT BE DISCHARGED FROM YOUR OBLIGATION TO PAY SUCH RENT TO THE SECURED PARTY. YOU WILL NOT BE SUBJECT TO SUCH DAMAGES OR OBLIGATED TO PAY SUCH RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT ASSIGNEE.

**6.** Your obligation to pay rent under this demand shall continue until you receive either:

6.1 A written notice from a court directing you to pay the rent in a manner provided therein; or

6.2 A written notice from the secured party named above cancelling this demand.

PAGE 1 OF 2 — FORM 457

straighten out their financial affairs before enforcing the assignment of rents. Over a short period of time, the secured mortgage holder has little to lose but patience.

## Property maintenance issues

Sending a demand for rent notice to a tenant also savages a mortgage holder's relationship with the owner. Serving a demand for rent is perceived as a hostile event unless a meaningful dialogue first took place between the mortgage holder and owner.

To compound the hostilities, the owner may burden the mortgage holder with bills to be paid, whether the mortgage holder gives the demand notice for rent to the tenants, the owner, or both.

Further, if tenants have maintenance or security problems, the owner might refuse to correct them due to a lack of rental income, and simply in frustration refer the tenants to the mortgage holder, another example of the adverse effect on the tenant/landlord relationship.

The mortgage holder may then feel obligated to respond as though it was the property manager, even though the mortgage holder is not in possession of the property and the owner is still responsible for its operation.[13]

If the mortgage holder finds collecting the rents is necessary on the owner's default, the best course of action is to seek the appointment of a receiver, preferably selecting a licensed real estate broker experienced in property management.

## Rents collected through a receiver

When a mortgage holder makes the decision to collect rents through a receiver, the mortgage holder immediately serves a notice on the owner demanding the rents. The demand on the owner establishes the date of enforcement and entitlement to unpaid rents from the owner on the owner's default.

The mortgage holder then files a *specific performance action* seeking a receiver. A receiver is appointed without the mortgage holder having to initiate a judicial foreclosure action or trustee's foreclosure on the real estate involved.[14]

The court-appointed receiver is not considered an agent of the mortgage holder. Thus, the mortgage holder is not liable for a receiver's mismanagement of the property.[15]

Although having a receiver appointed is not as easy or inexpensive as making a demand on the tenants or owner for rents, the mortgage holder will not be burdened with accounting for rent collections or disbursement, or property management situations, all of which take time and expertise to administer.

## Accounting for rents received

All rents received by a mortgage holder are first applied to the debt and credited to the amount in default. Thus, the rents collected apply to **reinstate** the debt, except when the mortgage holder complies with the owner's demand to reimburse the owner for reasonable costs of property operations.[16]

However, failure of the mortgage holder to apply rents to the debt will not:

- result in a loss of the mortgage holder's security interest;
- render the debt unenforceable; or

13 CC §2938(g)(2)

14 Calif. Code of Civil Procedure §564(b)(11)

15 **Tourny** v. **Bryan** (1924) 66 CA 426

16 CC §2938(c)

- constitute an action which bars a foreclosure under the one-action rule.[17]

*Editor's note — No statutory sanctions exist to penalize a mortgage holder that does not follow the accounting rules.*

## Priority to rents between lienholders

Now consider property encumbered by a first and second trust deed. Both mortgages contain an assignment of rents provision.

On a default in a payment on both trust deeds, the junior lienholder promptly enforces its assignment of rents provision by making demands for the rents on both the tenants and the owner.

Later, the senior mortgage holder enforces its assignment of rents provision by making its demand for the rents on both the tenants and the owner.

The senior mortgage holder then claims the junior lienholder is required to hand over all rents collected by the junior lienholder after the owner defaulted on the first mortgage.

The senior mortgage holder demands these rents even though the senior mortgage holder did not commence enforcement by notice of its right to the rents until after enforcement by the junior lienholder.

The junior lienholder claims the senior mortgage holder may only collect the rents which were paid after the senior mortgage holder made a demand on the tenants or the owner.

Is the senior mortgage holder entitled to all the rents from the time of the default on the first mortgage?

No! The junior lienholder serving notices under its assignment of rents provision is entitled to collect the rents *until* the senior mortgage holder enforces its right to collect the rents by serving notice.

All rents collected by the junior lienholder prior to the time the senior mortgage holder enforces its assignment of rents provision are uncollectible by the senior mortgage holder as a source of funds to cure the default on its loan.[18]

When the junior lienholder who has enforced its assignment of rents provision receives notice of the senior's enforcement, the junior lienholder is required to then:

- *cease collecting* the rents; and
- *send a notice* to the tenants cancelling its demand for rents.[19] [See **RPI** Form 458]

The junior lienholder's failure to send the cancellation notice will not result in any penalties.

17 CC §2938(c)
18 CC §2938(h)
19 CC §2938(h)

However, the junior lienholder will be liable to the senior mortgage holder for any rents received by the junior lienholder and not forwarded to the senior mortgage holder after the senior mortgage holder enforces its assignment of rents clause.

## Receiving rents after notice

If an owner or a junior lienholder receives rents after a notice of demand for rents from a senior mortgage holder has been served on the owner or tenant, the senior mortgage holder serving notice is entitled to the rents collected following notice.

To recover rents improperly received and withheld by the owner or junior lienholder, the senior mortgage holder may bring an action against the owner or junior lienholder.

The senior mortgage holder's recovery action is not a violation of the *one-action rule*. Again, the dispute over rents is unrelated to the foreclosure of the mortgage lien on the real estate, except for the amount of the debt remaining unpaid (which will require an *underbid* at a foreclosure sale to compensate for the net rent collected).

Further, if a dispute arises between the senior mortgage holder and another party claiming an interest in the rents — such as in bankruptcy — the mortgage holder has a continuously perfected security interest in those cash proceeds from rents which remain identifiable in the hands of the owner (or the court).

To remain identifiable, the cash proceeds will be placed in a segregated account, or traceable if the rent has been commingled with the owner's or junior lienholder's other accounts.

## Owner files a bankruptcy petition

If an owner files for **bankruptcy protection** before their mortgage holder enforces the assignment of rents provision, the mortgage holder retains a security interest in the post-petition rents collected by the owner or bankruptcy trustee since they are considered **cash collateral**.[20]

**cash collateral**
In Chapter 11 Bankruptcy, cash or cash equivalents from the sale of property in which the lender has an interest.

*Cash collateral* may be used by the owner in bankruptcy in limited circumstances, and only then with the consent of the mortgage holder holding a security interest in the rents.[21]

Under the current statutory assignment of rents scheme when no bankruptcy protection has been sought by the property owner, the mortgage holder is only entitled to rents which are paid *after the mortgage holder enforces* the assignment of rents provision. The rule applies whether the rents accrued or became due and unpaid before enforcement.

20 11 United States Code §363(a)

21 11 USC §363(c)(2)

However, when the owner files a bankruptcy petition, cash collateral includes those rents which were due pre-petition if the rents were received:

- after the petition for bankruptcy was filed; and
- after the assignment of rents provision was enforced through a demand for rents by the mortgage holder.

## Chapter 15 Summary

Following a default, the assignment of rents provision in a trust deed gives the mortgage holder the right to collect unpaid rents from the income-producing real estate described in the trust deed. Two types of assignment of rents provisions exist:

- an absolute assignment; and
- a conditional assignment.

A mortgage recorded on or after January 1, 1997 which contains any type of assignment of rents provision establishes a present security interest — a lien — on existing and future unpaid rents generated by the property encumbered by the mortgage lien.

Once the assignment is recorded it:

- gives constructive notice of the mortgage holder's security interest in the rents; and
- is fully perfected even though the provision states the lien is unenforceable until a default occurs on the note or trust deed.

On default, the mortgage holder may take any of several enforcement steps, including:

- delivering a written demand for rents to the owner, with a copy to all persons holding a recorded interest in the rents;
- delivering a written demand for rent to the tenants with a copy to the owner and all persons holding a recorded interest in the rents, such as senior and junior trust deed holders;
- having a receiver appointed judicially; or
- taking possession of the property and collecting rents nonjudicially.

If an owner files for bankruptcy before their mortgage holder enforces the assignment of rents provision, the mortgage holder retains a security interest in the post-petition rents collected by the owner or bankruptcy trustee since they are considered cash collateral.

## Chapter 15 Key Terms



**Quiz 4 Covering Chapters 13-17 is located on page 622.**

*Notes:*

# Beneficiary statements and payoff demands

Chapter 16

## Learning Objectives

After reading this chapter, you will be able to:

- distinguish a mortgage lender's beneficiary statement from their payoff demand;
- explain the process for requesting a beneficiary statement or payoff demand;
- understand when an error in a statement regarding the amount owed the mortgage holder becomes the unsecured debt of the named payor on the note; and
- advise property owners on the recourse versus nonrecourse nature of their mortgage obligations.

## Key Terms

| | |
|---|---|
| **anti-deficiency** | **novation** |
| **beneficiary statement** | **payoff demand** |
| **entitled person** | **reconveyance** |
| **nonrecourse debt** | **recourse debt** |

## The amount and terms of the mortgage debt

Consider a holder of a note and a **blanket trust deed** encumbering more than one parcel of real estate. The owner of the parcels has a partial release agreement with the mortgage holder for the **reconveyance** of individual parcels from the trust deed lien on the owner's payment of a portion of the debt. The agreement is not attached as an addendum to the mortgage holder's recorded trust deed. [See **RPI** Form 280]

**payoff demand**
A written demand, prepared by a mortgage lender, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

**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.

The owner of the parcels negotiates the sale of one of the properties, and a sales escrow is opened. Escrow requests a **payoff demand** from the mortgage holder on behalf of the property owner.

The mortgage holder delivers their *payoff demand* for the amount agreed to in the partial release agreement for the parcel in question. The amount is less that the full amount remaining due on the note. No notation is made on the payoff demand indicating the payment is for less than the entire amount remaining due on the mortgage debt. On the close of escrow, the mortgage holder is paid the amount stated in the payoff demand.

The title insurance company involved monitors trust deed *reconveyances* to verify title is ultimately cleared of liens paid off on properties it insures. The mortgage holder does not cause a reconveyance of the *blanket trust deed* to be recorded within 75 days of payoff.[1]

The title insurer notifies the mortgage holder of its intent to record a "**release of obligation of trust deed**" to fully reconvey the trust deed if the mortgage holder does not do so.

The mortgage holder does not respond and fails to record a partial reconveyance of the trust deed.

Finally, the title insurer records a "*release of obligation under deed of trust*" which fully reconveys the trust deed as authorized by statute. Consequently, the remaining unsold parcels are released from the trust deed lien by the action of the title company.

## A demand is made

On discovery of the full reconveyance, the mortgage holder makes a demand on the title insurer for payment of the balance of the unpaid mortgage debt. The mortgage holder claims the release of the trust deed recorded by the title insurer caused them to lose their security interest in the unsold parcels and thus caused the loss.

The title insurer claims it is not liable for any amount of the unpaid balance due the mortgage holder since they were paid the amount stated in the payoff demand. The title insurer further claims it was the payment of the demand which caused the debt to become unsecured, not the reconveyance which cleared the record title.

Is the title insurer liable to the mortgage holder for the value of the security lost on the full reconveyance?

No! On the close of escrow — payment of the mortgage holder's unconditional demand and the title company's release of the trust deed lien — any sums due which the mortgage holder omitted from the payoff demand are recoverable by the mortgage holder as an unsecured debt remaining owed by the property owner as originally obligated under the note.[2]

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1 Calif. Civil Code §2941(b)(3)

2 CC §2943(d)(3); **Cathay Bank** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 266

Except for the owner, no person involved in a mortgage transaction, including the owner's agents, is liable for any amounts omitted from an unconditional payoff demand.[3]

## The status of the mortgage debt, on request

A mortgage holder states the amounts necessary to pay a mortgage in full by preparing and delivering either a **beneficiary statement** or a payoff demand when requested.[4]

**beneficiary statement**
A written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note. [See **RPI** Form 415]

A request for a *beneficiary statement* is usually made by escrow on the mortgage holder of record. On receipt of the statement, it is relied upon in situations such as:

- a buyer of real estate takes title either subject to the mortgage or by an assumption, with or without a release of liability for the seller;
- a mortgage holder or other creditor receives a trust deed or other lien recorded as a junior encumbrance on the real estate; or
- a tenant acquires or encumbers a long-term leasehold interest in the real estate.

A beneficiary statement is a written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a note. With a mortgage, the debt is secured by a trust deed lien on the real estate described in the trust deed. [See **RPI** Form 415]

A complete beneficiary statement includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the debt;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* for final/balloon payoff of the debt;
- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the mortgage; and
- whether it is possible for the mortgage to be *assumed* by a new owner.[5] [See **RPI** Form 415]

When delivering a beneficiary statement, the mortgage holder is to also provide a copy of the note or other evidence of the debt, including any modifications.[6]

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3 **Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305
4 CC §2943(d)(1)
5 CC §2943(a)(2)
6 CC §2943(b)(1)

However, the statutory scheme controlling beneficiary statements does not require that a payoff demand include delivery of a copy of the note.

## Statements for an ARM obligation

On **adjustable rate mortgages (ARMs)**, the beneficiary statement needs to list the note rate as adjustable, and reference the rate formula.

Formulas for ARM adjustments and payment options vary extensively from mortgage to mortgage. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. To that end, the mortgage holder *attaches a copy* of the ARM note to the beneficiary statement for full disclosure of the index used to calculate the periodic adjustments with the margin which comprises the note rate.

## Requesting a statement

**entitled person**
The original borrower on a note and trust deed, their successor-in-interest or an authorized agent of either who may request, in writing, a beneficiary statement or payoff demand statement.

A mortgage holder need only respond when a written request for a beneficiary statement is made by an **entitled person**. An *entitled person* includes:

- the **property owner** who entered into the mortgage;
- the **successor-in-interest** (new property owner) to the person who originally entered into the mortgage;
- any junior mortgage holder; and
- the **authorized agent** of an entitled person, such as a real estate broker, attorney or escrow agent.[7]

When an entitled person does not *specifically request* a beneficiary statement, the mortgage holder need only send a payoff demand statement.[8]

The request for either statement needs to be in writing and delivered to the mortgage holder by:

- mail, at the address given in the payment notice or payment book; or
- fax.[9]

Before delivering the beneficiary statement or payoff demand, the mortgage holder may require proof the request is being made by an entitled person — proof of ownership or other authority. Thus, the written request from an escrow holder needs to be accompanied by escrow's written authorization to order a statement signed by the entitled person.[10]

Further, any **oral amendment** to either the beneficiary statement or the payoff demand statement given by the mortgage holder requires delivery of a written *amendment* by the next business day. Entitled persons may rely on an amended statement to establish, prorate and adjust payoff amounts for closing.[11]

7 CC §2943(a)(4)
8 CC §2943(e)(1)
9 CC §§2943(a)(3), 2943(e)(5)
10 CC §2943(e)(3)
11 CC §§2943(d)(1), 2943(d)(2)

Form 415

Beneficiary Statement

**BENEFICIARY STATEMENT**
(California Civil Code §2943)

**NOTE:** This form is used by an escrow officer when, on behalf of an authorized person, escrow requests information from the holder of a mortgage on a property in sale or loan escrow to confirm the terms and conditions of the debt owed on the mortgage.

**DATE:** ____________, 20______, at ______________________________________________, California.
**TO:** ______________________________________________
(Name and address of party requesting statement)
______________________________________________

**Loan No.** ______________________________________________
We are the holder(s) of a promissory note for $______________, dated ________________,
made by ______________________________________________,
and secured by a Trust Deed recorded on ______________________, as Instrument No. ________________,
in ______________________________________________ County, California,
as a lien on property referred to as ______________________________________________
______________________________________________.

**1.** Present principal balance....................................................$ ____________
   1.1 Additional charges, costs or expenses advanced by Lender under its lien ....................$ ____________
**2.** Balance in impound/escrow accounts....................................................$ ____________
**3.** Rate of interest:
   3.1 Annual fixed rate of interest is ______%
   3.2 Present note rate of interest adjustable per the note is ______%
   ☐ Attached is a copy of the note containing adjustment formulas.
**4.** Interest is paid through ____________, 20______.
**5.** Taxes and special assessments are paid through ____________, 20______.
   5.1 Taxes and special assessments for the fiscal year of ______ and ______ were.......................$ ____________
**6.** Payments are delinquent for the months of ______________________________.
   6.1 Total amount of delinquencies to bring the loan current is ........................................$ ____________
   which includes any late charges and foreclosure costs.
**7.** Monthly payments are due on the __________________ day of each month.
   7.1 Monthly payments are comprised of:
   Interest only ....................................................$ ____________
   Principal and interest ....................................................$ ____________
   Tax impounds of ....................................................$ ____________
   Hazard insurance premium impounds....................................................$ ____________
   **TOTAL** monthly payments....................................................$ ____________
   The taxes and premiums are subject to change.
**8.** The principal balance is all due and payable on ______________, in the amount of $______________.
**9.** Hazard insurance is described as follows:
   Insurance Company ________________________ Expiration Date ____________, 20______.
   Insurance Agent ________________________ Policy Term from ____________ to ______________
   Policy Number ________________________ Amount of Premium $______________
   Amount of Coverage $______________
**10.** ☐ The Trust Deed securing the note contains a due-on-sale clause requiring Lender's consent and approval on any transfer of an interest in the secured real estate.
**11.** ☐ As requested, a copy of the Trust Deed securing this note is attached.
**12.** ______________________________________________
______________________________________________

Date: ______________, 20_____

Beneficiary: ______________________________

**FORM 415** 10-14 

However, any error in a statement regarding the amount owed the mortgage holder becomes the **unsecured debt** of the person named in the original note once:

- escrow closes;
- title is transferred; or
- a trust deed is recorded.[12]

When the statement from a mortgage holder is amended prior to the close of escrow or a trustee's sale, the amounts listed in the amended statement control, whether the statement is a payoff demand or a beneficiary statement.[13]

12 CC §2943 (d)(3)(A)
13 CC §2943(d)(3)(B)

## An understated example

For example, an owner refinances an existing mortgage with a new lender. The payoff demand from the existing mortgage holder understates the amount due. The new lender funds the amount stated in the payoff demand and the existing mortgage is reconveyed.

Later, the paid-off mortgage holder realizes their mistake in the amount of the payoff and seeks to recover the underpayment from the new lender. The paid-off mortgage holder claims the new lender is liable for the unpaid amount since it funded the payoff which was inadequate to fully satisfy the debt.

The new lender claims the property owner who signed the note is liable for the unpaid amount since only the owner signing the note is obligated for any amount due that remains unpaid on reconveyance of the trust deed.

Is the new lender liable for the unpaid amount since it funded the payoff?

No! The mortgage holder delivering an erroneous payoff demand may only recover amounts remaining unpaid from the original signer of the note evidencing the debt. The person named in the note is the sole source of recovery for amounts understated in the payoff demand.[14]

**anti-deficiency**
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

On the sale of a property, when a prepayment penalty, late charge, attorney fees or other enforceable charges are not included in a payoff demand, the charges become unsecured obligations of the original payor on the note, not the buyer. However, collection of any underpaid amount is limited by **anti-deficiency rules** to the value of the property at the time of the payoff.[15]

## Timely delivery required

Delivery of a beneficiary statement by the holder of any type of mortgage is to be made within 21 days of their receipt of the written request from an entitled person.[16]

The mortgage holder may not charge more than $30 for each beneficiary statement, with the exception of mortgages insured by the **Federal Housing Administration (FHA)** or the **U.S. Department of Veterans Affairs (VA)**. Occasionally, the trust deed states a lesser amount which then controls the charge.[17]

When a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the mortgage holder needs to supply copies of the document at no extra charge.[18]

The mortgage holder's *intentional failure* to send the statement within 21 days of receipt of request results in the mortgage holder's forfeiture of $300 to the person making the request. Also, the mortgage holder is liable for all money losses resulting from its intentional failure to comply.[19]

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14 **Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305
15 **First Nationwide Savings** v. **Perry** (1992) 11 CA4th 1657
16 CC §2943(b)(1)
17 CC §2943(e)(6)
18 CC §2943(e)(2)
19 CC §2943(e)(4)

However, the mortgage holder's failure to timely deliver the statement needs to be proven to be an intentional failure without legal excuse before the entitled person making the request may recover a penalty — a very difficult burden.

## Mortgage payoff demand

A *payoff demand statement* is a written demand, typically the result of a request from escrow. It is prepared by the mortgage holder and delivered to escrow stating the amounts required as of the date of preparation to pay off the mortgage debt and reconvey the trust deed.

The statement includes information and formulas escrow is to use to calculate on a per diem basis the payoff amount after the date it is issued. The statement is effective for 30 days; less when the mortgage terms will change earlier such as on notes with adjustable interest and payments.[20]

The payoff demand, as with the beneficiary statement, is required to be delivered within 21 days of receipt by the mortgage holder on a written request from an entitled person. The charge for this service is limited to $30, unless the loan is insured by the FHA or VA.[21]

Further, intentional failure to timely reply to a request for a payoff demand also results in the mortgage holder's forfeiture of $300 and liability for any resulting money damages.[22]

Occasionally, a mortgage may be in foreclosure and the notice of sale has been published for a trustee's or judicial sale of the property. Here, a separate rule applies to requests for statements during the notice-of-sale period. The mortgage holder need not respond to requests for a payoff demand received on or after publication of the foreclosure sale.[23]

## Requests received during the foreclosure process

The request for a beneficiary statement or payoff demand statement may be made at any time up to two months after the recording of a **notice of default (NOD)**. During this time, the mortgage holder is obligated to respond.[24]

When the mortgage is in foreclosure, an entitled person may request a payoff demand until the publishing of:

- the **notice of trustee's sale (NOTS)** in a nonjudicial foreclosure; or
- the **notice of sale** in a judicial foreclosure.[25]

However, part of complying with the foreclosure process requires the mortgage holder to provide the owner-in-foreclosure with an accounting of the exact amount due to **reinstate** or **redeem the mortgage**.

20 CC §2943(a)(5)
21 CC §§2943(c), 2943(e)(6)
22 CC §2943(e)(4)
23 CC §2943(c)
24 CC §2943(b)(2)
25 CC §2943(c)

Procedurally, the recorded *NOD* states the beneficiary will provide the owner-in-foreclosure with accurate information in response to the owner's written request to determine the exact amount to be paid to stop the foreclosure.[26]

Consider a beneficiary statement or payoff demand that is requested after an NOD is recorded, and the mortgage is not reinstated or paid in full. When an error exists in the amount requested and the property is sold at a foreclosure sale for a price based on the error, the amount of the error becomes the unsecured obligation of the payor on the note on completion of the foreclosure sale.[27]

Also, once the mortgage holder is tendered the amount demanded to pay off the debt, the omitted amounts become unsecured. The owner originally signing the note remains liable for the unpaid amount which is now unsecured and payable on the terms set forth in the note.[28]

The mortgage holder may enforce collection without first foreclosing since the security has been reconveyed.

## Nonrecourse vs. recourse obligations after payoff

When a mortgage holder forecloses on a purchase-assist mortgage secured by a buyer-occupied, one-to-four unit residential property, they are barred from obtaining a judgment against the foreclosed owner for any deficiency in the value of the property to cover the amount owed. These mortgages are considered **nonrecourse debt**, also called **purchase-money** paper. Likewise, carryback notes secured only by the property sold are also *nonrecourse*, *purchase-money* paper.

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

Occasionally, a mistake is made by the mortgage holder in the amount of a payoff demand or beneficiary statement for a nonrecourse mortgage. Here, the mortgage holder is barred from recovering losses in excess of the property value to cover the correct amount due at the time of the erroneous payoff demand.

The amount of the error is an unsecured purchase-money obligation of the original buyer signing the note, but the amount remains nonrecourse debt. The character of the debt did not change — it only became unsecured.[29]

Since an error in the payoff demand on nonrecourse paper is still a nonrecourse debt, the mortgage holder is limited to a money judgment for the difference between the amount received and the value of the property at the time of the initial payoff.[30]

Further, an error made in the beneficiary statement or payoff demand for a **recourse debt** also converts the amount of the understatement or underpayment to an unsecured debt. However, recovery on a *recourse debt* is not limited to the value of the property on the date of the payoff.[31]

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

26 26 CC §2924c(b)(1)
27 CC §2943(d)(3)(B)
28 CC §2943(d)(3)
29 CC §2943(d)(3)
30 **Ghirardo** v. **Antonioli** (1996) 14 CA4th 39
31 Calif. Code of Civil Procedure §726(b)

The mortgage holder who demands and is paid an erroneous amount on payoff of a *recourse debt* may proceed directly to litigation for a money judgment to collect the now unsecured amount, without regard to the value of the property.

Thus, sellers are exposed to continuing liability for mortgages they owed as original or assuming buyers when the property is sold subject to the existing mortgage.

## Selling property subject to a mortgage

When a buyer acquires property subject to or by assumption of an existing mortgage, the real estate remains the mortgage holder's primary source for debt recovery — the buyer becoming the primary source of payments. However, the seller is considered a guarantor — secondarily liable for payment of the mortgage — unless any assumption included a significant modification to which the seller did not consent or the seller is released of liability.[32]

When the buyer who purchases the property later resells the property and a mistake is made in the beneficiary statement prepared by the mortgage holder leading to a deficiency on payoff, then the seller, as a guarantor of payments, is liable for the error.

Thus, the seller who enters into a written assumption of the mortgage with the mortgage holder may feel compelled to condition the closing of any sale on a *release of liability* from the mortgage holder for any future errors in the beneficiary statements, called a **novation**.

**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.

The release eliminates the seller's risk of liability for a future error by the mortgage holder in payoff demands or beneficiary statements.[33]

In a *novation*, as with an assumption, the buyer promises to perform the duties of the original owner. In addition, the mortgage holder agrees to release the seller from all liability for the debt under the novation.

32 **Braun** v. **Crew** (1920) 183 CA 728

33 CC §1531

## Chapter 16 Summary

A mortgage holder states the amounts necessary to pay a mortgage in full by preparing and delivering either a beneficiary statement or a payoff demand when requested.

Any error in a statement regarding the amount owed the mortgage holder becomes the unsecured debt of the person named in the original note. However, collection of any underpaid amount is limited by anti-deficiency rules to the value of the property at the time of the payoff.

A payoff demand statement is a written demand, typically the result of a request from escrow. It states the amounts required as of the date of preparation to pay off the mortgage debt and reconvey the trust deed.

The request for a beneficiary statement or payoff demand statement may be made at any time up to two months after the recording of a notice of default (NOD).

When an error exists in the amount requested and the property is sold at a foreclosure sale for a price based on the error, the amount of the error becomes the unsecured obligation of the payor on the note on completion of the foreclosure sale.

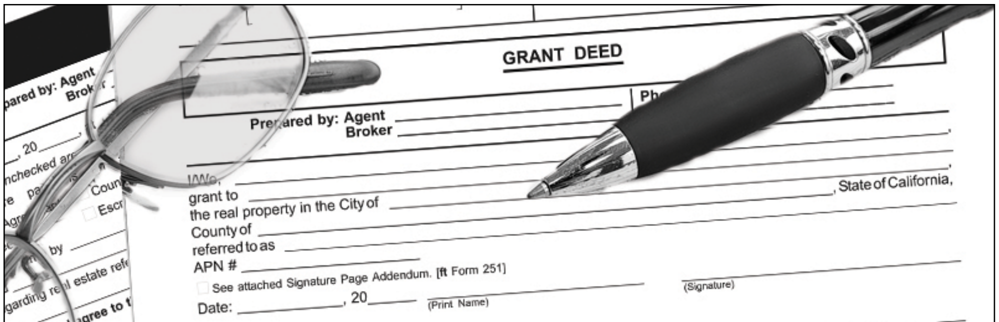
However, when a mortgage holder forecloses on a purchase-assist mortgage secured by a buyer-occupied, one-to-four unit residential property, they are barred from obtaining a judgment against the foreclosed owner for any deficiency in the value of the property to cover the amount owed.

In contrast, recovery on a recourse debt is not limited to the value of the property on the date of the payoff.

## Chapter 16 Key Terms

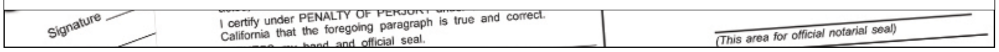


**Quiz 4 Covering Chapters 13-17 is located on page 622.**




# Chapter 17

# Grant deed as a mortgage




## Learning Objectives

After reading this chapter, you will be able to:

- recognize the recharacterized nature of a grant deed when used to hold title to property as security until a debt is fully repaid;
- appreciate the risks inherent in using a grant deed to document the lender's interest in the properties; and
- understand the proper use of a trust deed to document and create a security interest in property.

## Key Terms

**redemption**

**secured loan transaction**

**sale-leaseback and purchase option arrangement**

## Risks in alternative security devices

Consider a parcel of real estate encumbered by a mortgage securing a loan which is coming due. The **loan-to-value ratio (LTV)** is 70%. The owner of the real estate does not have sufficient funds of their own to pay off the mortgage.

The owner attempts to refinance the property but is unable to arrange new financing. Eventually, a private investor is located who advances the funds needed to pay off the mortgage on the property. The investor wants to be repaid in two years.

As security for the repayment of funds advanced, the owner conveys title of the real estate to the investor by a **grant deed**. However, the owner retains possession of the property under a *net lease agreement*. Thus, the owner remains responsible for all the maintenance of the property and payment of:

- all property taxes;

- insurance premiums; and
- other costs ownership incurs.

**sale-leaseback and purchase option arrangement**
A disguised mortgage arrangement created when a seller conveys title to an investor/lender and retains possession under a lease agreement with the right to repurchase title and redeem the property for a fixed dollar sum.

To document the arrangements, the owner, on handling their grant deed to the private investor, is given the net lease agreement and an option to repurchase the property, called a **sale-leaseback and purchase option**.

The rent installments and a single balloon payment due on exercise of the option equal the amount advanced and the earnings sought by the private investor.

Did the grant deed from the owner convey *fee simple ownership* of the property to the investor?

**secured loan transaction**
A mortgage transaction which places a lien on the owner's interest in a property for the amount of the debt owed the mortgage holder, including financial transactions documented by sellers as sale-leaseback and purchase lease-option arrangements.

No! The *sale-leaseback and purchase option* transaction is not a sale. Rather, it is a **secured loan transaction**, a *mortgage-in-fact* by documentation of the arrangements by other than a note and trust deed.

Thus, delivery of a grant deed simply imposed a lien on the owner's fee interest in the property for the amount of the debt owed to the investor, since:

- the owner remains in possession of the property and pays all property taxes, insurance and operating costs;
- the amount of the sale-leaseback pricing is not based on the value of the property; and
- the repurchase option indicates the owner and lender intend for the owner to pay back the amount advanced plus a fixed return and be reconveyed title to the property.

## Recharacterized as a mortgage

By an analysis of the economic function of the transaction, the grant deed conveying legal title to the lender is *recharacterized as a mortgage*.

The deed grants the investor a security interest in the real estate in the form of a lien on the property for repayment of the amounts advanced. It does not function as a conveyance of an ownership interest which shifts the risks of loss or the right to evict occupants to the investor.

Here, the grant deed, like a trust deed, does not convey an ownership interest in the real estate. Instead, it merely establishes a lien in favor of the grantee for recovery of money – limited to foreclosing judicially as though the investor was a beneficiary under a trust deed but without the right to a trustee's foreclosure.[1]

## A mortgage-in-fact by grant deed

A grant deed is used as the fundamental document for transferring fee ownership of real estate from a seller to a buyer. At first glance, one assumes a new ownership has been established whenever a grant deed is recorded.

1 **Orlando** v. **Berns** (1957) 154 CA2d 753

The buyer acquires title and the right of possession to the property conveyed, subject only to those encumbrances known to exist affecting title to the property.[2]

However, a grant deed given by an owner for the sole purpose of securing the future *performance of an obligation* — such as the payment of money — is considered a *mortgage*. Thus, the grant does nothing more than impose a lien on the property, and does not represent a transfer of title or ownership.[3]

When a grant deed is given to secure a repayment arrangement, the owner portrayed as a seller (*grantor*) remains the true owner of the property, subject to the security interest granted to the investor which, though cloaked in terms of a buyer (*grantee*), is merely a secured lender by recharacterization of the grant for what it is — a mortgage.

Thus, the rights and remedies of the grantor and grantee under the grant deed are analogous with those of an owner and lender, not a seller and buyer or a landlord and tenant when repayment of money advanced by the seller is involved.

## An owner's risks when giving a deed as a mortgage

An owner using a grant deed to provide a lender with security for the repayment of debt creates many risks of loss. It is inherently precarious since a recorded grant deed:

- fosters confusion based on the county records as to who owns the real estate in the event the owner later decides to sell, further encumber the property or rent it out;
- triggers the due-on clause in any existing trust deeds on the real estate;
- gives rise to an inquiry by the county assessor as to whether a change of ownership has occurred, triggering property reassessment; and
- allows the lender who now holds title to further convey the property to others, refinance or further encumber the property, or attempt an eviction upon the owner's default without first judicially foreclosing.

## Transfer of title vs. a security interest

Whether a grant deed conveyance constitutes a mortgage or a *change of ownership* depends on all aspects of the transaction, including:

- whether a substantial difference exists between the price to be paid to repurchase title to the property under an option and the property's fair market value (FMV);
- who assumes the ownership duties of the property; and
- the parties' intentions, evidenced by written documents, such as:
  - purchase agreements;
  - escrow instructions;
  - loan documents;

2 Calif. Civil Code §1105

3 CC §2924

- leases; and
- repurchase options.

For example, consider a real estate investor who receives a grant deed, assumes the existing liens, takes possession of the property, collects rents, pays taxes and insurance premiums and maintains the property. Here, the investor is acting as the owner of the property.

When the investor assumes the duties of ownership, the grant deed is treated as a true change of ownership, even if an option to repurchase the property is granted to the seller in the sales transaction.[4]

## Due-on sale and reassessment

Under normal circumstances, further encumbering an owner-occupied, single family residence (SFR) with a junior lien does not trigger a senior lender's **due-on clause**.[5] [See Chapter 19]

However, a grant deed used as security for a mortgage is not only a further encumbrance, but a transfer of legal title on the face of the document. The grant deed can thus lead to due-on enforcement, since the *due-on clause* in an existing trust deed is triggered by the conveyance of any interest in real estate, including a:

- lease coupled with an option to purchase the property;
- lease with a term over three years; or
- land sales contract.[6]

A junior trust deed will not lead to the senior lender calling the mortgage on an owner-occupied SFR. However a grant deed used to document the same transaction will trigger the due-on clause unless it can be shown to the lender that the transaction is a secured transaction not a change in ownership.

A further risk exists regarding *reassessment* by the county assessor. A grant deed indicates a change of ownership. However, the transfer of a security interest in real estate, even by a grant deed given as a mortgage-in-fact, is not considered a change of ownership for property reassessment purposes.[7]

Thus, to avoid reassessment, the true owner must demonstrate to the assessor (or the assessment appeals board) that the grant deed is only a *lien* on their title to the property. According to this evidence, it needs to be shown the grant deed was not intended to transfer any rights of ownership.

## Subsequent buyers

An owner who uses a grant deed to convey title to property they own to secure repayment of a loan also faces the possibility the investor who advances the funds needed to pay off the mortgage on the property might deed the property to others, become incapacitated or die. In this instance, who is to reconvey on payoff when a trust deed is not used?

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4 **Develop-Amatic Engineering** v. **Republic Mortgage Co.** (1970) 12 CA3d 143

5 12 Code of Federal Regulations §591.5(b)(1)(i)

6 12 CFR §591.2(b)

7 Calif. Revenue and Taxation Code §62(c)(1)

Whether the conveyance of the property by the lender to another party constitutes a valid sale depends on whether the buyer has notice of the borrower's ownership interest in the property.

For example, if an owner executes a grant deed as security for a loan and remains in possession of the real estate and acts as the owner of the property, a third party buyer or mortgage lender is on notice to inquire into the rights of the person in possession (the owner).[8]

Also, the buyer may have constructive notice of the owner's rights based on a recorded document, such as a *lis pendens* or any other document relating to the loan transaction for which the grant deed is security.

If the buyer has notice of the owner's rights, the buyer is not considered a **bona fide purchaser (BFP).** Thus, the buyer does not acquire any greater title or interest in the property than was held by the lender under the grant deed giving them a lien on the property as security.

However, if the buyer acquires the property without receiving actual or constructive notice of the owner's rights — i.e., without being aware the grant deed to the lender functioned as a mortgage — the buyer acquires clear title as a *BFP*.[9]

The owner cannot recover the property from a buyer who is classified as a BFP. The owner's only remedy is to recover their lost equity in the property from the lender.[10]

## A lender's grant deed mortgage risks

The private lender who holds a grant deed as the device used to secure repayment of the funds they advance has concerns which include:

- possible *usury claims* by the owner if the amount of the installments and repurchase price exceeds the amount of the funds advanced by more than the allowable average annual yield [See Chapter 38];
- the need to *foreclose judicially* to exhaust the **right of redemption** if the owner defaults, since the grant deed, when recharacterized as a security device, does not contain a power-of-sale provision, as does a trust deed;
- compliance with *equity purchase (EP) laws* if the property is an owner-occupied, one-to-four unit residential property in foreclosure;
- compliance with licensing and loan repayment terms under federal mortgage law for consumer mortgages secured by one-to-four residential units [See Chapter 2]; and
- *tax reporting* as an owner or lender. [See Chapter 51]

**redemption**
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

Thus, in any mortgage transaction, a simple note and trust deed is a far better choice of documentation to express and establish the rights and obligations of both the lender and the borrower than a grant deed.

8 **Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356
9 **Carpenter** v. **Lewis** (1897) 119 C 18; CC §2950
10 **Segura** v. **McBride** (1992) 5 CA4th 1028

## Usury

A private lender using a grant deed as a security device may be charging a usurious rate of interest under California law, unless the mortgage is exempt as being made or arranged by a mortgage broker.[11]

When a grant deed with a leaseback and repurchase option is used to secure a mortgage, the interest charged is calculated as the difference between:

- the amount of the funds advanced by the lender, which is the amount of the mortgage; and
- the repurchase price to be paid by the borrower and rent payments.

Since a sale-leaseback transaction is considered a mortgage, *usury laws* limit the amount of the repurchase price (repayment of the loan plus a yield calculated as interest) the lender may charge the borrower. [See Chapter 43 and 44]

## Equity purchase rules

Equity purchase laws protect owners who enter into sale-leaseback transactions on owner-occupied, one-to-four unit residential property *in foreclosure* in which a grant deed conveys title to the property as security for a mortgage.[12]

If the EP agreement grants the seller an *option to repurchase* the property, the transaction is considered a mortgage which grants only a security interest. [See **RPI** Form 156; see Chapter 36]

## Broker's duty to advise

A broker advising the use of a grant deed as a mortgage to secure an otherwise legal loan transaction is not liable for malpractice since the lender receives security for the loan.[13]

However, the broker who gives such advice does not serve the best interests of their client. Given the heinous disadvantages for both the lender and the owner when a grant deed is used as a mortgage, the conventional note and trust deed is always a better form for documenting a real estate loan transaction.

11 Orlando, *supra*

12 Segura, *supra*

13 **Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25

## Chapter 17 Summary

The sale-leaseback and purchase option transaction is not a sale, but a secured loan transaction.

A grant deed is typically used to transfer the fee ownership of real estate from a seller to a buyer. However, a grant deed given by an owner for the sole purpose of securing the future performance of an obligation — such as the payment of money — is considered a mortgage. However, when an investor assumes the duties and risks of ownership, the grant deed transferring title to the investor is treated as a true change of ownership, even if a repurchase option is included in favor of the seller.

A simple note and trust deed is a far better choice of documentation to express and establish the rights and obligations of both the lender and the borrower than the use of a grant deed as a mortgage-in-fact.

## Chapter 17 Key Terms



**Quiz 4 Covering Chapters 13-17 is located on page 622.**

*Notes:*

# Chapter 18

# Equity purchase: sale-leaseback, no option

## Learning Objectives

After reading this chapter, you will be able to:

- understand a sale-leaseback arrangement coupled with a repurchase option is recharacterized for its legal and tax consequences; and
- identify the loss of ownership benefits when an equity purchase (EP) investor grants an option to repurchase the property to the seller.

## Key Terms

**equity purchase (EP) investor**

**equity purchase (EP) transaction**

**holdover tenancy**

**mortgage-in-fact**

**reinstatement**

**reverse lease-option**

**right of rescission**

## The home-in-foreclosure sales scheme

An **equity purchase (EP) transaction** occurs when:

- an owner-occupant transfers title of a one-to-four unit residential property in foreclosure under a recorded Notice of Default (NOD); and
- title to the property is acquired by a buyer for rental, investment or dealer purposes, or a person advancing funds which are to be repaid, called an **EP investor**.

EP rules apply to all EP transactions without exemptions.

Conversely, an EP transaction does not occur and the EP rules do not apply if:

- the buyer who acquires title to the property occupies it as their *personal residence*, such as the classic buyer-occupant of a home; or
- a lender originates a trust deed loan for the acquisition of the property.

**equity purchase investor**
A person who acquires title to a seller-occupied, one-to-four unit residential property in foreclosure for dealer, investment or security purposes.

The EP codes distinguish *principal residence* of the seller from *personal use* of a residence by the seller. The seller of a **principal residence** comes under the protection of EP codes. However, buyers avoid application of the EP code by meeting the test of using the property as their **personal residence**.

Thus, a buyer's acquisition of a second home or vacation home for "personal use" is legislatively excluded from the EP laws which implicitly includes their use of the property acquired as their principal residence. All other uses are considered *investment purposes*.

The equity purchase statutes apply to all investors, without regard to the number of EP transactions the investor completes. Thus, for the EP statutes to apply, the investor is not required to be *in the business* of purchasing or advancing funds on homes in foreclosure.[1]

## Structuring and negotiating the EP transaction

An EP investor and all brokers involved need to use a written agreement configured and containing statutorily mandated EP notices. Failure to use the correct forms subjects the investor and the brokers to liability for all the losses incurred by the seller-in-foreclosure, plus severe penalties.[2] [See **RPI** Form 156]

After entering into an EP sale, a *seller-in-foreclosure* has a statutory five-business day *right to cancel* the sales agreement they have entered into with an investor. Cancellation avoids the sale entirely.

The seller-in-foreclosure's five-business day *right to cancel* does not commence until proper notice of the cancellation period is given to the seller, whether given before or after the transaction is closed. Thus, the notice is contained in the purchase agreement forms designed for **equity purchase transactions** to trigger the running of the cancellation period beginning when the seller accepts an offer.[3] [See **RPI** Form 156 §19]

**equity purchase transaction**
A sales transaction in which a one-to-four unit residential property in foreclosure, occupied by the owner as their principal residence, is acquired for dealer, investment or security purposes by an investor. [See **RPI** Form 156]

Further, and until expiration of the seller-in-foreclosure's right to cancel the transaction, the EP investor may not:

- *accept a conveyance* from the seller of any interest in the property;
- *record a conveyance* of the residence with the county recorder;
- *transfer an interest* in the property to a third party;
- *encumber any interest* in the residence; or
- *hand the seller* a "good faith" deposit or other consideration.[4]

1 **Segura** v. **McBride** (1992) 5 CA4th 1028
2 Segura, *supra*
3 Calif. Civil Code §§1695.4, 1695.5
4 CC §1695.6

In negotiations with the seller-in-foreclosure, the EP investor may not misrepresent:

- the *value of the property* in foreclosure;
- the *net sales proceeds* the seller will receive on closing escrow;
- the *terms of the purchase agreement* or any other document the EP investor uses to induce the seller to sign; or
- the *rights of the seller* in the EP transaction.[5]

## Cancellation and rescission

Cancellation of the purchase agreement by the seller-in-foreclosure is *effective on delivery* of the signed written notice of cancellation to the EP investor's address in the purchase agreement.

When the cancellation period expires for lack of cancellation, the purchase agreement becomes enforceable and escrow may be closed — unless other conditions remain to be eliminated.

After escrow closes, the EP investor's title remains subject to the seller-in-foreclosure's **right of rescission** for two years. The rescission is to be based on some *unconscionable conduct* of the EP investor. As a matter of public policy, the seller's two-year right to *rescind and recover* the property from the EP investor cannot be waived by the seller.[6]

**right of rescission**
The right to cancel a completed transaction such as a sale or letting of property, including restoration, after the transaction has been closed.

An EP investor who violates the five-day cancellation period or takes *unconscionable advantage* of the seller-in-foreclosure will be subject to:

- imprisonment for no more than one year;
- a fine no greater than $25,000; or
- both imprisonment and a fine for each violation.[7]

Also, any broker representing an EP investor needs to provide the seller-in-foreclosure with proof they are a currently licensed real estate broker.[8] [See **RPI** Form 156 §14.1]

## A mortgage or tenancy on breach?

Consider a homeowner who defaults on their mortgage secured by a trust deed on their home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are in turn advised of the NOD. An EP investor tracking NOD recordings as a subscriber contacts the homeowner, intending to investigate the property for suitability and acquisition.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

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5 CC §1695.6(d)
6 CC §§1695.10, 1965.14
7 CC §1695.8
8 CC §1695.17(a)

However, the homeowner queries the EP investor about their desire to retain possession of the residence with the intent to buy back the property when their personal financial situation improves.

As an alternative to the EP investor's offer, the homeowner proposes a *sale/lease-option* arrangement in which:

- the investor acquires title to the property by investing only the funds needed by the owner to cure the delinquent mortgage payments and property taxes, and pay the annual property insurance premium and foreclosure costs;
- the seller-in-foreclosure remains in possession under a lease with sufficient rental payments to cover the investor's costs of ownership; and
- the owner is given an *option to repurchase* the residence at a price to include a profit for the investor.

The EP investor refuses. The investor claims the grant of a purchase option to the owner will:

- transform the investor's intended purchase into a disguised mortgage transaction;
- bar the investor from conveying title or encumbering the property at any time without the owner's further consent; and
- deprive the investor of the investment and tax benefits of owning real estate.

As a result, the investor and the owner reach a compromise. They enter into an EP agreement that provides the owner with a six-month *holdover tenancy* — no repurchase option included.

Has the EP investor correctly represented the mortgage and tax consequences of holding title subject to a repurchase option as a loan, called a **mortgage-in-fact**?

**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.

Yes! A sale-leaseback and purchase option arrangement is a *mortgage*. Thus, the EP investor will have made a loan, not a purchase of ownership of the property. When an owner occupying a one-to-four unit residential property as their principal residence conveys title in exchange for money to cure delinquencies and the right to retain possession with an *option to repurchase* the property, a mortgage has been negotiated, not a sale.

## Mortgage in disguise

The financial arrangement of the lease-option sale contains all the elements of a mortgage:

- a yield (interest and principal paid as rent); and
- a due date (final/balloon payment of principal and further earnings on exercise of option) as a condition for returning (reconveying) title.

Thus, the investor becomes a lender holding title as security for repayment of a debt, not a buyer receiving the possessory rights and economic risks and benefits of a true owner.[9]

As a lender, the EP investor is not able to take depreciation or other *tax benefits* available to an owner of rental property.[10]

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an *option to buy* does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a *mortgage-in-fact*.

Despite any additional set of agreements or circumstances (even using EP agreements and fully complying with right to cancel notices), the investor taking title may not give the owner-in-foreclosure an option to recover title to the property.

However, the investor taking title who does grant an option to buy to the owner must later obtain written permission from the owner before the investor may:

- encumber the property; or
- grant any interest in the property to another person.[11]

Thus, when the owner defaults on the lease and vacates the property, the investor who granted a purchase option is left with naked title, unable to refinance the property, convey title to another person or create a leasehold interest under a rental or lease agreement with a tenant since they are a lender— without the owner's prior approval.[12]

## Equity mortgage during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on their home. The owner asks a friend to make them a mortgage loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called **reinstatement**. [See Chapter 42]

**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.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangements, the owner remains in possession under a *net lease agreement* and is granted an option to recover title to the residence on a final/balloon payment made to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend locates a buyer, enters into a purchase agreement and conveys title to the buyer.

9 Calif. Civil Code §1695.12
10 **Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288
11 CC §1695.6(e)
12 CC §1695.12

The vacated owner seeks to recover the value of their lost equity from their (former) friend. The owner claims an investor who takes title and grants an option to the owner to repurchase the property must first obtain the owner's consent before the investor may convey any interest in the property to another since the transaction was entered into while the home was in foreclosure.

The friend claims EP law does not apply to them since they are not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes.

The friend, cast as an investor, conveyed title to the property without first obtaining written consent from the owner, in violation of equity purchase law.[13]

Even though the investor held title, the EP investor's failure to obtain the owner's written permission prior to conveyance on the property's resale imposes liability on the EP investor for breach of the owner's redemption rights when a mortgage-in-fact is involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred the property without the owner's consent.[14]

## No exemptions for court-ordered sales

Consider an owner-in-foreclosure who is in bankruptcy and conveys their property to an EP investor at a price lower than its market value.

The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Mandatory equity purchase forms with the required right of rescission are not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner seeks to quiet title to the property in their name, claiming the sale-leaseback agreement violated of the *Home Equity Sales Contract Act (HESCA)* EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the EP notice requirements.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a bankruptcy trustee acting on behalf of the court.[15]

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13 CC §1695.6

14 Segura, *supra*

15 CC §1695.1(a)(5)

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee.[16]

## Continued occupancy by the owner-in-foreclosure

Any leaseback agreement negotiated with an owner-in-foreclosure is to be reduced to a written addendum as part of the EP agreement. Alternatively, it may be documented by amendment to the EP agreement prior to funding by the EP investor and conveyance of title by the seller.[17]

The owner-in-foreclosure and EP investor structuring a transaction may consider one of several occupancy arrangements for the owner:

- a sale-leaseback, typically a **holdover tenancy** for a fixed time period at which point the owner is to vacate [See **RPI** Form 272];
- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact), sometimes called a **reverse lease-option** [See **RPI** Forms 161 and 550]; or
- an unexecuted purchase agreement coupled with a lease-option agreement with the seller, a variation on the prior arrangement that does not call for immediate conveyance. [See **RPI** Form 163]

**holdover tenant**
A tenant who retains possession of the rented premises after their right of possession has been terminated, called a tenant-at-sufferance.

**reverse lease-option**
A sale-leaseback agreement with an option to purchase as an addendum.

In a straightforward lease arrangement, a security deposit and the first month's rent are payable to the EP investor at the closing of an EP sale since the seller will holdover for a specified time period. The seller usually prepays rent and a security deposit through escrow from their net sales proceeds.

So long as the EP laws calling for the use of special Equity Purchase agreements and right-of-rescission notices are complied with, the sale-leaseback arrangement does not violate the EP laws. [See **RPI** Form 156]

It is the *repurchase option* given under any circumstances which sets the investor up for a future violation of the EP law.

## Sale-leaseback recharacterized

Inherent in an EP sale-leaseback and option to repurchase the property is the risk the mortgage transaction will be misinterpreted by the local assessor, the existing lender and the Internal Revenue Service (IRS).

*Reassessment* of the property occurs on execution of a sale-leaseback.[18]

However, if the "two-step" financing scheme is brought to the attention of the assessor, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single financing arrangement, rather than two consecutive sale and repurchase transactions. Thus, no change of ownership occurs, even though the vesting of title is altered, and no reassessment takes place.[19]

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16 **Spencer** v. **Marshall** (2008) 168 CA4th 783

17 CC §1695.3(f)

18 **Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155

19 Calif. Revenue & Taxation Code §65(b)

*Existing lenders* view a sale-leaseback, with or without a repurchase option, as an opportunity to *call or recast* a mortgage under their **due-on clause** — if they become aware of the transaction. An EP investor needs to consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing to avoid a call or recast of the loan. [See Chapter 19]

An existing lender usually will not demand a modification or call its mortgage unless the current market rates are high, allowing the lender to increase its portfolio yield through points or an increased interest rate, either by mortgage modification or a payoff and reinvestment in a new mortgage.

## Federal tax consequences

The *IRS* also treats sale-leasebacks as mortgage transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property.

Taxwise, the sale-leaseback is considered a financing arrangement when:

- rental payments under a long-term lease equal an amortization of the fair market value (FMV) over the term of the lease when title is to be reconveyed to the seller/tenant; or
- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that will be financially similar to the due-date payoff under a mortgage.[20]

The EP investor's tax consequences on recharacterization of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;
- imputing of interest income reportable at 110% of the applicable federal rate (AFR);[21]
- reporting of potential rental income as investment/portfolio category interest income on a mortgage; and
- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a mortgage loan.

For the EP investor to receive the tax benefits of owning real estate, they need to limit the leaseback to a:

- periodic tenancy, such as a month-to-month [See **RPI** Form 551]; or
- a tenancy with a set date requiring the tenant to vacate the premises (a fixed-term lease agreement). [See **RPI** Form 550]

Under either structuring, no repurchase option is granted to the owner.

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20 **M & W Gear Co.** v. **Commissioner** (7th Cir. 1971) 446 F2d 841

21 Internal Revenue Code §1274(e)

## No repurchase options granted

An EP investor structuring a sale-leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for their equity (or for their payment of rent); or
- the rent charged is the current fair market rate; and
- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor.[22]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor may begin an **unlawful detainer (UD)** action against the seller without prior notice to the seller to vacate.[23]

As in any lease, the leaseback agreement needs to provide for payment of increased rent if the seller-in-foreclosure does not vacate upon either:

- the expiration of the lease; or
- a notice to vacate used to terminate the tenancy under a month-to-month rental agreement. [See **RPI** Form 569]

A reminder: The seller-in-foreclosure has previously defaulted on home payments. Thus, the seller-in-foreclosure poses a serious adverse credit risk as a tenant for the EP investor.

22 **Camp** v. **Matich** (1948) 87 CA2d 660
23 **Ryland** v. **Appelbaum** (1924) 70 CA 268

## Chapter 18 Summary

Equity purchase (EP) laws are designed to provide the seller of their principal residence with protection from investor acquisitions of title their property. EP statutes apply to all investors regardless of the number of EP transactions the investor completes. The investor does not need to be in the business of purchasing or advancing funds on homes in foreclosure for the EP statutes to apply.

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an option to buy does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a mortgage-in-fact.

The Internal Revenue Service (IRS) also treats sale-leasebacks as mortgage transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property.

For the EP investor to receive the tax benefits of owning real estate, they need to limit the leaseback to a:

- periodic tenancy, such as a month-to-month; or
- a tenancy with a set date requiring the tenant to vacate the premises (a fixed-term lease agreement).

## Chapter 18 Key Terms



**Quiz 5 Covering Chapters 18-22 is located on page 624.**

# Chapter 19

# Due-on-sale regulations

## Learning Objectives

After you read 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;
- explain ownership activities which trigger due-on enforcement for profit 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

**due-on clause**

**waiver agreement**

**inter vivos trust**

## Rising rates bring lender interference

During times of upward sales volume, increasing mortgage originations at lower interest rates, and rising absorption rates for space available to rent, the marketplace functions at full throttle. This is known economically as a **virtuous cycle**.

Responsibility for this frenzy lies with the *gatekeepers* to real estate ownership — brokers, builders and lenders. To keep those responsible for the activity from excesses which harm the rest of society, the government implements regulations to reduce *adverse conduct* by these gatekeepers.

During times of rising prosperity, buyers put up with the onerous threshold of entry procedures maintained by the gatekeepers. In their rush to close deals, all the numerous steps to ownership seem justified to the buyers.

However, when short-term interest rates and mortgage rates rise, lending likewise tightens. At this point, buyers become unwilling to further cope with the regime of higher rates, deceasing mortgage funding, seller price expectations, failure of property condition disclosures and excessive documentation demands. This recurring paradigm shift triggers a **vicious cycle** which begins quickly but takes years to unwind after it hits bottom.

**due-on clause**
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

Lenders do not call mortgages due or seek a rate modification on a sale of real estate when market interest rates fall below the yield on their portfolio of existing mortgages. Lenders simply permit assumptions of high-rate loans rather than calling them due to lend the funds at lower market rates.

As shown by history, the cycle of values will again turn vicious for owners and lenders when mortgage rates rise.

Enter the seller-crippling **due-on-sale** restrictions remaining from the Reagan-era federal 1982 mortgage deregulation.

## Burden on the use and mobility of title available for ownership

The single greatest burden on the use and mobility of commercially available title for ownership of property rights is created by the existence of the *due-on clause* buried within all trust deeds held by mortgage holders and carryback sellers.

During long-term cyclical episodes of declining fixed rate mortgage (FRM) interest rates such as 1980 to 2012, the due-on clause is not an issue. The clause lays dormant as unused for lack of its ability to increase mortgage lender and servicer profits beyond the earnings bargained for at the time of origination.

The decades of the '80s, '90s and '00s are examples of a prosperous time when buyers could easily qualify for new mortgage financing at ever decreasing interest rates to cash out the sellers who in turn paid off their existing higher-rate mortgage as they sold at ever increasing prices.

However, booms always turns to bust — *cycles are always completed.*

In a *vicious recession cycle*, buyers return to purchase property after prices fall. Also, the most efficient sale arrangement for financing the purchase price is for *the buyer to take over the seller's mortgage* — but only when it has an interest rate lower than the rates currently demanded by mortgage lenders.

## A lender's noose

Mortgage holders in periods of rising FRM rates refuse to consent to any type of mortgage takeover or assumption by buyers.

The reason: they prefer payoff as the payoff funds allows them to re-lend the money at the *higher* current FRM rate.

Though the due-on clause did not present a danger to sellers during the quarter century leading up to the Millennium Boom, it now becomes the lender's noose tightening around the seller's title during periods like we are now experiencing with interest rates on a long-term rising trend.

The combination of generally rising interest rates (following the 2009-2015 zero lower bound interest rates) and the existence of due-on clauses tends to tie the seller to their property. Further, it kills their motivation the upgrade to another property as it requires owners to forfeit their current lower interest rate for one that is higher. Thus, sellers are too often fettered to their home without a financially suitable way out when the principal amount of their mortgage is at or above the resale price for the home.

California agents always feel the effects of the due-on clause whenever either adjustable or fixed mortgage rates increase for a period of time greater than 18 months.

With steady and continuing rate increases, agents will again be shocked by the realization that due-on clauses permit lenders to call a note due (or modify its rate or payment schedule) when an owner seeks permission to sell, lease, or further encumber property financed by the lender.

This severe restraint on all types of real estate transactions was last felt during the 1974-75 recession through the 1980-82 recession period. The virtuous cycle time from 1983 to 2013 is gone, with the vicious cycle now upon us.

## Attempts to circumvent the lender's sales restraint

Consider a parcel of real estate listed for sale in a market of rising mortgage rates. The parcel is encumbered by a mortgage with an interest rate below current market rates, but contains an ever present 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 note. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's substantial down payment.

The buyer is advised the senior mortgage holder may:

- refuse to allow the mortgage to be assumed, forcing the buyer to arrange new financing when they do not elect to cancel the purchase agreement; or
- require a modification of the note to increase the interest rate and payments than the current note provides, and demand the exaction of an 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.[1]

## Economic recessions and recoveries

Mortgage holders have no financial incentive to recast mortgages, or call and re-lend the funds at a lower rate when interest rates are in a decline, and buyers are unwilling to take them over. [See Chapter 8]

However, in times of steadily rising rates, mortgage funds become more expensive and mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio.

The **inhibiting effect** the due-on clause has on buyers and sellers during recessions has a similar adverse economic effect on all real estate sales, as well as the availability of private junior financing and long-term leases.

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 mortgage debt, often leaving recent owners with *negative equity* in the property. It is a vicious cycle which evolves into a dramatic increase in mortgage **foreclosures**, the antithesis of the mortgage holder's profit motive for automatic enforcement of the due-on clause.

## Primary event triggering the mortgage holder's exercise of the due-on clause

In times of steadily rising interest rates, mortgage holders jump on any event triggering the due-on clause their trust deed to call or recast the mortgage debt to increase earnings on their portfolio.

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.

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 in the real estate interest encumbered by the trust deed. [See **RPI** Form 404 and 405]

1 12 CFR §591.2(b)

Examples of sales with seller financing other than a standard carryback trust deed include wraparound carryback security devices such as:

- **land sales contracts** [See **RPI** Form 168];
- **lease-option sales** [See **RPI** Form 163]; or
- **all-inclusive trust deeds (AITDs)**. [See **RPI** Form 421]

For example, a *land sales contract* does not involve a conveyance of title to real estate to the buyer by 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.[2]

## Due-on-lease trust deed provision

The typical event triggering the mortgage holder's **due-on clause** is a *sale* of any property encumbered by the mortgage holder's trust deed containing a due-on clause.

But a sale is hardly the only instance. The due-on clause includes an additional event – *hazard* – for income property owners.

Here, 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.[3]

Consider an owner constructing a commercial rental property who obtains a *take-out* commitment from a lender for permanent financing to pay off the construction loan. Funding of the mortgage commitment 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. As agreed, the lender funds the commitment which is secured by a trust deed containing 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 trust deed was recorded.

However, after obtaining the mortgage, the owner continues to lease out space in their property for five-year terms.

Later, when interest rates rise, a representative of the lender visits the property and observes the new tenants. The lender learns that some of the tenants recently entered into leases, or had their leases extended. The recently arranged leasing periods were greater than three years — lease terms granted by the owner *after* the mortgage was originated.

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2 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

3 12 CFR §591.2(b)

**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.*

The lender sends the owner a letter informing them it is calling the mortgage due, payable in 30 days, since the owner entered into lease agreements which granted leasing periods exceeding 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 at current interest rates?

Yes! By requiring leases with terms over three years as a condition for originating the mortgage, the lender did not waive its right to call or recast the mortgage under its due-on clause when a lease with a term over three years is granted by the owner after the mortgage was originated.

## Due-on assignment or modification of a lease

An **assignment** by a tenant or **modification** by an owner of an existing lease does not trigger the due-on clause in a trust deed encumbering fee title, unless the owner:

- modifies the lease by extending the term beyond three years; or
- grants to the tenant a purchase option.

For example, consider an owner of commercial real estate who enters into a lease agreement granting the tenant a ten-year term. After leasing the property, the owner refinances the property, recording a trust deed containing a due-on clause.

Later, the tenant assigns the lease to a new tenant when more than three years remains on its term. The owner approves the assignment as provided in the lease agreement.

Here, the due-on clause is not triggered by the lease assignment. The mortgage holder may not call the mortgage loan due since the due-on clause is not triggered by the tenant's assignment of a pre-existing lease.

Further, the mortgage encumbers only the owner's interest, which does not include the leasehold interest the owner previously conveyed and was owned by the tenant. The fee owner whose interest is encumbered by the mortgage transferred nothing.

The assignment by a tenant of a leasehold, senior or previously consented to by the lender, is not a transfer of any interest in the fee encumbered by the trust deed.

## Due-on lease novation

Now consider a landlord who releases the original tenant from all liability under the lease as part of an assignment and assumption of the lease by the new tenant. The remaining term on the lease is greater than three years.

Here, the release of the original tenant from liability and an assumption of the lease agreement obligations by a new tenant constitutes a **novation** of the lease agreement. The result is 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 lease term exceeding three years, the mortgage holder may enforce a call the mortgage.[4]

Thus, a new tenant's assumption of the lease with a remaining term greater than three years coupled with a release of the former tenant from liability constitutes a present transfer of fee ownership interest in the real estate to the new tenant since the assumption and release of liability constituted a *novation* which cancelled the original lease agreement.

Accordingly, a lease novation triggers the due-on clause when the lease has a remaining term of over three years or includes an option to purchase.

Typically, an owner wants long-term leases which run more than three years. Here, the leasing periods have to be held to three years each, the initial term, and any options to extend the occupancy under a lease agreement.

Unless otherwise agreed by modifying the due-on clause when a mortgage is originated, the mortgage holder may call the mortgage when the leasehold period granted to the tenant is for more than three years, either initially or on exercise of an option to extend.

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4 **Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424

## Due-on-further encumbrance

Here, we'll discuss further instances in which a mortgage holder may properly exercise the **due-on clause** in a trust deed – on a further encumbrance of a property or foreclosure by a junior lienholder.

Consider an owner-occupant of an SFR subject to a first mortgage. The first mortgage contains a due-on clause.

The owner applies for an *equity loan* to be secured by a second trust deed on their property.

The lender tells the owner they are concerned about due-on enforcement by the senior mortgage holder during times of rising rates. Here, the second trust deed lender is aware encumbering the property with a junior lien 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.

Will the equity loan in a subordinate position trigger the due-on clause in an existing mortgage?

No! So long as long as the owner continues 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.[5]

However, do note that this is a narrow exception and does not include a foreclosure by the junior lender. 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 private 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-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 remains 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

5 12 CFR §591.5(b)(1)(i)

mortgage holder then 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 their mortgage due on completion of the **foreclosure sale** by a junior mortgage holder on any type of real estate.

Why? 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,* or a judgment lien foreclosure sale.[6]

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 during periods of rising mortgage rates.

Prudent lenders and sellers are unwilling to accept a junior position as it exposes them to paying off the principal balance on a senior mortgage when they are forced to foreclose on the real estate.[7]

The junior lender making payments on a senior mortgage to keep it current prior to the trustee's sale does not waive the due-on clause triggered by the foreclosure sale under the junior lenders trustee's sale.

## Due-on-death

Consider the transfer of a one-to-four unit residential property to a relative on the death of the owner. Does the death when title is transferred to a relative who occupies the property trigger the due-on clause in an existing owner-occupant *consumer mortgage*?

No! The due-on clause is not triggered by the death or the transfer so long as the relative taking title becomes an **occupant** of the residential property.

However, this waiver of the clause is conditioned on the lender's confirmation the relative taking title becomes or will become an occupant of the property.[8]

Also, when two or more people hold title to one-to-four unit residential property as **joint tenants**, does the death of one *joint tenant* trigger due-on enforcement in the existing consumer mortgage?

6 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 [Disclosure: the legal editor of this publication was an attorney in this case]

7 **Pas** v. **Hill** (1978) 87 CA3d 521

8 12 CFR §591.5(b)(1)(v)(A)

Yes, unless at least one of the joint tenants, either the deceased or a surviving joint tenant, occupied the property when the mortgage was originated. Thus, the mortgage when originated was an owner-occupant consumer-purpose mortgage.

Occupancy is not required for a surviving joint tenant who qualifies for this joint tenancy exception.[9]

In the transfer of all properties other than a one-to-four residential property encumbered by an owner-occupied consumer mortgage, 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:

- the death of any vested owner of a consumer mortgaged one-to-four unit residential property by a transfer of the deceased's ownership to a **non-relative**, by will or by *inter vivos 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 either of the joint tenants;
- the death of a co-owner of any type of property other than an exempt transfer of consumer mortgaged one-to-four residential unit residential property; and
- the transfer of any property, other than an exempt transfer of a consumer mortgaged one-to-four unit residential property, to a relative or anyone else on the death of the owner.

## Divorce and inter-family transfers

Consider a married couple who occupies a one-to-four unit residence vested in the name of the husband and owned as his separate property. The residence is encumbered by an owner-occupant consumer mortgage containing a due-on clause.

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.

Related, federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse in a divorce, so long as the acquiring spouse occupies the property.[10]

However, when 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.

9 12 CFR §591.5(b)(1)(iii)

10 12 CFR §591.5(b)(1)(v)(C)

## Inter-family exception

Similarly, the due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property encumbered by an owner-occupant consumer mortgage to a **spouse or child** who occupies the property.[11]

Keep in mind this *inter-family transfer exception* to due-on enforcement applies only to transfers from an owner to a spouse or child. Any transfer from a child to a parent triggers due-on enforcement.

Consider an owner-occupant of one-to-four unit residential property encumbered by a consumer mortgage who intends to transfer title to the property into an **inter vivos trust** vesting, naming themselves as beneficiary. The owner continues to occupy the property after transferring title into the living trust.

**inter vivos trust**
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. Also known as a living trust. [See **RPI** Form 463]

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.[12]

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. When the owner conveys the property into the inter vivos trust without the mortgage holder's approval, the mortgage holder may call the mortgage due.

Further, when 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.

## 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 when its due-on rights were exercised based on the further encumbrance and it was not paid in full.[13]

In periods of rising interest rates, 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

11 12 CFR §591.5(b)(1)(v)(B)
12 12 CFR §591.5(b)(1)(vi)
13 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

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.

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 due. To avoid the call, the buyer assumes the first mortgage and modifies the note by shortening the due date.

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.[14]

## Lender waiver by negotiations

An owner wishing to enter into a transaction to sell, lease or further encumber their real estate which is presently encumbered by a mortgage needs to first negotiate a limitation or waiver of the mortgage holder's due-on rights. [See **RPI** Form 410]

**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 may demand valuable consideration such as:

- additional points, like an origination;
- additional security;
- principal reduction;
- increased interest;
- a shorter due date; or
- an assumption fee. [See **RPI** Form 410]

The waiver needs to be in writing to be enforceable against the mortgage holder.[15]

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14 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869
15 12 CFR §591.5(b)(4)

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 since interest rates are likely to continue to rise.

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. [See Chapter 20]

The mortgage holder's waiver of their due-on rights under an *assumption agreement* applies only to the **present transfer** to the buyer, and **one future transfer** to a qualified buyer.

Unless additionally agreed to, any *other transfer* of an interest in the property will trigger the due-on clause, allowing the mortgage holder to call or recast the mortgage again.

## Lender waiver by conduct

In addition to a *formal written 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. [See **RPI** Form 410]

Consider a buyer who purchases real estate subject to a mortgage containing a due-on clause.

The mortgage holder discovers the transfer and promptly calls the mortgage.

But the mortgage holder then behaves strangely. They accept payments from the buyer for several months, a period longer than a reasonable time to enforce a call by foreclosure when the principal is not paid in full.

After interest rates increase, the mortgage holder then starts foreclosure to enforce their prior call by refusing further payments.

Can the mortgage holder, after accepting payments from the borrower following their discovery of the transfer or any call for payment of a lump sum payoff, later attempt to call or foreclosure?

No! Here, the mortgage holder waived the right to enforce their due-on clause by their conduct.[16]

After discovery of the transfer or calling the loan they *accepted payments* which is inconsistent with enforcing the due-on clause. The mortgage holder may not later foreclose to enforce a call as they waived that right by continuing to accept payments long before or after the call.

16 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

## Broker liability when masking the change of ownership

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.

Regardless, the mortgage holder can only call the mortgage when they actually discover a change of ownership has taken place. When 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.[17]

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.[18]

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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17 **Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49

18 **J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799

## Chapter 19 Summary

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.

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 in a decline.

In times of continuously rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. Thus, real estate ownership encumbered by due-on mortgages becomes increasingly difficult to sell as interest rates rise.

The inhibiting effect the due-on clause has on buyers during recessions has a similar adverse economic effect on all real estate sales, as well as the availability of private junior financing and long-term leasing.

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.

However, 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 acquiring spouse occupies the property. Further, 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.

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.

## Chapter 19 Key Terms



**Quiz 5 Covering Chapters 18-22 is located on page 624.**

*Notes:*

# Chapter 20

# Assumptions: formal and subject-to

## Learning Objectives

After reading this chapter, you will be able to:

- identify the financing procedures available to a buyer when negotiating to take over a mortgage on the seller's property; and
- evaluate the costs and benefits of each procedure when advising a buyer or seller on a sale of real estate, based on the characteristics of the property, financing encumbering the property and condition of the market.

## Key Terms

| | |
|---|---|
| **anti-deficiency** | **novation** |
| **buyer-seller assumption agreement** | **purchase-assist funding** |
| **deficiency judgment** | **retroactive interest differential (RID)** |
| **formal assumption** | **subject-to transaction** |
| **nonrecourse debt** | **waste** |

## The buyer takes over the seller's mortgage

On the sale of a parcel of real estate, existing financing encumbering the property known as a **mortgage** sometimes remains of record and is taken over by a buyer. The buyer takes title to the property under one of four procedures:

- a **formal assumption** between the mortgage holder and the buyer;
- a **subject-to assumption** between the seller and the buyer;
- a **subject-to transfer** of ownership without an assumption agreement of any type; and
- a **novation** between the mortgage holder, seller and buyer.

**formal assumption**
A buyer's promise to perform all the terms of the mortgage, given to the mortgage holder on the buyer's takeover of an existing mortgage, typically involving a modification of the interest rate and payments and an assessment of points and fees. Compare with a subject-to transaction.

If the buyer of a one-to-four unit residential property encumbered by a mortgage will occupy the property as their principal residence, and the buyer is to *formally assume* the mortgage by entering into a written assumption agreement with the mortgage holder, the assumption is considered an origination of a new mortgage requiring the mortgage holder to comply with **Regulation Z (Reg Z)**.

Here the written **assumption agreement** with the mortgage holder involves *consumer-purpose financing* controlled by *Reg Z* and thus is subject to:

- new disclosures by the mortgage holder to the assuming buyer based on the remaining obligation; and
- verification of the assuming buyer's ability to repay the mortgage based on Reg Z **Ability-to-Repay (ATR) rules**.[1] [See Chapter 2]

A mortgage assumption is considered a new mortgage origination if:

- the mortgage is being assumed to finance the buyer's purchase of their one-to-four unit principal residence;
- the mortgage holder expressly agrees to accept the assuming buyer as the borrower; and
- the assumption agreement is in writing.[2]

If an assumption meets each of those criteria—and the mortgage holder makes more than five consumer mortgages or one **Section 32 high-cost consumer mortgage** in a calendar year—it triggers ATR verification and Reg Z disclosures. Whether the mortgage being assumed was originally a consumer or business mortgage is not an issue.[3] [See Chapter 2]

Of the four procedures mentioned above, only formal assumption and novation involve a written assumption agreement with the mortgage holder. Thus, the formal assumption and novation of a mortgage, taken over for consumer purposes, trigger a lender's Reg Z disclosures and ATR verification.

## The mortgage holder's interference

Consider a seller of mortgaged property. The seller and a buyer enter into a purchase agreement and escrow instructions which provide for the buyer to **take title subject-to** the existing mortgage. [See **RPI** Form 150 §§ 5 and 6]

The buyer plans to close escrow on the subject-to transfer *without* first entering into a **written assumption agreement** with the mortgage holder. The buyer intends to negotiate with the mortgage holder after closing only if the mortgage holder:

- calls the mortgage; or
- demands an assumption and modification.

1 12 Code of Federal Regulations §1026.20(b)

2 12 CFR §1026.20(b) Supplement I – Official Interpretation

3 Consumer Financial Protection Bureau Bulletin 2014-07: Application of Regulation Z's Ability-to-Repay Rule to Certain Situations Involving Successors-in-Interest

If the mortgage holder does not do either, the buyer will refinance the mortgage with another lender.

The buyer's motivation for this **subject-to transaction** is the interest rate on the seller's mortgage. It is at or below current market rates. Due to the buyer and their broker's experience with the mortgage holder, the buyer feels the mortgage holder will not **call** the mortgage or demand an assumption and modification. If the mortgage holder calls the mortgage, the buyer reasons it will lose its servicing fees since it does not own the mortgage but is servicing it for another lender.

**subject-to transaction**
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

A **beneficiary statement** is requested by escrow. The mortgage holder properly complies with the request by sending a statement of the mortgage condition to escrow within 21 days of its receipt of the request.[4] [See Chapter 16; see **RPI** Form 415]

However, the mortgage holder unilaterally instructs escrow not to close until the buyer has been approved by the mortgage holder and has assumed the mortgage since the mortgage contains a **due-on clause**.

Is the mortgage holder able to legally interfere with the closing of a *subject-to transaction* when the buyer and seller do not instruct escrow to process a mortgage holder approval or mortgage assumption?

No! Escrow instructions for the sale of property subject to the mortgage are entirely between three parties only: the buyer, seller and escrow. [See **RPI** Form 401]

The mortgage holder has no legal right to interfere with the transaction to prevent the closing since it is not a party to the escrow.

Further, escrow has no authority from its principals to follow any mortgage holder instructions whether or not they are attached to the beneficiary statement. The mortgage holder's remedy – and leverage to force a payoff or modification – is limited to calling the mortgage due under its due-on clause after the subject-to transaction has closed, if it chooses to do so.[5]

## The subject-to transaction

A subject-to transaction is initially structured by use of financing provisions in a **purchase agreement**. The provisions call for the amount of an existing mortgage to be part of the buyer's purchase price paid to acquire the property. The financing provisions state the buyer is to take title to the property *subject to* the seller's existing mortgage. [See **RPI** Form 150 §§5 and 6]

The buyer confirms the seller's representation of the mortgage's terms and condition through the escrow's request and receipt of the mortgage holder's *beneficiary statement*. The buyer relies on the beneficiary statement for:

- the future payment amount and schedule;
- interest rate; and

4 Calif. Civil Code §2943(e)(3)
5 **Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847

- mortgage balance.

The mortgage holder typically attempts to condition the use of the beneficiary statement on the buyer's formal assumption of the mortgage and payment of fees.

Some buyers intentionally instruct escrow not to order a beneficiary statement. These buyers understand the notice of the sale will likely cause the mortgage holder to *call* or demand a *modification* of the mortgage after escrow closes.

The seller's most recent mortgage payment receipt or statement might then be used as the source of mortgage information. However, the buyer needs to be aware the mortgage holder is not bound by the payment statements in the same way it is bound by the beneficiary statement. [See Chapter 16]

## An unrecorded transfer

Some buyers acquire their ownership rights using **unrecorded transfer documents**, including *lease-option agreements* or *land sales contracts*.

Here, the seller and buyer completely avoid present conveyances, escrow, title insurance and other customary transfer disclosures and activities until they are either able to work out an assumption or originate new financing. [See Chapter 32]

However, these unrecorded sales documents do trigger due-on clauses and **property tax reassessments** if later discovered. Further, as a matter of practice, unrecorded transactions create a further risk of loss by leaving room for misunderstandings about who owns what interests in the property.

## Market rates motivate

During periods when current market interest rates are comparable to or lower than the **note rate** on a mortgage:

- a *beneficiary statement* is ordered to confirm the mortgage amount and terms for repayment [See **RPI** Form 415];
- the change of ownership conveyance is *recorded and insured*; and
- the conveyance is promptly brought to the *mortgage holder's attention* so the mortgage holder is not able to later call the mortgage when rates rise by claiming the transfer went undisclosed.

Conversely, during periods of rising or high interest rates, as compared to the note rate on a mortgage, the mortgage holder is often not notified of a subject-to sales transaction.

Notice of the transaction during periods of rising interest rates allows the mortgage holder to gain financially from a **call** or **recast** of the mortgage at the expense of both the seller and buyer.

However, the mortgage holder is allowed to enforce its due-on clause and call the mortgage on its **future discovery** of any sale, regardless of how the sale is structured.

Also, on a later discovery of the transfer, any brokers, attorneys or accountants whose *primary objective* in negotiating the sales transaction was to induce the buyer and seller to avoid the due-on clause may be liable to the mortgage holder (in tort) for any **retroactive interest differential (RID)** lost based on market rates at the time of the transfer.

**retroactive interest differential (RID)**
The mortgage holder's losses, calculated based on the interest differential between the note rate and the market rate on the date of a third party's unlawful interference with the mortgage holder's right to call a mortgage.

Thus, a **hold harmless agreement** from the seller or buyer is appropriate for providing *indemnity* to the agents and brokers who negotiate the undisclosed transaction at the behest of their clients.

The seller of property sold either subject-to or by an assumption of a mortgage needs to be concerned about their liability for the remaining balance due on the mortgage. Seller liability depends on whether the mortgage debt is classified as:

- **recourse;** or
- **nonrecourse debt.**

Additionally, the seller is exposed to liability for any mortgage holder's loss due to the mortgage holder's error in amounts stated on a beneficiary statement or a payoff demand. [See Chapter 16]

## Nonrecourse debt

A seller is not liable for a deficiency in the value of mortgaged property to cover the mortgage debt on the foreclosure of a **nonrecourse debt** taken over under any transfer procedure by the buyer.

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

*Nonrecourse mortgages* include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback mortgage;
- a mortgage which financed the purchase of an owner-occupied, one-to-four unit residential property, known as **purchase-assist funding**[6];
- a mortgage used to refinance an existing mortgage which funded the purchase of an owner-occupied, one-to-four unit residential property, less any additional principal advanced (such as a cash-out refinance)[7]; and
- a mortgage made for the construction of an owner-occupied, single family residence (SFR), and perhaps a mortgage made to improve the structure (the legal status of dwelling improvement loans remains uncertain).

**purchase-assist funding**
The use by a buyer of proceeds from a mortgage to fund a portion of the price paid to acquire real estate.

When a default occurs on a nonrecourse mortgage, the mortgage holder is only able to foreclose on the mortgaged property to recover the balance due on the mortgage.[8]

Even if the mortgaged property has insufficient remaining value to satisfy the balance of the nonrecourse mortgage (known as a **deficiency**), the mortgage holder is not able to hold the original borrower or an assuming

6 Calif. Code of Civil Procedure §580b(a)(3)
7 CCP §580b(b)
8 CCP §§580b(d), 580e

**waste**
The intentional destruction or neglect of property which diminishes its value. [See **RPI** Form 550 §6.8 and 552 §7.4]

**anti-deficiency**
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

buyer *personally liable* for the deficient property value. A narrow exception exists if the owner damages the property to an extent which decreases its value, called **waste**.

On a buyer's takeover of a nonrecourse mortgage, the mortgage retains its original nonrecourse character regardless of whether the buyer takes title subject-to or assumes the mortgage, or a **novation** occurs.[9]

Further, a non-occupying buyer who takes over a nonrecourse mortgage under any procedure is entitled to **anti-deficiency** protection. [See Chapter 40]

In contrast, *purchase-assist financing* originated by a non-occupying buyer of any type of property, including one-to-four residential units, is a recourse mortgage and the buyer is not protected by *anti-deficiency rules* from a **deficiency judgment**.

However, while the mortgage holder has no recourse to the buyer, if the mortgage is insured against default by the **Federal Housing Administration (FHA)** or the **Department of Veterans Affairs (VA)**, the FHA or the VA have recourse to the buyer under the default insurance for losses on a foreclosure and resale of the property. [See Chapter 36]

## Recourse mortgages

*Recourse mortgages* are all mortgages that are not statutorily protected from deficiency judgments, as reviewed above.

Consider a buyer who takes title to property subject to a seller's existing **home equity mortgage**, which is classified as a recourse debt. The mortgage proceeds were not used to purchase, refinance or improve the seller's residence.

The buyer defaults on the mortgage and the mortgage holder initiates and completes a **judicial foreclosure** on the property. The **fair market value** of the property on the day of the judicial foreclosure sale is insufficient to fully satisfy the remaining mortgage balance, resulting in a deficiency. [See Chapter 43]

The mortgage holder seeks a money judgment against the seller for the amount of the deficiency in the property's market value. The seller claims they are not responsible for the mortgage since it was taken over by the buyer when the property was sold.

Is the seller liable for the deficiency on the recourse mortgage after the buyer takes title to the property subject-to the mortgage?

Yes! When property is sold and its title is conveyed to a buyer *subject-to* an existing recourse mortgage, the seller remains liable for any deficiency on the recourse mortgage if the buyer fails to pay.[10]

9 **Jackson** v. **Taylor** (1969) 272 CA2d 1
10 **Braun** v. **Crew** (1920) 183 C 728

Further, unless the buyer enters into an *assumption agreement* with either the seller or the mortgage holder, a subject-to buyer is not liable to either the seller or the mortgage holder for a drop in the property's value below the mortgage balance. That is, unless the buyer commits *waste*.[11]

However, if the subject-to buyer and the mortgage holder enter into an **assumption agreement** which significantly modifies the terms of the recourse mortgage without the seller's consent, the seller is not liable for the mortgage.[12]

## Buyer-seller assumption

A seller is able to reduce their **risk of loss** on a buyer's takeover of a recourse mortgage by negotiating for a provision in the purchase agreement calling for the buyer to enter into an *assumption agreement* with the seller.

A buyer-seller assumption agreement is not to be confused with a so-called *formal assumption* between the buyer and a mortgage holder.

The **buyer-seller assumption agreement**, referenced in the purchase agreement and prepared in escrow, is a promise given by the buyer to the seller to perform all the terms of the mortgage the buyer is taking over. [See Form 431 accompanying this chapter]

**buyer-seller assumption agreement**
A promise given by the buyer to the seller to perform all the terms of a mortgage taken over by the buyer on the property purchased.

The *assumption agreement* gives the seller the right to collect from the buyer the amount of any **deficiency judgment** a holder of a recourse mortgage may be awarded against the seller in a judicial foreclosure. To be enforceable by the seller, the assumption agreement needs to be in writing.[13]

**deficiency judgment**
A money award obtained by a mortgage holder to recover money losses experienced when the value of the mortgaged property is less than the remaining mortgage debt at the time of the judicial foreclosure sale.

Although the buyer's promise to pay the mortgage under a buyer-seller assumption agreement is given to the seller, the buyer also becomes liable to the recourse lender under the legal doctrines of *equitable subrogation* and *third-party beneficiaries*.[14] [See **RPI** Form 431 §6]

Even though the buyer, upon entering into any type of assumption agreement, takes over the primary responsibility for the recourse mortgage, the seller remains **secondarily liable** to the mortgage holder. The seller's risk of loss arises when the buyer fails to pay the recourse mortgage and there is a lack of market value remaining in the property to cover the mortgage amount.[15]

Unlike the subject-to seller, the seller under the buyer-seller assumption agreement is entitled to be **indemnified** (held harmless) by the buyer for any losses later incurred due to their continued liability on the taken-over recourse mortgage.

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11 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929
12 Braun, *supra*; CC §2819
13 CC §1624
14 Braun, *supra*
15 **Everts** v. **Matteson** (1942) 21 C2d 437

## Performance trust deed avoids delay

To avoid a delay in pursuing reimbursement from the buyer for any loss covered by the buyer-seller assumption agreement, sales negotiations of the assumption agreement may also call for the buyer to secure the agreement using a **performance trust deed** carried back by the seller as a lien on the property sold. [See **RPI** Form 432 and 451]

With a recorded trust deed held by the seller to secure the buyer's assumption agreement promise to pay the mortgage holder, any default by the buyer allows the seller to:

- demand the buyer tender the entire balance remaining due on the assumed mortgage, subject to the buyer's right to *reinstate* the delinquencies; and
- if the demand is not met, proceed with foreclosure under the performance trust deed to recover the property and *cure the default* on the assumed mortgage.

A buyer-seller assumption, like a subject-to transaction, does not alter the mortgage holder's right to enforce its due-on clause on discovery of the conveyance. However, the mortgage holder waives its due-on rights after acquiring knowledge of the transfer of ownership by failing to promptly:

- call the mortgage; or
- act on any call they may have made. [See Chapter 19]

## Novation

Consider a buyer who is willing to cash out the seller's equity and assume an existing recourse mortgage with the mortgage holder.

However, the seller is unwilling to sell the property and remain liable for the mortgage when they no longer have an interest in the property.

Is the seller able to close the sale without remaining liable on the recourse mortgage assumed by the buyer?

Yes! The mortgage holder may enter into an agreement with both the buyer and the seller for the buyer's *assumption* of the mortgage and a *release* of the seller's liability, a three-party agreement called a **novation** or **substitution of liability**.

**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.

For this, the mortgage holder charges a fee and likely demands a modification of the mortgage terms.

On a buyer-mortgage holder assumption of a mortgage secured by an owner-occupied, one-to-four unit residential property, the assumed mortgage becomes **consumer purpose** in character (regardless of any prior purpose).

When the buyer takes over a consumer mortgage on a novation, the mortgage holder:

- *releases the seller from liability* for the mortgage assumed by the buyer;[16]

16 12 CFR §591.5(b)(4)

**ASSUMPTION AGREEMENT**
Unsecured and Subrogated

**NOTE:** This form is used by a seller's agent or escrow officer when the sale of a property calls for the transfer of title with the buyer taking over an existing mortgage, to document the buyer's unsecured promise to the seller to fully perform all terms of the mortgage.

**DATE:** _______________, 20______, at _______________________________________________, California.
*Items left blank or unchecked are not applicable.*

**FACTS:**

**1.** This assumption agreement is entered into by
1.1 ______________________________________________________________, as the Buyer,
1.2 and ___________________________________________________________, as the Seller,
1.3 regarding Buyer's acquisition of real estate referred to as ______________________________________
_________________________________________________________________________.

**2. FIRST TRUST DEED NOTE:**
2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated __________________________,
2.2 executed by ______________________________________________________, as The Trustor,
2.3 in which _______________________________________________________ is the Beneficiary,
2.4 recorded on ______________________, as Instrument No. __________________, in the Offical Records of ____________________________________ County, California, and
2.5 given to secure a promissory note of the same date for the principal sum of $__________________.

**3. SECOND TRUST DEED NOTE:**
3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated ________________________,
3.2 executed by ______________________________________________________, as the Trustor,
3.3 in which _______________________________________________________ is the Beneficiary,
3.4 recorded on __________________, as Instrument No.______________________, in the Official Records of ____________________________________ County, California, and
3.5 given to secure a promissory note of the same date for the principal sum of $__________________.

**AGREEMENT:**

**4.** Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

**5.** Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

**6.** This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

**7.** If Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) will become immediately due at the option of the holder of this assumption agreement.
7.1 On default, Seller is to become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

**8.** In any action to enforce this agreement, the prevailing party is to receive attorney fees.

| **I agree to the terms stated above.**<br>Date:_______________, 20______ | **I agree to the terms stated above.**<br>Date:_______________, 20______ |
|---|---|
| Seller: ____________________________________ | Buyer: ____________________________________ |
| Seller: ____________________________________ | Buyer: ____________________________________ |

**FORM 431** 03-11 

Form 431

Assumption Agreement

- makes new Reg Z disclosures to the buyer based on the remainder of the obligation; and
- verifies the assuming buyer's ability to repay (ATR) under Reg Z.[17]

A *novation agreement* is comparable to the existing mortgage holder originating a new mortgage with the buyer, except the trust deed executed by the seller remains on record and the note remains unpaid.

Thus, under a novation agreement (or an assumption) the mortgage holder will:

- review the buyer's **creditworthiness**;

17 12 CFR §1026.20(b)

- likely seek a modification of the interest rate to current levels; and
- charge an assumption fee.

These are benefits equal to what a mortgage holder receives when they originate a new mortgage with the buyer.

Thus, a mortgage holder's ability to collect fees or increase the interest rate on the mortgage defeats most of the advantages a seller has when they are selling property which is subject to a mortgage with a lower-than-market interest rate .

## Chapter 20 Summary

Existing financing encumbering a property sometimes remains of record and title is take by a buyer under one of four procedures:

- a formal assumption;
- a subject-to assumption;
- a subject-to transfer of ownership; and
- a novation.

If a buyer-occupant formally assumes a mortgage encumbering a one-to-four unit residential property by a written assumption agreement with the mortgage holder, the assumption is considered a new transaction requiring compliance with Regulation Z rules for consumer mortgage disclosures and ability-to-repay evaluation. Only formal assumptions and novation trigger Reg Z requirements.

In a subject-to transaction the amount of an existing mortgage is made part of the buyer's purchase price paid to acquire the property. The purchase agreement states the buyer is to take title to the property subject to the mortgage.

The buyer relies on the mortgage holder's beneficiary statement for the future payment amount and schedule, interest rate and mortgage balance. Some buyers attempt to avoid notifying the mortgage holder of the transfer by instructing escrow not to order a beneficiary statement or by transferring ownership using unrecorded transfer documents. However, these arrangements trigger due-on clauses and tax reassessment if discovered and leave room for misunderstandings about legal ownership of the property.

During periods of rising or high interest rates, the mortgage holder is often not notified of a subject-to transaction. Notice allows the mortgage holder to gain financially from a call or recast of the mortgage at the expense of both the seller and buyer.

The seller of property sold either subject-to or by an assumption of a mortgage needs to be concerned about their liability for the remaining balance due on the mortgage, which depends on whether the mortgage is recourse or nonrecourse.

A seller is not liable for a deficiency in the value of mortgaged property to cover the mortgage debt on the foreclosure of a nonrecourse mortgage taken over under any transfer procedure by the buyer. On a buyer's takeover of a nonrecourse mortgage, the mortgage retains its original nonrecourse character regardless of whether the buyer takes title subject-to or assumes the mortgage, or a novation occurs.

When property is sold and its title is conveyed to a buyer subject-to an existing recourse mortgage, the seller remains liable for any deficiency on the recourse mortgage if the buyer fails to pay. Unless the buyer enters into an assumption agreement with either the seller or the mortgage holder, a subject-to buyer is not liable to either the seller or the mortgage holder for a drop in the property's value below the mortgage balance.

The buyer-seller assumption agreement is a promise given by the buyer to the seller to perform all the terms of the mortgage being taken over. The assumption agreement gives the seller the right to collect from the buyer the amount of any deficiency judgment a holder of a recourse mortgage may be awarded against the seller in a judicial foreclosure.

The mortgage holder may enter into an agreement with both the buyer and the seller for the buyer's assumption of the mortgage and a release of the seller's liability, a three-party agreement called a novation. A novation agreement is comparable to the existing mortgage holder originating a new mortgage with the buyer, except the trust deed executed by the seller remains on record and the note remains unpaid.

## Chapter 20 Key Terms

**novation** ........ **pg. 246**
**purchase-assist funding** ........ **pg. 243**
**retroactive interest differential (RID)** ........ **pg. 243**
**subject-to transaction** ........ **pg. 241**
**waste** ........ **pg. 244**

**Quiz 5 Covering Chapters 18-22 is located on page 624.**

Chapter 21

# FHA and VA mortgage assumptions

## Learning Objectives

After reading this chapter, you will understand:

- the assumption rules on Federal Housing Administration (FHA)- and Veterans Administration (VA)-insured mortgages;
- how to close a sale subject to an FHA-insured mortgage;
- the seller's risk of FHA recourse when permitting a buyer to take title subject-to their FHA-insured mortgage;
- when a buyer of property secured by a VA-guaranteed mortgage is able to take over the mortgage; and
- how a lender calculates a VA assumption fee based on the out-of-pocket costs or reasonable cost estimates for processing the assumption.

## Key Terms

**Federal Housing Administration (FHA)-insured mortgage**

**U.S. Department of Veterans Affairs (VA) mortgage guarantee**

**rent skimming**

## Avoiding fees and investor prohibitions

The **Federal Housing Administration (FHA)** and the **U.S. Department of Veterans Affairs (VA)** are Federal mortgage programs that:

- offer down payment assistance for low- to moderate-income buyers and first-time buyers;
- mortgage refinance or modification programs to distressed owners; and
- special programs for veterans.

**Federal Housing Administration (FHA)-insured mortgage**
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

The *FHA* insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders.

The *VA* mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.

Consider an equity purchase (EP) investor and their licensed agent who discuss the EP investor's intent to add more single family residences (SFRs) to the pool of rentals the EP investor owns. This exchange between the agent and the EP investor is called **counseling**.

The EP investor is interested in low price-tier SFR properties in foreclosure financed with maximum loan-to-value (LTV) fixed-rate mortgages insured by the Federal Housing Administration (FHA).

Specifically, the EP investor wants to **take over** existing financing rather than obtain new financing to fund their purchase of the SFRs. The EP investor's cash reserves are to be used to upgrade the properties.

The EP investor is aware the interest rate and the mortgage insurance premium (MIP) on FHA mortgages is higher by approximately 0.6% than conventional mortgages with private mortgage insurance (PMI), the result of greater leverage.

EP investors, however, generally have a high default rate compared to owner-occupants of SFRs. The Department of Housing and Urban Development (HUD) is committed to reducing the number of defaults on FHA mortgages. Thus, EP investors are discouraged from taking over FHA mortgages.

**U.S. Department of Veterans Affairs (VA) mortgage guarantee**
A program that assists qualified veterans or their surviving spouses to buy a home with zero down payment. [See **RPI** Form 153]

However, the EP investor is made aware that before the lender is permitted to *call* an FHA-insured mortgage on the sale of the SFR property, the lender is to first obtain HUD's approval.[1]

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an EP investor to assume the mortgage, typically accomplished by contacting the seller prior to the close of escrow.

The objective of lenders is extra *revenue*. They obtain it by demanding and receiving an assumption fee of one-half point or more on the sale.

## Taking over an FHA-insured loan

Prudent long-term EP investors seek out desperate property owners who are in default, then pay little or no money down and convert the property to a rental unit based on investment fundamentals of:

- price;
- time; and
- location.

1 HUD Mortgagee Handbook 4000.1 III(C)(1)(b)(i)(B)

The best time for property acquisition is during a crisis, such as a recession, when the market is temporarily devoid of sufficient buyers to keep prices at their past levels and property selection within recession-proof rental locations is extensive.

However, some individuals entering the real estate market are not in the ownership of real estate for long-term income benefits. **Speculators** enter the market during boom times intending to immediately flip the property upon buying it, without investing any further capital. In doing so, they often do not make payments to the lender, looking only to pay off the mortgage on a prompt resale.

Homeowners' associations (HOAs) and the local tax collector (supplemental tax billings) also get burned by the conduct of *speculator*s as they sandwich themselves between sellers and homebuyers or rental investors to withdraw wealth from the real estate market.

Speculators often collect and keep rent without making payments on the mortgage, called **rent skimming,** or **equity skimming** when done on a scale of five or more units. *Rent and equity skimming* is a crime under federal and state law.[2]

**rent skimming**
When an investor receives rents from a parcel of residential rental property during their first year of ownership and does not apply the rents (or an equivalent amount) to the payments due on all mortgages secured by the property.

In response to the activities of rent-skimming speculators during the 1980s, HUD prohibited investor assumptions of FHA-insured SFR mortgages. Thus, FHA only allows the assumption or take-over of an FHA-insured SFR mortgage by qualified owner-occupant buyers. Further, HUD has the right to call the mortgage if taken over by anyone other than an owner-occupant buyer.[3]

In spite of the HUD due-on enforcement policy, the servicing lender is permitted to call the mortgage on a subject-to transfer to an EP investor only with HUD's prior approval. However, as a matter of practice, HUD has not authorized a call when an EP investor acquires the property, unless the EP investor defaults on mortgage payments.

## Closing sales subject to FHA-insured loans

Rental investors and unqualified buyers who have the financial ability to make payments on an FHA-insured mortgage need to obtain a **beneficiary statement** from the lender, through escrow, to confirm the seller's representation of the mortgage terms. [See **RPI** Form 415]

The buyer then closes escrow, taking over the mortgage by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

## The seller's risk of FHA recourse

Sellers face a **risk of loss** when permitting a buyer to take title subject-to their FHA-insured mortgage.

2 12 United States Code §1709-2; Calif. Civil Code §§890 et seq.

3 HUD 4000.1 III(C)(1)(b)(i)(B) .

The downside risk for a seller of a property encumbered by an FHA-insured mortgage is the seller's **personal liability** for any loss the FHA incurs due to a deficiency in the property value at the time of a default by the buyer. This deficiency in the property value may arise after the close of escrow if property values fall.

If the subject-to buyer fails to make payments on the FHA-insured mortgage, and the property's value becomes insufficient to satisfy the remaining mortgage balance, HUD has the right to collect a deficiency from the seller who is the original borrower.

The right to pursue the seller as the original borrower for any deficiency belongs to HUD, not the lender.

Borrowers under programs insured by the FHA or Veterans Administration (VA) do not receive California **anti-deficiency protection** for losses sustained by these federal agencies. The federal statutory right to collect losses on the HUD mortgage insurance program preempts state law to the contrary.[4]

Thus, the seller, on a transfer of title subject to an FHA mortgage, is to consider entering into an **assumption agreement** with the buyer and securing the agreement by a performance trust deed. [See **RPI** Form 432 and 451]

Then, if the buyer does not perform on the *assumption agreement* by making payments on the mortgage, the seller has the option to call all amounts due by the terms of the assumption agreement and foreclose under the trust deed to protect the seller's interests.

## Release of liability

To be released from liability for any deficiency on an FHA-insured mortgage taken over by a buyer, a seller is obligated to obtain a formal **release of liability** as part of the assumption package presented by the lender on an FHA-insured mortgage.[5] [See Chapter 20]

A *release of liability* is granted by the lender if:

- the seller requests a release from personal liability;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the mortgage; and
- the lender uses an FHA-approved form to release the seller from personal liability.[6]

If the conditions for a release of liability exist, but the seller does not request the release from personal liability, the seller remains liable to the FHA for any losses due to a default occurring within five years after the sale.[7]

4 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611
5 HUD 4000.1 III(C)(1)(c)(ii).
6 HUD Form 92210.1; 24 Code of Federal Regulations §203.510(a)
7 12 USC §1709(r)

However, after five years pass from the time the property is resold, the seller is released from personal liability, if:

- the buyer assumes the mortgage with the lender;
- the mortgage is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender.[8]

Many owners sell their properties subject-to FHA-insured mortgages knowing full well the risks of a deficiency. However, sellers generally believe future appreciation and HUD's refusal to pursue collection of mortgage losses minimize any real risk of value-deficiency exposure.

In economically depressed parts of the country, property is conveyed subject-to FHA-insured mortgages as a way to obtain buyers. It is an activity which tends to decrease the level of foreclosures against homeowners who are no longer able to afford to own the property or are compelled to relocate for job opportunities.

Conversely, a demand for a substitution of liability and assumption fees on a mortgage takeover tends to drive potential buyers away. Thus, the prices of properties are driven down, adversely affecting the level of foreclosures and increasing the risk of loss in homeownership.

## FHA inactivity on a sale

Any hesitation a seller has about selling an SFR subject-to an FHA-insured mortgage is put at ease by HUD's internal policy not to collect deficiencies against owners who made mortgage payments in **good faith**.

After foreclosure by a lender, the FHA pays the lender for any mortgage losses under their mortgage insurance policy or acquires the property by paying off the mortgage. If acquired, the FHA resells the property to offset its losses. FHA then sends collection letters but does not have a history of otherwise contacting the homeowner.

Sellers who receive cash for their equity occasionally ignore the mortgage assumption provision and lender threats, and close subject to an FHA-insured mortgage.

Sellers with well-seasoned mortgages, or who are extremely motivated to sell, possibly disregard the due-on clause when selling their property.

Through its **no-investor policy**, HUD severely cripples a defaulting seller's ability to sell their property in order to:

- financially right themselves, or
- obtain mobility to relocate to a better job.

If, hypothetically, HUD's *no-investor* policy were enforced, the number of FHA repossessions will increase and unemployment levels will remain higher than if owners were able to readily sell and move near places of employment.

8 24 CFR §203.510(b)

Thus, buying a residence subject-to an FHA-insured mortgage, regardless of when the mortgage was originated, naturally progresses without further government interference and lender assumption threats, so long as the mortgage is kept current.

## Assuming a VA loan

The VA mortgage assumption policy is entirely different from the HUD/FHA assumption policy.

A buyer of property secured by a VA-guaranteed mortgage is able to take over the mortgage if:

- the mortgage is **current**;
- the buyer **assumes** the mortgage; and
- the buyer is **creditworthy**.[9]

For a buyer to assume a VA mortgage, a fee of 0.5% of the mortgage balance is to be paid to the VA by the buyer.[10]

The **VA assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or faces late charges.[11]

Additionally, the lender is permitted to charge and retain an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law.[12]

While no statutory rule exists in California for calculating assumption fees, the fees are to reflect actual *out-of-pocket costs*, or reasonable cost estimates for processing the assumption.

When an assumption application is approved by the lender, the VA borrower is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments.[13]

## Liability on a refinance

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the mortgage. For instance, the veteran who **refinances** their property with a VA-insured mortgage has liability under the mortgage (as well as to the VA) for any deficiency in the property value to cover the mortgage.

The veteran exposed to refinancing liability is best served by entering into a **novation agreement** with the lender. The agreement relieves the seller of

9 38 USC §§3713(a); 3714(a)(1)
10 38 USC §3729(b)
11 38 CFR §36.4313 (e)(3)
12 38 CFR §36.4313(d)(8)
13 38 CFR §36.4508(b)

liability for a potential deficiency. Liability to a lender for a mortgage used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A *novation agreement* requires the consent by three parties — the buyer, seller and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

If the lender refuses to allow the buyer to assume the mortgage, the VA is to review the findings and determine whether the buyer is entitled to assume the mortgage.

If the veteran is unable to make payments on their VA-insured mortgage, but finds a qualified buyer to assume the mortgage, the VA is to require the lender to agree to the mortgage assumption since it is in the best interest of the VA.[14]

However, neither the lender nor the VA is required to release the seller from liability on the mortgage when the assumption is granted to avoid foreclosure.[15]

If the VA refuses to allow the buyer to assume the mortgage, and the veteran borrower sells the property nonetheless, the lender is to call the mortgage and demand payment of the remaining principal and interest without prior approval from the VA.[16]

Also, the lender is to call the VA mortgage if the veteran borrower sells their personal residence and fails to notify the lender of the sale.[17]

However, when a lender becomes aware the veteran borrower sold the property secured by a VA mortgage and the lender fails to notify the VA, then the lender, not the seller, is liable for any VA losses on the mortgage.[18]

---

14 38 USC §3714(a)(4)(B)
15 38 CFR §36.4508(b),(c)
16 38 USC §3714(a)(4)(C)
17 38 USC §3714(b)
18 38 USC §3714(c)(1), (2)

## Chapter 21 Summary

The Federal Housing Administration (FHA) insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders.

The VA mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.

EP investor-owners generally have a high default rate compared to owner-occupants of single family residences (SFRs). Thus, the

Department of Housing and Urban Development (HUD) discourages equity purchase (EP) investors from taking over FHA-insured mortgages. HUD has the right to call the mortgage if taken over by anyone other than an owner-occupant buyer. However, in spite of the HUD due-on enforcement policy, the servicing lender is permitted to call the mortgage on a subject-to transfer to an EP investor only with HUD's prior approval. However, as a matter of practice, HUD has not authorized a call when an EP investor acquires the property, unless the EP investor defaults on mortgage payments.

The VA mortgage assumption policy is entirely different from the HUD/FHA assumption policy. A buyer of property secured by a VA-guaranteed mortgage takes over the mortgage if:

- the mortgage is current;
- the buyer assumes the mortgage; and
- the buyer is creditworthy.

For a buyer to assume a VA mortgage, a fee of 0.5% of the mortgage balance is to be paid to the VA by the buyer.

## Chapter 21 Key Terms



**Quiz 5 Covering Chapters 18-22 is located on page 624.**

Chapter 22

# Personal property as security

## Learning Objectives

After reading this chapter, you will be able to:

- identify the documentation needed in real estate sales and mortgage transactions where personal property becomes additional security for a debt;
- distinguish whether an item is classified as a real estate fixture or personal property; and
- understand the filing requirements when structuring a sale involving personal property items.

## Key Terms

**bill of sale**
**constructive notice**
**mixed collateral transaction**
**perfecting the lien**
**real estate fixture**
**security agreement**
**trade fixture**

## Additional collateral and financing statements

Consider a seller's real estate agent who lists a furnished apartment complex for sale. The sale includes interior and exterior furnishings, such as:

- refrigerators; and
- maintenance equipment.

The seller is willing to carry a mortgage secured by a note and trust deed on the property.

The seller's agent advises the seller the furnishings and maintenance equipment they are selling as part of the price will be *additional security* for any carryback mortgage. Thus, the seller will minimize their risk of loss in the event the buyer defaults and foreclosure is required.

Likewise, loan brokers arrange short-term loans with private lenders. Since brokered loans made by private lenders usually are secured by second mortgages on real estate, junior lenders often want additional security. Additional security might take the form of *personal property*, such as:

- furnishings;
- business inventory;
- equipment;
- machines; or
- business revenue (accounts receivable).

## Documenting debt secured with personal property

Two documents are involved to properly secure a debt with personal property:

- a **security agreement** which creates a lien on the personal property; and
- a **UCC-1 Financing Statement** which is recorded to give public notice of the lien.

**security agreement**
An agreement entered into between a mortgage holder and buyer to grant the mortgage holder additional security in the form of a lien on personal property described in the agreement. [See **RPI** Form 436]

**perfecting the lien**
The preparation and filing of a UCC-1 Financing Statement (UCC-1) to put the public on notice of the lien created by a security agreement.

To create a lien on personal property transferred in a sale or as additional security for lender financing of real estate, a *security agreement* is entered into which grants the lienholder holder a security interest in personal property described in the agreement.

To put the public on *notice of the lien* created by the security agreement, a *UCC-1 Financing Statement (UCC-1)* is prepared and filed. The filing is a recording of the UCC-1 with the Secretary of State or with the county recorder, depending on the type of personal property and its relationship to the real estate. This process is called **perfecting the lien**.[1] [See Figure 436-1 accompanying this chapter]

*Perfecting the lien* establishes the mortgage holder's interest and priority over all other security interests in the personal property acquired by others after the UCC-1 is recorded.

*Editor's note — A carryback seller does not use a trust deed as a security device to create a lien on personal property. A recorded trust deed imposes a perfected lien on real estate, not personal property.*

## Personal property defined

All property is divided into two categories:

- **real property**, commonly known as **real estate**; and
- **personal property**, also called **personalty** or **chattel**.

1 Calif. Commercial Code §§9310; 9501

*Real estate* includes land and anything permanently affixed or appurtenant to it, such as buildings, trees or rivers.[2]

Every kind of property which is not real estate is classified as *personal property*.[3]

Thus, personal property includes:

- *tangible goods*, such as furniture, equipment and vehicles;
- *general intangibles*, such as the goodwill of a business, accounts receivable and business income;
- *instruments and documents*, such as notes, whether or not they are secured by a mortgage; and
- other items, such as cash and contract rights.

**Rents** form a separate category of personal property. *Rents* become security for a debt under a lien called an **assignment of rents provision** typically included in a mortgage. [See Chapter 15]

## Real property vs. personal property

A **real estate fixture** is personal property which is permanently attached or affixed to the land or buildings located within the parameters of a parcel of real estate and is part of that real estate.[4]

**real estate fixture**
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

For example, an air conditioning unit in an apartment complex is a *real estate fixture* since it is a necessary, integral part of the building. On the other hand, furniture is not a real estate fixture since it is not permanently attached to the building.

Fixtures which are used as part of a trade or business are called **trade fixtures**, such as the equipment and sinks in a restaurant, or chairs and plumbing fixtures affixed to the floor and walls in a beauty salon.

**trade fixture**
A fixture used to render services or make products for the trade or business of a tenant.

*Trade fixtures*, like real estate fixtures, are often affixed to the real estate. However, they remain personal property items since they are necessary to the operation of the business on the premises, not the use of the real estate itself.[5]

Whether an item is a real estate fixture or personal property is resolved by the application of a three part test:

- the *permanence* of the item's attachment to the real estate;
- the *degree* to which the real estate was constructed to support the fixtures; and
- the parties' *intentions* when the items were attached to the real estate.[6]

2 Calif. Civil Code §658
3 CC §663
4 CC §660
5 **Beebe** v. **Richards** (1953) 115 CA2d 589
6 **Security Data, Inc.** v. **County of Contra Costa** (1983) 145 CA3d 108

Form 436-1

UCC-1 Financing Statement

Page 1 of 2

For illustrative purposes only.
Click for the UCC-1 Financing Statement published by the California Secretary of State which may be filed.

**UCC - 1 FINANCING STATEMENT**
California (Rev. 04/20/11)

**UCC FINANCING STATEMENT**
FOLLOW INSTRUCTIONS

A. NAME & PHONE OF CONTACT AT FILER (optional)

B. E-MAIL CONTACT AT FILER (optional)

C. SEND ACKNOWLEDGMENT TO: (Name and Address)

Print | Reset

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S NAME: Provide only one Debtor name (1a or 1b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 1b, leave all of item 1 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

| | | | | |
|---|---|---|---|---|
| 1a. ORGANIZATION'S NAME | | | | |
| OR 1b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 1c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY |

2. DEBTOR'S NAME: Provide only one Debtor name (2a or 2b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 2b, leave all of item 2 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

| | | | | |
|---|---|---|---|---|
| 2a. ORGANIZATION'S NAME | | | | |
| OR 2b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 2c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY |

3. SECURED PARTY'S NAME (or NAME of ASSIGNEE of ASSIGNOR SECURED PARTY): Provide only one Secured Party name (3a or 3b)

| | | | | |
|---|---|---|---|---|
| 3a. ORGANIZATION'S NAME | | | | |
| OR 3b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 3c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY |

4. COLLATERAL: This financing statement covers the following collateral:

5. Check only if applicable and check only one box: Collateral is ☐ held in a Trust (see UCC1Ad, item 17 and Instructions) ☐ being administered by a Decedent's Personal Representative

6a. Check only if applicable and check only one box: ☐ Public-Finance Transaction ☐ Manufactured-Home Transaction ☐ A Debtor is a Transmitting Utility

6b. Check only if applicable and check only one box: ☐ Agricultural Lien ☐ Non-UCC Filing

7. ALTERNATIVE DESIGNATION (if applicable): ☐ Lessee/Lessor ☐ Consignee/Consignor ☐ Seller/Buyer ☐ Bailee/Bailor ☐ Licensee/Licensor

8. OPTIONAL FILER REFERENCE DATA:

UCC FINANCING STATEMENT (Form UCC1) (Rev. 04/20/11)

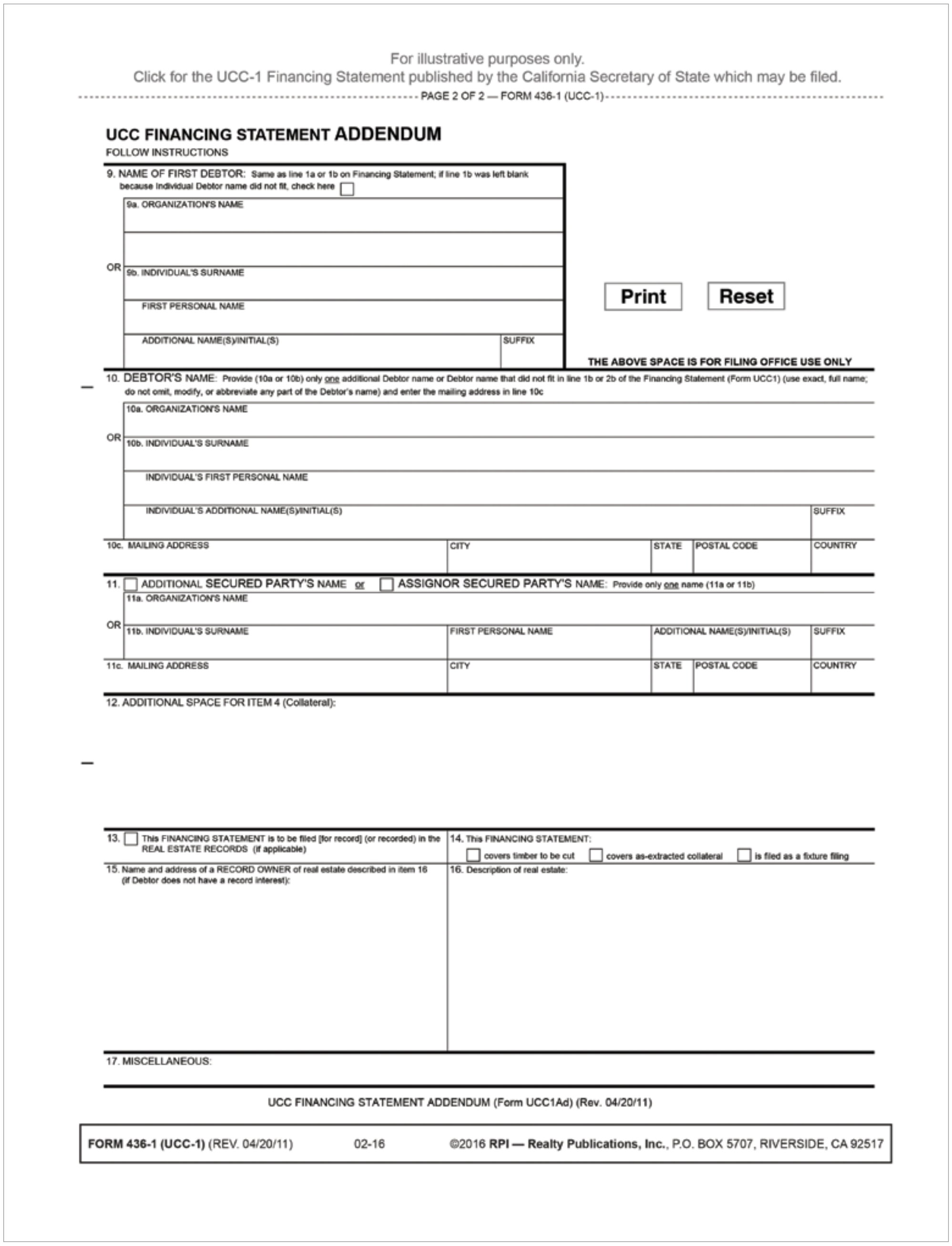
PAGE 1 OF 2 — FORM 436-1 (UCC-1)

Intent is the crucial, overriding factor in determining whether an item is to be classified as personal property or a real estate fixture.[7]

Intent to establish a fixture as real estate or personal property is usually manifested in a written agreement.

Thus, in a real estate transaction, the buyer and mortgage holder demonstrate their intent to treat an item as personal property, not a real estate fixture, by creating a lien on the item under a security agreement and recording a UCC-1 Financing Statement to perfect the mortgage holder's security interest.

7 **Seatrain Terminals of California, Inc.** v. **County of Alameda** (1978) 83 CA3d 69



For illustrative purposes only.
Click for the UCC-1 Financing Statement published by the California Secretary of State which may be filed.

PAGE 2 OF 2 — FORM 436-1 (UCC-1)

**UCC FINANCING STATEMENT ADDENDUM**
FOLLOW INSTRUCTIONS

9. NAME OF FIRST DEBTOR: Same as line 1a or 1b on Financing Statement; if line 1b was left blank because Individual Debtor name did not fit, check here ☐

9a. ORGANIZATION'S NAME

OR 9b. INDIVIDUAL'S SURNAME

FIRST PERSONAL NAME

ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX

Print Reset

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

10. DEBTOR'S NAME: Provide (10a or 10b) only one additional Debtor name or Debtor name that did not fit in line 1b or 2b of the Financing Statement (Form UCC1) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name) and enter the mailing address in line 10c

10a. ORGANIZATION'S NAME

OR 10b. INDIVIDUAL'S SURNAME

INDIVIDUAL'S FIRST PERSONAL NAME

INDIVIDUAL'S ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX

10c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY

11. ☐ ADDITIONAL SECURED PARTY'S NAME or ☐ ASSIGNOR SECURED PARTY'S NAME: Provide only one name (11a or 11b)

11a. ORGANIZATION'S NAME

OR 11b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX

11c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY

12. ADDITIONAL SPACE FOR ITEM 4 (Collateral):

13. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS (if applicable)

14. This FINANCING STATEMENT: ☐ covers timber to be cut ☐ covers as-extracted collateral ☐ is filed as a fixture filing

15. Name and address of a RECORD OWNER of real estate described in item 16 (if Debtor does not have a record interest):

16. Description of real estate:

17. MISCELLANEOUS:

UCC FINANCING STATEMENT ADDENDUM (Form UCC1Ad) (Rev. 04/20/11)

FORM 436-1 (UCC-1) (REV. 04/20/11) 02-16 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

Form 436-1

UCC-1 Financing Statement

Page 2 of 2

*Editor's note — The parties' intent as to whether an item is personal property or a fixture does not control for property assessment purposes.*[8]

## Personal property secures the carryback mortgage

Consider a broker who advises the seller of an apartment complex to additionally secure their carryback mortgage with personal property in the form of furnishings, refrigerators and maintenance equipment included in the purchase price.

Unless the personal property sold as part of an *installment sale* is security for the mortgage owed the seller, the buyer may sell the personal property

8 **Kaiser Co.** *v.* **Reid** (1947) 30 C2d 610

at their discretion. The buyer receiving a bill of sale becomes the owner of the personal property, unencumbered by the debt owed the carryback seller, unless the seller is granted a security interest in the personal property. [See **RPI** Form 408]

More importantly, if the personal property sold is not included with the real estate as additional security for the carryback mortgage, the seller may only foreclose on the real estate. The personal property cannot be repossessed.[9]

However, even if the mortgage is additionally secured by personal property sold as part of the underlying real estate transaction, the buyer has no personal liability on the carryback mortgage for any deficiencies on a foreclosure.[10]

## Documenting a perfected security interest

Three documents are required to properly structure a sale or loan transaction which includes personal property as additional security for a mortgage:

- a *promissory note* [See Form 420 in Chapter 3];
- a *security agreement* [See Form 436 accompanying this chapter]; and
- a *UCC-1 Financing Statement*. [See Form 436-1]

**bill of sale**
A written instrument given to pass title of personal property from vendor to the vendee. Compare with a grant deed. [See **RPI** Form 408]

To process a sale involving personal property, a **bill of sale** is prepared by escrow and signed by the seller. A *bill of sale* transfers ownership of the personal property to the buyer, just as a grant deed conveys the ownership of real estate. [See **RPI** Form 408]

The *promissory note* evidences the buyer's obligation to pay the mortgage created by the installment sale or loan.

**mixed collateral transaction**
A transaction which is evidenced by one note and secured by both real estate (using a trust deed) and personal property (using a UCC-1 Form).

The mortgage can be evidenced by one note and secured by both the real estate using a trust deed and the personal property using a UCC-1, called a **mixed collateral transaction**.

Alternatively, when a carryback mortgage is to be secured by both real estate and personal property, the mortgage holder and the buyer-owner may agree to divide the debt in two, each evidenced by a separate mortgage — one secured by real estate, the other by personal property.

If two separately secured debts are created, both the trust deed and the security agreement can contain a cross-collateral provision stating a default on one of the debts constitutes a default on the other, called a **dragnet clause**.[11] [See Chapter 13]

## The security agreement

A security agreement creates a *lien on personal property*. It is the personal property counterpart to a trust deed used as the security device to impose a mortgage lien on real estate.

9 **C.B. Cunningham** v. **Security Title Insurance Co.** (1966) 241 CA2d 626
10 Calif. Code of Civil Procedure §580b
11 **Wong** v. **Beneficial Savings and Loan Association** (1976) 56 CA3d 286

Form 436

Security Agreement — For Note Secured by Personal Property

**SECURITY AGREEMENT**
For Note Secured by Personal Property

**NOTE:** This form is used by a seller's agent or escrow officer when on a carryback sale the price includes the transfer of personal property which together with the property sold will be security for the carryback note, to grant the seller a security interest in the personal property. [See **RPI** Form 436-1 and 436-2]

**DATE:** ____________________, 20______, at ________________________________________________, California.
*Items left blank or unchecked are not applicable.*
**FACTS:**

**1.** This agreement provides security for the payment of a promissory Note in the amount of $______________________,
1.1 ☐ of same date, or dated _________________, 20______, at ________________________________, California,
1.2 executed by ________________________________________________________________, as the Debtor,
1.3 and ____________________________________________________________________, as the Creditor.

**2.** Debtor hereby grants to Creditor a security interest in the following personal property ________________________
______________________________________________________________________________________
______________________________________________________________________________________
______________________________________________________________________________________
______________________________________________________________________________________
_____________________________________________________________________________________.

**3.** The personal property is located on real estate referred to as __________________________________________
______________________________________________________________________________________
______________________________________________________________________________________
_____________________________________________________________________________________.

**4.** A UCC-1 financing statement will be executed concurrent with this agreement. [See **RPI** Form 436-1 and 436-2]

**5.** The Note is additionally secured by a trust deed entered into by the parties:
5.1 dated ___________________, at ____________________________________________________, California,
5.2 regarding real estate referred to as ______________________________________________________________,
5.3 recorded on ____________________, as document number ______________,
in the County of _________________________________________________________________, California.

**6.** Should Debtor offer to sell, accept an offer to purchase, lease or encumber the personal property or their interest in the promissory Note, or remove the personal property from its location without Creditor's written consent, Creditor may call the promissory Note immediately due.

**7.** Debtor will maintain insurance on the personal property against risks of fire, theft, vandalism and other extended coverage risks in an amount sufficient to protect the promissory Note.

**8.** Any advances made by Creditor to protect the security from impairment, or for property taxes, insurance or defense of title, including reasonable costs and attorney fees, is to be reimbursed by Debtor on demand, and if not paid, will be added to the amount due on the promissory Note and be immediately payable.

**9.** On default under the promissory Note or this agreement, or any other security device or obligation affecting the Note or this agreement, Creditor may call the Note due.

**10.** On default, Creditor has all the remedies of a secured party under the California Commercial Code.

| | |
|---|---|
| **I agree to the terms stated above.**<br>Debtor's Name: ______________________________<br>Address: ___________________________________<br>__________________________________________ | **I agree to the terms stated above.**<br>Creditor's Name: ____________________________<br>Address: ___________________________________<br>__________________________________________ |
| Debtor's Signature: ___________________________ | Creditor's Signature: __________________________ |
| Debtor's Signature: ___________________________ | Creditor's Signature: __________________________ |

**FORM 436** 02-13 

The security agreement contains the rights and obligations of the parties regarding the secured personal property, including:

- protection against waste;
- remedies on default; and
- transfer-alienation provisions. [See Form 436]

The security agreement is retained by the mortgage holder and not recorded with any agency.

To create an enforceable security interest in personal property, the *security agreement* needs to:

- identify the debt or other obligation for which the personal property is security, typically evidenced by a mortgage;
- describe the personal property which functions as the security; and
- grant a security interest in the personal property from the buyer or borrower to the mortgage holder.[12]

An enforceable security interest or lien *attaches* to personal property when:

- the borrower or buyer signs and delivers a security agreement containing a description of the personal property;
- the borrower or buyer has ownership rights in the personal property, as on a bill of sale; and
- value is given in exchange for the security interest, such as an installment sale of property by a seller or a loan made by a lender.[13]

If the personal property consists of *standing timber* or *unharvested crops* which the buyer intends to remove, the security agreement needs to also include a description of the real estate on which the personal property is located.[14]

## The recorded UCC-1 perfects the lien

A security agreement, unlike a trust deed, is not recorded. Thus, the agreement used to create the lien on personal property is not the document used to *perfect* the mortgage holder's security interest in personal property against future claims or transfers of that personal property.[15]

To perfect a lien on personal property against later claims acquired by others, a *UCC-1 Financing Statement* is prepared and filed with the Secretary of State, or the local county recorder depending on the type of property.[16] [See Form 436-1]

The UCC-1 Financing Statement, UCC-2 Change Form and UCC-3 Request for Information Form may be downloaded from the Secretary of State's website at: *http://www.ss.ca.gov*.

The UCC-1 is a statutory form which contains information about:

- the lender, called the **secured party**;
- the borrower, called the **debtor**;
- a description of the personal property, called **collateral**; and
- a description of the real estate where the personal property is located.[17] [See Form 436-1]

12 **Needle** v. **Lasco Industries, Inc.** (1970) 10 CA3d 1105
13 Com C §9203(b)(3)
14 Com C §9203(b)
15 Com C §9308
16 Com C §§9310, 9501
17 Com C §§9502, 9503

Additionally, a UCC-1 which describes timber, oil, gas, minerals or unharvested crops as the security for a debt is required to contain:

- a statement the UCC-1 will be recorded with the local county recorder; and
- the name of the owner of the described real estate, if the owner is not the borrower.[18] [See Form 436-1]

A holder of a mortgage secured by personal property needs to file a UCC-1 to put all parties who later acquire an interest in the secured property on notice of the mortgage holder's priority interest.

**constructive notice**
A legal fiction charging persons who own or acquire an interest in real estate with knowledge of recorded documents affecting title and conditions observable on the property.

If the holder of a mortgage secured by personal property fails to file a UCC-1, they run the risk of their lien being wiped out if the borrower or buyer later sells or encumbers the property or files a bankruptcy petition.

Without filing a UCC-1, a later buyer or creditor will not have **constructive notice** of the lender's unperfected security interest in the personal property.[19]

## Filing requirements

In most cases, the UCC-1 Financing Statement is filed with the Secretary of State.[20] [See Form 436-1]

If the UCC-1 covers standing timber, oil, gas, minerals or unharvested crops, it is recorded in the county in which the described real estate is located, usually concurrent with any mortgage recorded against the real estate.[21]

A *search for liens* on personal property is initiated by filing a *UCC-3 Request for Information (UCC-3)* with the Secretary of State. The response from the Secretary of State to the UCC-3 request is comparable to a title search on real estate.[22]

*Editor's note — Before closing a sale involving personal property items, the broker has escrow file a UCC-3 with the Secretary of State or the county recorder to obtain a lien report to verify the personal property is unencumbered.*

## Real estate sold with personal property

Several types of real estate when sold typically include the sale of personal property, such as:

- apartment complexes;
- office buildings;
- vacation homes;
- business opportunities;
- hotels or motels;
- farms or timberland;

18 Com C §§9502, 9503
19 Com C §9317
20 Com C §9501(b)
21 Com C §9501(a)(1)
22 Com C §9523

- oil, gas or minerals; and
- mobilehome spaces.

The sale of *apartment complexes* and *office buildings* typically include the sale of furniture, maintenance equipment, computer systems and trade fixtures.

Further, *vacation homes* are often sold fully furnished for recreational uses. Thus, the sale of the vacation home can potentially include everything from furniture and snow clearing equipment, to linens and kitchenware.

## Sale of a business opportunity

The sale of a *business* consists of the transfer of both categories of property:

- personal property assets such as goodwill, equipment, trade fixtures, receivables, and inventory; and
- the real estate interest held in the premises occupied by the business, whether fee simple or leasehold.

Usually, the sale of a business opportunity includes a leasehold interest in the real estate occupied by the business. Thus, the sale involves an *assignment* of the existing lease or a sublease is entered into.

The seller of a business located on leased property, in addition to filing a UCC-1 to secure the carryback mortgage, obtains and records a mortgage executed by the buyer describing the leasehold under which the business occupies the premises. A lease of the premises is an interest in real estate, and is not personal property requiring use of a UCC-1.[23]

However, when a UCC-1 is used to describe real estate as the property liened, a mortgage on the real estate is created which needs to be judicially foreclosed, unless a **power-of-sale provision** is included in the UCC-1 or security agreement.

Thus, a mortgage with a *power-of-sale provision* is preferable to a UCC-1 for creating liens on any interest in real estate. Security interests in leases on real estate are governed by real estate and mortgage law, not commercial codes which govern personal property liens.

## The sale of hotels and motels

The sale of hotels, motels and boarding houses involves substantial amounts of personal property, such as furniture, trade fixtures, appliances, maintenance and kitchen equipment. It also includes the sale of future *revenues* from the rooms, restaurants and shops owned and located on the premises.

Income from *room revenue* is classified as rent. Rent is recoverable by a secured creditor under an assignment of rents provision as contained in most mortgages. [See Chapter 15]

23 **Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25; CC §761

Rent from real estate, even if generated by a hotel, is not considered business income and thus is not subject to UCC rules governing personal property security.[24]

*Editor's note — To include the hotel's rental income as security for the carryback mortgage, the seller includes an assignment of rents provision in the mortgage carried back on the sale. An assignment of rents provision allows the mortgage holder to collect the rental income from a hotel, motel or any other type of income-producing building on the owner's default. [See Chapter 15]*

However, income from other services rendered by the hotel or motel owner, such as food and beverage sales, is liened by a security agreement and perfected by filing a UCC-1.[25]

## Sale of a farm or timberland

The sale of a farm involves personal property such as:

- equipment;
- livestock;
- unborn livestock; and
- unharvested crops

All of these personal property items may be pledged as security for a debt.[26]

Although plants and trees are considered real estate until severed from the land, unharvested crops, also called **future crops**, and standing timber may be sold or encumbered as personal property, separate from the real estate. These items are sold or encumbered with a security agreement and a UCC-1.[27]

## UCC-1 extension

The UCC-1 is effective for *five years* after it is filed.[28]

To *prevent expiration* of the UCC-1 and retain priority, the lender files a continuation statement, called a *UCC-2 Change Form*, with the Secretary of State or county recorder within the six-month period before expiration.

The UCC-2 needs to identify the original UCC-1 and be signed by the mortgage holder.[29]

Any number of later continuations may be filed, simply by repeating the process every five years.[30]

24 **In re Days California Riverside Limited Partnership** (9th Cir. 1994) 27 F3d 374
25 In re Days California Riverside Limited Partnership, *supra*; Com C §9102(a)(2)
26 Com C §9102(a)(34),(44)
27 Com C §9102(a)(34), (44)
28 Com C §9515(a)
29 Com C §9515(c), (d)
30 Com C §9515(e)

## Chapter 22 Summary

All property is divided into two categories:

- real property; and
- personal property.

The holder of a mortgage secured by personal property needs to file a UCC-1 Financing Statement to put all parties who later acquire an interest in the secured property on notice of the lender's or carryback seller's priority interest.

A security agreement creates a lien on personal property and is the personal property counterpart to a mortgage used as a security device to impose a lien on real estate.

The process of perfecting the lien establishes the mortgage holder's interest and priority over all other security interests in the personal property granted to or acquired by others and filed after the mortgage holder's UCC-1 is recorded.

## Chapter 22 Key Terms



**Quiz 5 Covering Chapters 18-22 is located on page 624.**

# Chapter 23

# Carryback financing overview

## Learning Objectives

After reading this chapter, you will be able to:

- comprehend the financial benefits afforded sellers and buyers who enter into seller carryback financing arrangements;
- identify the seller's financial risks involved in carryback financing;
- advise on the various forms of documentation used to structure seller carryback 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)**
**carryback financing**
**impound account**
**portfolio category income**
**private mortgage insurance (PMI)**

## Carryback 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 **carryback financing**.

**carryback 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 seller financing.

*Carryback financing* is also known as:

- a carryback mortgage;

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

Carryback 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 Department of Real Estate (DRE) license.*

*However, a broker offering or negotiating a carryback consumer mortgage as part of a home sale to a buyer-occupant 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 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.

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.

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

## Flexible sales terms for the buyer

Carryback financing also provides tangible benefits for buyers. Typically, carryback financing offers a buyer:

- 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).** PMI adds about one percent in addition to the annual mortgage interest rate 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 ratio (LTV)**.

**private mortgage insurance (PMI)**
Default mortgage insurance coverage provided to a mortgage holder by private insurers on conventional mortgages with loan-to-value (LTV) ratios higher than 80%.

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

Additionally, a *price-to-interest rate tradeoff* often takes place in the carryback environment. The buyer typically negotiates 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.

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.

When the seller does not carry back a note payable in future years, they are cashed out. With no carryback, they 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 cashed-out 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 the note's principal.

Tax on the interest the seller receives on their carryback mortgage is classified as **portfolio category income**. This is the case even when the property sold was in another income category (passive/business/personal).

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

## Proper documentation for carryback financing

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

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive.

Legally, the **note and trust deed** provide the most certainty. Further, they are the most universally understood of the various documents used to structure carryback 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]

**all-inclusive trust deed (AITD)**
A note entered into by a 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]

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 30]

For instance, when 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.

However, when the holder of the existing mortgage will not allow the buyer to assume the mortgage, the buyer needs to 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.

2 Calif. Civil Code §2956

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 carryback mortgage. This alternative is referred to as an **all-inclusive trust deed (AITD)**, also called a **wraparound mortgage** or **overriding note**.

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.

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).

## 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.

Another implicit risk of loss for any mortgage holder arises when a 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, 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 a 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 no longer want. Financially, they 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 debt**. 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]

However, as with any lender, when 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.

## Taxes and premiums paid through the carryback seller

Consider the seller of a single family residence (SFR) who receives an offer from a buyer. Terms for payment of the purchase price include:

- a cash *down payment* of less than 20%;
- an *assumption* of the existing first mortgage (or new *purchase-assist financing*) of less than 80%; and
- a seller *carryback note* for the balance of the purchase price.

Here, the combined *LTV* of the first mortgage and the seller carryback note is more than 80% of the price paid for the property.

The seller's agent prepares and reviews a seller's **net sheet** with the seller. The seller observes the net proceeds of cash and the carryback note and their amounts. [See **RPI** Form 310]

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3 Calif. Code of Civil Procedure §580b

The seller voices concern as to whether the net cash proceeds they will receive on closing will be adequate to cover out-of-pocket expenditures to foreclose if the buyer defaults on either the first or the seller's carryback mortgage. The agent prepares a foreclosure cost sheet itemizing and calculating the costs and net proceeds on a foreclosure and resale of the property and reviews it with the seller. [See **RPI** Form 303]

They determine the buyer is sufficiently creditworthy and financially capable to carry the costs of owning the property. However, any failure of the buyer to pay property taxes and insurance premiums (TI) will automatically **impair** the carryback seller's *security interest* in the property exposing the seller to some risk of loss.

When the seller pays any of these delinquencies — called a **future advance** — the amounts paid become part of the carryback mortgage principal, until reimbursed by the buyer.

To minimize the risk of the buyer defaulting, the seller wants to make a counteroffer calling for a larger down payment. In turn, that will provide more net sales proceeds (and a reduced amount of carryback note). However, the seller's agent is concerned the buyer will not agree to an increase in the down payment.

## Impound account provision reduces risk

As an alternative, the seller's agent suggests the seller consider a counteroffer calling for the inclusion of an **impound account** provision in the carryback trust deed to reduce the risk of default. [See **RPI** Form 180]

**impound account**
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

The *impound account* provision will call for the buyer to make monthly payments toward taxes and insurance in addition to regular principal and interest installments, commonly referred to as **PITI (principal, interest, taxes and insurance)**.

Will the seller be able to enforce an impound provision for taxes and insurance?

Yes! An impound account provision is enforceable in a consumer carryback mortgage when the combined principal of the first and carryback mortgages totals more than 80% of the property's appraised value.[4] [See Chapter 14]

An impound account provision in a mortgage on any real estate, whether mandated by law, demanded by the mortgage holder or a service requested by the property owner, calls for the property owner to make a monthly deposit with the mortgage holder to accumulate sufficient funds for the periodic payment of:

- property taxes; and
- hazard insurance premiums.[5]

4 CC §2954(a)(1)
5 CC §2954

## Carryback consumer mortgage impounds

California law controls impound accounts for consumer mortgages carried back by sellers. Thus, carryback sellers need not pay interest on impound accounts established in a carryback mortgage.[6]

Surplus funds accumulated in the impound account by a carryback seller are to be refunded within 30 days of the surplus being incurred, unless the owner and the mortgage holder have agreed to apply the funds elsewhere.[7]

For example, an owner may agree in the impound account provision to either:

- credit surplus funds in the impound account toward mortgage principal; or
- retain the surplus in the impound account to cover any future deficiencies. [See **RPI** Form 455 §4]

However, a written agreement governing the use of *surplus impounded funds* (other than an immediate refund) can be rescinded by either the property owner or mortgage holder at any time.[8]

## Statements and accounting for carryback consumer impounds

A seller carrying back a mortgage on one-to-four unit residential property with an impound account provision provides the buyer with an annual impound accounting within **60 days** after the end of the calendar year.[9]

The carryback seller's annual impound accounting itemizes:

- the amount received and applied to principal and interest;
- money received and disbursed from the impound account for TI obligations; and
- any late charges.[10]

A buyer of property on an impounded carryback sale is entitled to the annual impound accounting statement without charge or prior request.[11]

## Impounds on AITDs

Consider a seller who will remain responsible for making payments on an underlying mortgage by carrying back an *AITD*.

The AITD will give the carryback seller additional protection against the buyer defaulting on payments on the first mortgage and the seller not learning of the default for several months.

The existing underlying mortgage contains an impound account provision for TI. The seller will continue to pay the monthly impound amount in addition to regular installments of principal and interest.

Here, the seller needs to establish an impound account payment on the AITD to collect and pass on TI payments to be made by the buyer.

6 CC §2954.9(b)
7 CC §2954.1(b)
8 CC §2954.1(b)
9 CC §2954.2
10 CC §2954.2(a)
11 CC §2954.2(a)

Now consider a carryback seller on any type of real estate made for any purpose whose trust deed contains an impound account provision. The seller receives monthly PITI payments.

Is the seller required to maintain a separate bank account for the impounded funds?

No! Unlike trust funds, a carryback seller or lender may **commingle** the owner's impounds with its **general funds** and retain all the benefits from these funds.

However, the impounded funds have to remain in the state of California. If invested, the funds are only permitted to be invested with individual residents of the state or entities doing business in the state.[12]

On carryback transactions with no present transfer of legal title — called **land sales contracts** — the seller is required to hold the impounded funds in a **trust account**. The trust funds are only permitted to be disbursed for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise.[13]

12 CC §2955
13 CC §2985.4

## Chapter 23 Summary

Carryback 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.

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.

Typically, carryback financing offers a buyer:

- 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.

On closing the sale, the carryback financing may be documented in a variety of ways. Arrangements include:

- land sales contracts;

- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive.

Legally, the note and trust deed provide by far the most certainty. Further, they are the most universally understood of the various documents used to structure seller financing.

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 any mortgage holder arises when a property's value declines due to deflationary future market conditions or the buyer committing waste.

As with any lender, when 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.

Any failure of the buyer to pay property taxes and insurance premiums (TI) will automatically impair the carryback seller's security interest in the property exposing the seller to some risk of loss. An impound account provision will call for the buyer to make monthly payments toward taxes and insurance in addition to regular principal and interest installments, commonly referred to as PITI (principal, interest, taxes and insurance).

A seller carrying back a mortgage on one-to-four unit residential property with an impound account provision provides the buyer with an annual impound accounting within 60 days after the end of the calendar year.

## Chapter 23 Key Terms

**all-inclusive trust deed (AITD) note** .................... pg. 274
**carryback financing** .................... pg. 271
**impound account** .................... pg. 277
**portfolio category income** .................... pg. 273
**private mortgage insurance (PMI)** .................... pg. 273

**Quiz 6 Covering Chapters 23-26 is located on page 625.**

# Chapter 24

# 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**
An employment agreement used by brokers and agents when a client retains a broker to render real estate transactional services as the agent of the client. [See **RP**I 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.

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: ______________________

**FORM 103** 12-15 

- a 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.

**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 **RP**I 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 **RPI** Form 281]

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 27]

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 27]

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** 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 27]

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 Form 412 in Chapter 45]

8.5 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application on acceptance. [See Form 302 in Chapter 29]

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 Form 436 in Chapter 22]

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 24 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 24 Key Terms



**Quiz 6 Covering Chapters 23-26 is located on page 625.**

# Chapter 25

# 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 debt**
**recourse debt**

## 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 27]

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 DRE Fall 2013 *Real Estate Bulletin*, "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 debt**
A debt recoverable on default solely through the value of the 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 Chapter 28; see **RPI** Form 303]

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 27]

## 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 52]; 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 52]

## 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.

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

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*.

**anti-deficiency**
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

**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 single trust deed which describes more than one parcel of real estate as security for the referenced debt. [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 Form 439 in Chapter 12;
- a **security interest** in personal property or other real estate, called **cross-collateralization** [See Form 436 in Chapter 22]; 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: ________________________________________

**FORM 424** 03-11 

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 **RP**I Form 437 & 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 25 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 25 Key Terms



**Quiz 6 Covering Chapters 23-26 is located on page 625.**

# Chapter 26

# 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)** | **recast** |
| **call** | **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.

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

**call**
A mortgage holder's demand for the balance of the loan to be immediately paid in full.

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.

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. [See Chapter 19]

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 19]

**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**.

**all-inclusive trust deed (AITD)**
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 **RP**I 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.

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 30]

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.

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 16]

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3 California 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 30]

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 26 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 26 Key Terms



**Quiz 6 Covering Chapters 23-26 is located on page 625.**

*Notes:*

# Chapter 27

# 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 monthl ____________ installments of $__________ to include _____% per annum interest, with a final/balloo 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 balanc of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of th 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 n variable or adjustable interest rates which would increase payments or result in the negative amortization of th 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 escro to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed o obtained.
   3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provision passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbranc 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 t place the Note on contract collection with any institutional lender or real estate broker, other than Selle 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 o 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 b Buyer.
   4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assur 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 an 2924e will be recorded and served on behalf of Seller on encumbrances senior to the carryback. [See **RPI** For 412]
   4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, their sole source of recove is limited to the net proceeds from a foreclosure sale or their subsequent resale of the real estate, and they ar not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Cod of Civil Procedure §580b]

---------- PAGE 1 OF 2 — FORM 300 ----------

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

PAGE 2 OF 2 — FORM 300

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."

**. 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<br>Type: _________ | _______ % ☐ ARM<br>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.

**. 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]

**. 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]

**. OTHER:** ________________________________________________

| | |
|---|---|
| Date: ______________, 20_____<br>Buyer's Broker: ____________________<br>CalBRE #: ____________________<br><br>By: ____________________<br>**I have and received a copy of this statement.**<br>Date: ______________, 20_____<br><br>Buyer: ____________________<br><br>Buyer: ____________________ | Date: ______________, 20_____<br>Seller's Broker: ____________________<br>CalBRE #: ____________________<br><br>By: ____________________<br>**I have and received a copy of this statement.**<br>Date: ______________, 20_____<br><br>Seller: ____________________<br><br>Seller: ____________________ |

**FORM 300** 03-11 

Form 300

Financial Disclosure Statement

Page 2 of 2

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 as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RP**I Form 185 §9]

- 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. [See Chapter 51]

## 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 substituting for a note and trust deed in an attempt to avoid due-on enforcement, Regulation Z (Reg 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]

**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.

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.

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]

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

Prepared by: Agent ______________ Phone ______________
Broker ______________ Email ______________

**NOTE:** This disclosure 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 the seller extending credit on a lease-option sales agreement, to prepare an addendum for disclosing the terms and conditions of the lease-option agreement.

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

**FACTS:**

1. This is an addendum to the following agreement:
☐ Offer for Lease-Option [See **RPI** Form 164]
☐ Lease-Option Contract for Deed [See **RPI** Form 163]
1.1 dated ______________, 20____
1.2 entered into by ______________, as the Lessee/Optionee,
1.3 and ______________, as the Lessor/Optionor,
1.4 regarding property referred to as ______________.

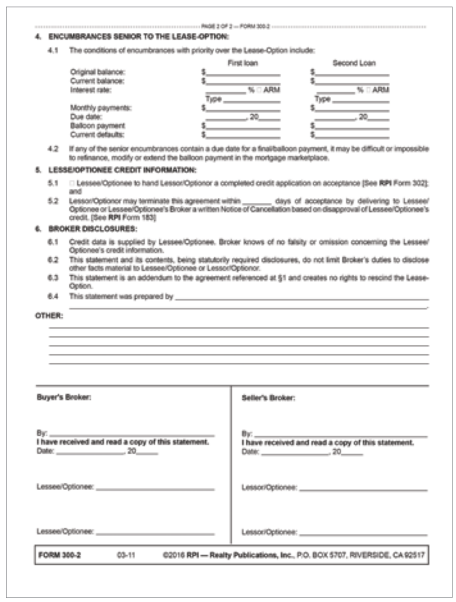
**DISCLOSURES:**

2. **GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:**
2.1 The purchase price is $__________. The price to be credited for $__________ of option money paid and for ______%, or $__________, of each payment of base monthly rent.
2.2 The Lease-Option provides for a final/balloon payment on exercise of the option. Thus, the debt is not fully amortized. On exercise of the option, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured. [See **RPI** Form 418-3]
2.3 Lessee/Optionee will make Lease-Option payments to ______________, who will be responsible for remitting these funds to Payees under senior encumbrances.
**Notice:** Lessee and Lessor may wish to use a collection agent for the purpose of accepting Lessee's payments and disbursing payment to underlying lenders and Lessor.
2.4 This Lease-Option is subject to the following provision: "This Lease-Option is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Lessee/Optionee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due on exercise of the option." [See **RPI** Form 419]
2.5 The Lease-Option wraps an existing trust deed, and any costs incurred by Lessor/Optionor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Lessee/Optionee as increased rent. [See **RPI** Form 163]

3. **SPECIAL PROVISIONS AND DISCLOSURES:**
3.1 ☐ Lessor will be designated as loss payee under Lessee's hazard and fire insurance.
3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Lessee/Optionee on encumbrances senior to the Lease-Option. [See **RPI** Form 164 §7.4]
3.3 The Lease-Option is an unescrowed seller-financing transaction which is fully executed on delivery of the signed Lease-Option documents and possession.
3.4 The Lease-Option will not be recorded, which may cause Lessee/Optionee's title to the property to be impaired if liens are levied against the Lessor/Optionor.
3.5 Lessee/Optionee is advised to consider obtaining title insurance on their real estate interest created by the option.
3.6 No tax reporting service will be obtained. Lessee/Optionee will assure themselves that real estate taxes are paid by Lessor/Optionor during the option period.
3.7 Lessee/Optionee will receive no proceeds or cash back on execution of the Lease-Option.
3.8 Lessor/Optionor is aware their sole source of recovery on Lessee/Optionee's default is limited to the net proceeds in the event of foreclosure under the Lease-Option. [Calif. Code of Civil Procedure §580b]

PAGE 1 OF 2 — FORM 300-2

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



PAGE 2 OF 2 — FORM 300-2

4. **ENCUMBRANCES SENIOR TO THE LEASE-OPTION:**
4.1 The conditions of encumbrances with priority over the Lease-Option include:

| | First loan | Second Loan |
|---|---|---|
| Original balance: | $________ | $________ |
| Current balance: | $________ | $________ |
| Interest rate: | ______% ☐ ARM Type ______ | ______% ☐ ARM Type ______ |
| Monthly payments: | $________ | $________ |
| Due date: | ________, 20____ | ________, 20____ |
| Balloon payment | $________ | $________ |
| Current defaults: | $________ | $________ |

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

5. **LESSE/OPTIONEE CREDIT INFORMATION:**
5.1 ☐ Lessee/Optionee to hand Lessor/Optionor a completed credit application on acceptance [See **RPI** Form 302]; and
5.2 Lessor/Optionor may terminate this agreement within ______ days of acceptance by delivering to Lessee/Optionee or Lessee/Optionee's Broker a written Notice of Cancellation based on disapproval of Lessee/Optionee's credit. [See **RPI** Form 183]

6. **BROKER DISCLOSURES:**
6.1 Credit data is supplied by Lessee/Optionee. Broker knows of no falsity or omission concerning the Lessee/Optionee's credit information.
6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Lessee/Optionee or Lessor/Optionor.
6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Lease-Option.
6.4 This statement was prepared by ______________.

**OTHER:**

| **Buyer's Broker:** | **Seller's Broker:** |
|---|---|
| By: ______________ | By: ______________ |
| **I have received and read a copy of this statement.** | **I have received and read a copy of this statement.** |
| Date: __________, 20____ | Date: __________, 20____ |
| Lessee/Optionee: ______________ | Lessor/Optionee: ______________ |
| Lessee/Optionee: ______________ | Lessor/Optionee: ______________ |

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- 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:

**straight note**
A note calling for payment of the entire amount of principal and accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

- bear interest; or

3 CC §2957

- include finance charges.

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]

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

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

**FINANCIAL DISCLOSURE STATEMENT**
For Entering Into a Land Sales Contract

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

**NOTE:** This disclosure 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 the seller extending credit on a land sales contract, to prepare an addendum to disclose the terms and conditions of the land sales contract.

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

**1. FACTS:**
This is an addendum to the following agreement:
☐ Offer for Land Sales Contract [See **RPI** Form 167]
☐ Land Sales Contract [See **RPI** Form 168]

1.1 dated ______________, 20______
1.2 entered into by ______________, as the Vendor, and ______________, as the Vendee,
1.3 regarding property referred to as ______________.

**DISCLOSURES:**

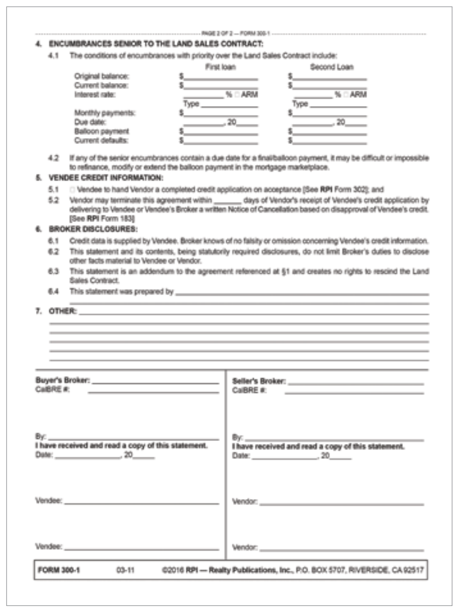
**2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:**

2.1 The balance of the purchase price due Vendor is $______________, payable in constant monthly installments of $______________, to include _____% per annum interest, all due and payable with a final/balloon payment on ______________, 20______, in the approximate amount of $______________.
2.2 The Land Sales Contract provides for a final/balloon payment. Thus, the debt is not fully amortized. On the final/balloon payment date, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured. [See **RPI** Form 418-3]
2.3 Vendor remains responsible to remit payments to Payees under senior encumbrances on receipt of installments paid by Vendee.
**Notice:** *The Vendor and Vendee may wish to use a collection agent for the purpose of accepting the Vendee's payments and disbursing payment to underlying lenders and the Land Sales Contract.*
2.4 This Land Sales Contract is subject to the following provision: "This Land Sales Contract is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due." [See **RPI** Form 419]
2.5 The Land Sales Contract wraps an existing trust deed, and any costs incurred by Vendor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Vendee for payment. [See **RPI** Form 168]

**3. SPECIAL PROVISIONS AND DISCLOSURES:**

3.1 ☐ Vendor will be designated as loss payee under Vendee's hazard and fire insurance, or
☐ Vendee will be designated as loss payee under Vendor's hazard and fire insurance.
3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Vendee on encumbrances senior to the Land Sales Contract. [See **RPI** Form 167 §14 and Form 412]
3.3 The land sales contract transaction ☐ will, or ☐ will not, be escrowed for the delivery of the signed Land Sales Contract to Vendor and possession to Vendee.
3.4 The Land Sales Contract ☐ will, or ☐ will not, be recorded. The lack of a recording may impair Vendee's interest in the property if liens attach to Vendor's interest in the property.
3.5 Vendee's policy of title insurance ☐ will, or ☐ will not, be obtained from a title insurance company.
3.6 No tax reporting service will be obtained. If an impound rider is agreed to, Vendee will confirm the real estate taxes are paid by Vendor. If no impound rider is agreed to, Vendor will confirm the real estate taxes are paid by Vendee.
3.7 Vendee is to receive no proceeds or cash back on execution of the Land Sales Contract.
3.8 Vendor is aware their sole source of recovery on Vendee's default is limited to the credit bid or net proceeds from Vendor's foreclosure under the Land Sales Contract. [Calif. Code of Civil Procedure §580b]

PAGE 1 OF 2 — FORM 300-1



PAGE 2 OF 2 — FORM 300-1

**4. ENCUMBRANCES SENIOR TO THE LAND SALES CONTRACT:**

4.1 The conditions of encumbrances with priority over the Land Sales Contract include:

| | First loan | Second Loan |
|---|---|---|
| Original balance: | $__________ | $__________ |
| Current balance: | $__________ | $__________ |
| Interest rate: | _______% ☐ ARM<br>Type _______ | _______% ☐ ARM<br>Type _______ |
| Monthly payments: | $__________ | $__________ |
| Due date: | _______, 20____ | _______, 20____ |
| Balloon payment | $__________ | $__________ |
| Current defaults: | $__________ | $__________ |

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

**5. VENDEE CREDIT INFORMATION:**

5.1 ☐ Vendee to hand Vendor a completed credit application on acceptance [See **RPI** Form 302]; and
5.2 Vendor may terminate this agreement within _______ days of Vendor's receipt of Vendee's credit application by delivering to Vendee or Vendee's Broker a written Notice of Cancellation based on disapproval of Vendee's credit. [See **RPI** Form 183]

**6. BROKER DISCLOSURES:**

6.1 Credit data is supplied by Vendee. Broker knows of no falsity or omission concerning Vendee's credit information.
6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Vendee or Vendor.
6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Land Sales Contract.
6.4 This statement was prepared by ______________

**7. OTHER:** ______________

| | |
|---|---|
| **Buyer's Broker:** ______________<br>CalBRE #: ______________ | **Seller's Broker:** ______________<br>CalBRE #: ______________ |
| By: ______________<br>**I have received and read a copy of this statement.**<br>Date: ______________, 20______ | By: ______________<br>**I have received and read a copy of this statement.**<br>Date: ______________, 20______ |
| Vendee: ______________ | Vendor: ______________ |
| Vendee: ______________ | Vendor: ______________ |

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## 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.

*Editor's note – For more information concerning balloon payment limitations on consumer mortgages, see Chapter 11.*

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 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 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 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]

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9 CC §2959
10 CC §2965

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

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 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]

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

## 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 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 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.

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

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 carryback a mortgage, needs to be primarily concerned with their **loan-to-value ratio (LTV)** 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* 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 27 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 27 Key Terms



**Quiz 7 Covering Chapters 27-29 is located on page 626.**

Chapter 28

# 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 provision**
**private mortgage insurance (PMI)**
**put option**
**recourse debt**
**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 as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RP**I Form 185 §9]

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 **RPI** Form 303 accompanying this chapter]

## Agency duties and carryback risks

**private mortgage insurance (PMI)**
Default mortgage insurance coverage provided to a mortgage holder by private insurers on conventional mortgages with loan-to-value (LTV) 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 debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

## 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 [See Chapter 7];
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) [See Chapter 28];
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 [See Chapter 42];
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 **RP**I 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** From 439 and 553-1]

**put option**
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

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 [See Chapter 10];

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 29 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 **RP**I 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 ratio (LTV)* 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.

. 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 ______________________________

. Estimated resale value of the real estate.......................................$__________

. Balances on senior trust deeds at the time of resale

3.1 Underlying first trust deed.......................................$__________
3.2 Underlying second trust deed.......................................$__________

. 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 _____).......................................$__________

. 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.......................................$__________
5.6 Miscellaneous charges.......................................$__________

. 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.......................................$__________
6.4 Broker fees and charges.......................................$__________

. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): .................... (-)$__________

. 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 grant deed conveying the mortgaged real estate to a mortgage holder which is accepted from the property owner in exchange for cancelling the mortgage debt to avoid foreclosure. [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; see Chapter 57]

**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.

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.

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. [See Chapter 8]

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 California 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 provision** to authorize the more efficient, less expensive trustee's foreclosure sale. [See Chapters 42 and 44]

**power-of-sale provision**
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 PL 111-22 §702(b)(3)

## Chapter 28 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.

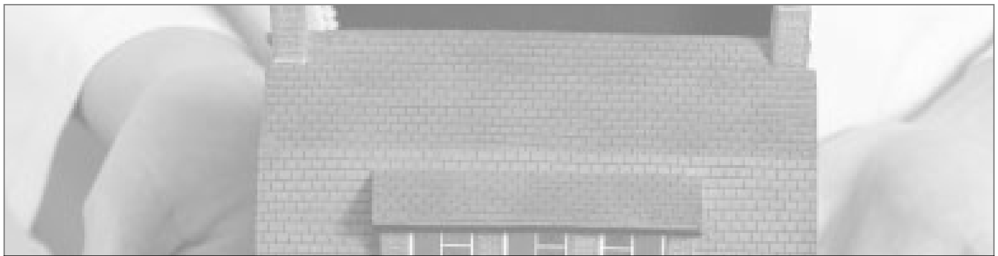
## Chapter 28 Key Terms



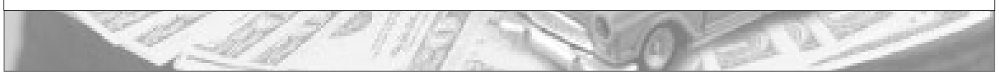
**Quiz 7 Covering Chapters 27-29 is located on page 626.**

*Notes:*

Chapter 29



# 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**

**further-approval contingency**

**impairment**

**implicit rent**

**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]

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 as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RPI** Form 185 §9]

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.

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 **ft** 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 27]

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 209-2 and 209-3]

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 209-2 and 209-3];
- 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 an interest held by another in real estate.

## 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 27]

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 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: ______



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** Forms 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, the **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 29 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 29 Key Terms

**debt service** .......... **pg. 343**
**further-approval contingency** .......... **pg. 336**
**impairment** .......... **pg. 339**
**implicit rent** .......... **pg. 342**
**unsecured note** .......... **pg. 336**

**Quiz 7 Covering Chapters 27-29 is located on page 626.**

# Chapter 30

# 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)**
**beneficiary statement**
**blanket mortgage**
**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)**
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 **RPI** Form 442, 443 and 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 **RPI** Form 421]

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.

## 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.

## 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**
The addition of unpaid interest to the principal balance of a mortgage due to insufficient monthly interest payments.

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. [See Chapter 7]

## 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.

Taxwise, 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 51]

## Due dates and 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 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 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 **RP**I 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 Chapters 4 and 19]

The due-on 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;
- 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 19]

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**. [See Chapter 29]

## 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 **RPI** Form 300; see Chapter 27]

## 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 written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note. [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** and **Notice of Delinquency** on any underlying mortgages. [See **RPI** Form 412; see Chapter 42]

The request for a *Notice of Delinquency (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 single trust deed which describes more than one parcel of real estate as security for the referenced debt. [See **RP**I 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 30 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 a Notice of Delinquency (NODq) assures the buyer they will promptly learn of any failure by the carryback seller to make payments to senior mortgage holders.

## Chapter 30 Key Terms



**Quiz 8 Covering Chapters 30-32 is located on page 627.**

# Chapter 31

# 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
- understand the consequences of concealing a sale from a mortgage holder.

## Key Terms

**land sales contract** **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;
- the payment schedule; and
- the 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.

**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 (Reg Z), reassessment for property taxes, profit reporting and the buyer's right of reinstatement or redemption on default. [See **RP**I 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] [See Chapter 19]

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**
A contract used in a sale of real estate when the seller retains title to the property until all or a prescribed part of the purchase price has been paid. [See **RPI** Form 168]

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 Figure 1, **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.

## 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.

5 Calif. Civil Code §2985

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).

## 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 1]

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.

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 2, **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 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.[6]

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

Taxwise, 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.

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

6 **Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798

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).[7]

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.

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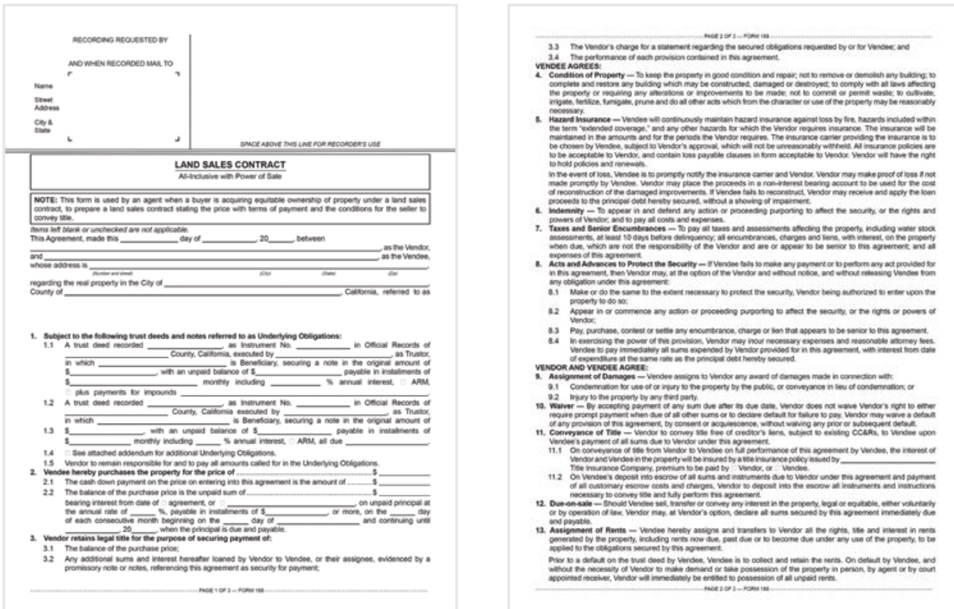
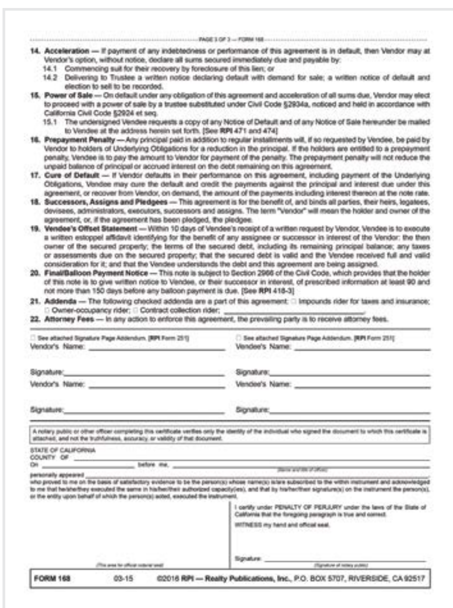
7 **Miller** v. **Cote** (1982) 127 CA3d 888

Figure 1

Form 168

Land Sales Contract





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The reverse trust deed is not perfect and has several potentially fatal flaws, both economic and legal.

## Economic and legal flaws

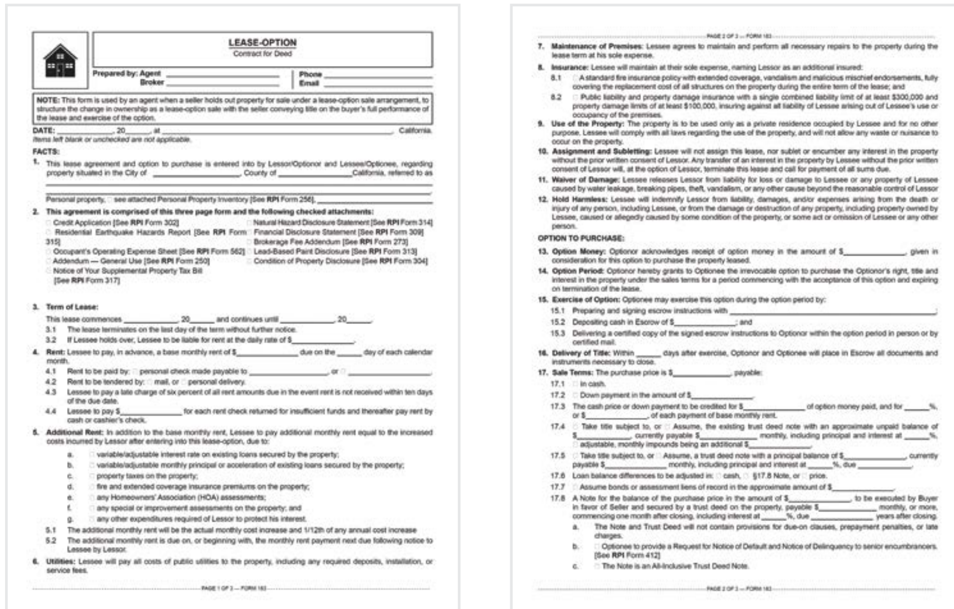
Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect their equity (due to the historical 2% annual rate of inflation as a monetary policy of the Federal Reserve and cyclical asset inflation).

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.

Figure 2

Form 163

Lease-Option



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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.[8]

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

Taxwise, 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.

8 12 CFR §591.5(b)(1)(i)

## Chapter 31 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 31 Key Terms



**Quiz 8 Covering Chapters 30-32 is located on page 627.**

# Chapter 32

# Conventional financing

## Learning Objectives

After reading this chapter, you will be able to:

- define conventional financing and differentiate it from government-related financing;
- understand the adversarial relationship between a mortgage lender and homebuyer; and
- advise homebuyers of the financial advantage gained by submitting mortgage applications to multiple lenders.

## Key Terms

**Closing Disclosure**
**conforming loan**
**conventional mortgage**
**government-related mortgage**
**institutional lender**
**jumbo mortgage**
**lender overlay**
**Loan Estimate**
**loan level price adjustment**
**mortgage shopping worksheet**
**portfolio lender**
**super-conforming loan**
**warehouse lender**

## The conventional mortgage

Consumer mortgages are either:

- **conventional mortgages**; or
- **government-related mortgages**.

A *conventional mortgage* is any mortgage that is not made, insured or guaranteed by the federal government.

**conventional mortgage**
A mortgage that is not made, insured or guaranteed by the federal government.

**government-related mortgage**
A mortgage that is made, insured or guaranteed by the federal government.

A *government-related mortgage* is a mortgage insured by the Federal Housing Administration (FHA), guaranteed by the U.S. Department of Veterans Affairs (VA) or guaranteed or funded by the U.S. Department of Agriculture (USDA).

The terms of a conventional mortgage are set by:

- the investor who purchases the mortgage;
- the private mortgage insurer, if the loan-to-value ratio (LTV) exceeds 80% [See Chapter 37]; and
- the lender originating the mortgage.

In contrast, the terms of a *government-related mortgage* are set by:

- the FHA, VA or USDA; and
- the lender.

## Investor guidelines

The majority of conventional mortgages are sold to the *Fannie Mae* or the *Freddie Mac* after origination. Collectively, these entities are known as *government-sponsored enterprises (GSEs)*.

To be eligible for sale to Fannie Mae or Freddie Mac, a mortgage needs to meet minimum mortgage standards set by Fannie Mae or Freddie Mac. As the bulk of consumer mortgages are sold after origination, Fannie Mae and Freddie Mac guidelines effectively dictate the minimum features of conventional mortgages.

## Lender guidelines

A lender may also impose additional minimum requirements on top of PMI or investor guidelines, based on the lender's business strategy or tolerance to risk. These guidelines are called **lender overlays.**

**lender overlay**
Lender-imposed standards on consumer mortgages to be met by applicants in addition to standards set by mortgage insurers and investors.

**loan level price adjustment**
Adjusted interest rates or fees based on the risk of default a mortgage poses.

*Lender overlays* come in the form of additional minimum underwriting guidelines. They may also adjust the interest rates or fees for certain products, depending on the level of risk of default it poses, adjustments known as **loan-level price adjustments (LLPAs).** These adjustments often reflect charges imposed by the GSEs for their purchase of the mortgage.

For instance, when a lender chooses to hold a mortgage in their portfolio, rather than sell it into the secondary market, they may set *lender overlays* which impose a very high credit score requirement for LTVs above a certain threshold.

## Private mortgage insurer guidelines

Frequently, a conventional mortgage has an LTV greater than 80%. To purchase these mortgages, Fannie Mae and Freddie Mac require the risk of loss on the mortgage be offset by private mortgage insurance (PMI). [See Chapter 37]

*When applying for a conventional mortgage, a homebuyer has a choice of lenders to choose from, including:*

- ***portfolio lenders*** *who fund the mortgage, and hold the mortgage to collect the interest income instead of selling the mortgage to investors in the secondary mortgage market;*
- ***institutional lenders****, such as banks, credit unions, insurance companies and trade association pensions, who fund a mortgage and may either hold it in their portfolio or sell it into the secondary mortgage market; and*
- ***warehouse lenders****, such as mortgage bankers, who fund a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.*

*Lenders may fall into more than one category. For instance, a bank is an institutional lender by its nature, but may fund mortgages to hold in its portfolio.*

*Portfolio and institutional lenders typically service their own mortgages. However, they often originate mortgages for immediate sale to an investor such as the* ***Federal National Mortgage Association (Fannie Mae)****, the* ***Federal Home Mortgage Corporation (Freddie Mac)*** *or Wall Street bankers — while retaining the servicing.*

*The business of servicing mortgages is also bought and sold. This causes the mortgage to appear to be changing hands. In most cases, the originating lender continues to service the mortgage when they sell the mortgage to an investor or another entity that becomes the mortgage holder.*

Sources of conventional financing

**portfolio lender**
A lender who both funds and holds a mortgage to collect the interest income.

**institutional lender**
A lender which pools deposits and invests them by making mortgages, e.g. a bank, credit union or insurance company.

**warehouse lender**
A lender who funds a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.

PMI providers set minimum guidelines to be met on a mortgage before they will insure it. Thus, these guidelines also control the terms on a conventional mortgage with an LTV exceeding 80%.

## Down payment and mortgage insurance

The decision about whether to choose a conventional or government-related mortgage hinges on numerous factors, but the main factors are the *down payment* and *mortgage insurance* requirements.

A conventional mortgage often offers the best terms, interest rates and mortgage costs when the homebuyer's down payment is at least 20% of the purchase price of the property. With an 80% or less LTV on a conventional mortgage, a homebuyer is able to forego the cost of mortgage insurance altogether.

For conventional mortgage applicants with less than a 20% down payment, they pay PMI monthly until the LTV reaches 78%. Additionally, PMI rates are determined based in part on the homebuyer's credit score. Premiums paid by homebuyers with high credit scores are less than those paid by homebuyers with lower credit scores.

In contrast, FHA-insured mortgages require payment of up-front and annual mortgage insurance premiums (MIPs), regardless of the LTV or the homebuyer's credit score. Further, the annual MIP lasts for at least 11 years for an LTV of 90% or less, and for the duration of the mortgage for an LTV higher than 90%.[1]

Other mortgage features also play a role in determining whether a homebuyer is best served going with a conventional or government-related mortgage.

## Mortgage amount

As the bulk of conventional mortgages (and nearly all with fixed rates) are sold to Fannie Mae or Freddie Mac, conventional mortgage principal amounts generally are limited to ceilings set by Fannie Mae and Freddie Mac.

**conforming loan**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

Mortgages with principal amounts at or below these ceiling amounts and which meet Fannie Mae and Freddie Mac lending guidelines, are known as **conforming loans.**

In 2024, the *conforming loan* amounts are:

- $472,030 for one-unit properties;
- $604,400 for two-unit properties;
- $730,525 for three-unit properties; and
- $907,900 for four-unit properties.[2]

**super-conforming loan**
A conforming loan with a maximum principal amount adjusted for a high-cost area.

In 2008, the Housing and Economic Recovery Act (HERA) set higher maximum mortgage amounts in high-cost areas, including many counties in California. Mortgages which have a principal amount greater than the conforming loan amount and which meet Fannie Mae and Freddie Mac lending guidelines are known as **super-conforming loans**.[3]

The super-conforming loan amounts vary by county. However, in 2024, California's maximum *super-conforming loan* amounts were:

- $1,089,300 for one-unit properties;
- $1,394,775 for two-unit properties;
- $1,685,850 for three-unit properties; and
- $2,095,200 for four-unit properties.[4]

California counties which have super-conforming loan amounts include Los Angeles, Orange, San Francisco, Santa Clara and San Diego.

*Editor's note — You can find county data on the websites for the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD).*

1 HUD Handbook 4000.1 Appendix 1.0
2 HUD Handbook 4000.1 II(A)(2)(a)(ii)(B)
3 12 United States Code §1454(a)(2)
4 HUD Handbook 4000.1 II(A)(2)(a)(ii)(C)

Mortgages with principal amounts exceeding the conforming or super-conforming loan amounts loan amounts are known as **jumbo mortgages**. *Jumbo mortgages* are not eligible for sale to Fannie Mae or Freddie Mac, and are instead sold to private investors on Wall Street.

**jumbo mortgage**
A conventional mortgage with a principal amount exceeding the conforming or super-conforming loan limits set by Fannie Mae and Freddie Mac.

Government-related mortgage amounts are limited to Fannie Mae and Freddie Mac conforming loan amounts (or super-conforming loan amounts, in affected counties).[5]

## Interest rates and other costs

Mortgage interest rates fluctuate daily. The relationship between interest rates available on conventional mortgages and government-related mortgages also changes periodically depending on:

- the lender's secondary market goals;
- mortgage investors' demand for one product over the other; and
- homebuyers' demands for one type of product over the other fueled by economic conditions or fluctuations in MIPs required by the FHA.

Typically, FHA-insured mortgages have a lower base interest rate for a mortgage than a conventional mortgage. However, FHA-insured mortgages require the payment of default insurance premiums set as a percentage of the mortgage's principal balance. This effectively adds an additional MIP payment to the homebuyer's monthly payments, and an up-front payment at the time of origination. [See Chapter 21]

Lenders also use *LLPAs* to adjust the points and fees due on FHA-insured mortgages when an applicant has lower credit scores, which increases the up-front costs at the time of origination.

Thus, while the initial interest rate on a government-related mortgage may appear lower than those of a conventional mortgage, a conventional mortgage may lower up-front and monthly costs for some homebuyers.

## Credit and asset requirements

The best terms and rates available on conventional mortgages require higher credit scores. For example, a buyer looking for a conventional mortgage with an 80% LTV may be able to qualify with a 620 credit score, but they may pay up to 3% more in points up-front in LLPAs.

On the flipside, a similar buyer who has a 740 credit score may qualify for both a conventional and an FHA-insured mortgage, but find their savings by avoiding the FHA's annual MIP is worth the higher interest rate on a conventional mortgage.

Government-related mortgages have less stringent credit and asset requirements than do conventional mortgages to actively promote the government's housing policy.

5 HUD Handbook 4000.1(II)(A)(2)(a)

## Property requirements

Both conventional and government-related mortgages finance the purchase price of one-to-four unit residential properties.

Conventional financing also allows homebuyers to finance the price paid for second homes, vacation homes and investment properties.

Government programs exist for buyers to finance second homes and investment properties, limited to special programs and circumstances.[6]

## Adversarial lender position

Each homebuyer's unique circumstances will dictate the best type of mortgage for them, whether conventional or government-related. However, the only way for the homebuyer to determine the best mortgage product for them is to shop several different lenders and look into various types of mortgages with the assistance of a mortgage loan originator (MLO) rather than on their own.

In shopping for a mortgage, it's important to remember the lender and the lender's representative are not agents, much less partners of the homebuyer in the funding and closing of the mortgage. Rather, the lender is the homebuyer's adversary. A mortgage lender's objectives and goals are diametrically opposed to those of the homeowner applying for purchase-assist financing — a debtor versus creditor relationship.

## Separate applications to multiple lenders

Multiple applications keep lenders vying for the homebuyer's business. This competition assures the homebuyer that their preferred lender (resulting from shopping) will remain competitive as promised to the last minute – the moment of funding.

Thus, a homebuyer who submits applications to two lenders has a bargaining chip against the initially preferred lender who later:

- increases the fees and charges above originally estimated amounts or otherwise available in the market at the time of funding (if the rate floats); or
- is unable or unwilling to originate the mortgage on the terms initially disclosed to the homebuyer, or at the lower prevailing par rate available in the mortgage market at the time of closing.

Submitting a mortgage application to a lender, much less multiple lenders, does not obligate the homebuyer to choose that lender. Lenders only disclose reasonable and competitive cost estimates, mortgage rates and terms when the initial mortgage application is submitted.

Within three business days after a lender's receipt of the homebuyer's mortgage application, the lender is mandated to hand the homebuyer a prepared **Loan Estimate** form.

**Loan Estimate**
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

6 HUD Handbook 4000.1(II)(A)(1)(b)(iii)

On this form, the lender discloses all mortgage related charges to be paid by the buyer if the mortgage were originated at the time of the application, such as:

- origination fees;
- credit report fees;
- insurance costs; and
- prepaid interest. [See **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885) and 204-5]

Lender representatives work up estimates of fees and charges and present them to homebuyers while they are shopping for a mortgage. On submitting a mortgage application to the lender, if the previously estimated mortgage costs are widely divergent from those furnished in *Loan Estimate*, the lender's true colors are instantly exposed. Little variation exists within the very few days involved between shopping for a mortgage and submitting a mortgage application, unless the lender's initial representations were deceitful. [See **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885), 204-5 and 221]

The critical reason for submitting applications to two or more lenders is that, prior to closing, the lenders will hand the homebuyer a **Closing Disclosure**. The homeowner then compares the initial Loan Estimate against the last-minute *Closing Disclosure,* side-by-side and item by item. If the homebuyer discovers they are being overcharged, the homebuyer using an MLO is encouraged to have the lender adjust their fees to bring them in line. If the lender does not, then the homebuyer turns to the alternative application for funding their home purchase. [See **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885) 204-5 and 221]

**Closing Disclosure**
A disclosure of the buyer's final settlement charges and mortgage terms handed to the buyer on a standard form within three business days before mortgage closing.

## Government supports multiple applications

To best protect the buyer, applications are to be submitted to at least two lenders. The second application is insurance against lenders' last minute changes to the rates and terms at the time of closing.

Without a backup application processed by another lender, the buyer is left with no opportunity to reject the lender's changes. Multiple government agencies promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the products of two or more lenders, entities such as the California Department of Financial Protection and Innovation (DFPI), Freddie Mac, the Federal Reserve (the Fed), and the Federal Trade Commission (FTC) publish a mortgage shopping worksheet.

**mortgage shopping worksheet**
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage. [See **RPI** Form 312]

The **Mortgage Shopping Worksheet** published by **Realty Publications, Inc. (RPI)** is designed to be completed by the buyer with the assistance of the transaction agent (TA). The worksheet contains a list of all the mortgage variables commonly occurring on origination and during the life of the mortgage. [See **RPI** Form 312]

After submitting mortgage applications to two lenders and receiving the corresponding Loan Estimates, the buyer will possess all the information needed to fill out a *mortgage shopping worksheet* for each lender. Once complete, the buyer and TA can clearly compare the terms offered by the competing lenders and if that lender remains competitive, close with that lender. [See **RPI** Form 312]

## Chapter 32 Summary


A conventional mortgage is any mortgage that is not made, insured or guaranteed by the federal government.

The majority of conventional mortgages are sold to the Fannie Mae or the Freddie Mac after origination.

Accordingly, the terms of a conventional mortgage are set by the investor who purchases the mortgage, the private mortgage insurer if the loan-to-value ratio (LTV) exceeds 80% and the lender.

The decision about whether to choose a conventional or government-related mortgage hinges on numerous factors, but the main factors are the down payment and mortgage insurance requirements. Other factors considered include the mortgage amount, the homebuyer's credit and assets, interest rates and mortgage costs and the property securing the mortgage.

To best protect the buyer, applications are to be submitted to at least two lenders. Shopping for a mortgage yields the best terms available in the market. Without a backup application concurrently processed by another lender, the homebuyer is left with no opportunity to reject the lender's changes.


## Chapter 32 Key Terms



**Quiz 8 Covering Chapters 30-32 is located on page 627.**


# Chapter 33

# The Uniform Residential Loan Application

## Learning Objectives

After reading this chapter, you will be able to:

- understand the components of the Uniform Residential Loan Application (URLA);
- guide your buyer on preparing the mortgage application;
- advise on the disclosures a mortgage lender is required to make; and
- distinguish the purposes of the different aspects and steps in the mortgage packaging process.

## Key Terms

**balance sheet**
**buyer mortgage capacity**
**creditworthiness**
**debt-to-income ratio (DTI)**
**loan-to-value ratio (LTV)**
**Real Estate Settlement Procedures Act (RESPA)**
**transaction agent (TA)**
**Truth in Lending Act (TILA)**
**Uniform Residential Loan Application (URLA)**

## Fundamentals of the Uniform Residential Loan Application

Home sales transactions are typically contingent on the buyer-occupant obtaining a purchase-assist mortgage, known as a **consumer mortgage**. With it, they fund the price they will pay to buy the residence they intend to occupy. Further, a consumer mortgage may also be needed by:

- an owner of vacant land to construct their home;
- a homeowner to improve or renovate the home they currently occupy;
- a homeowner to refinance an existing consumer mortgage; or

**Uniform Residential Loan Application (URLA)**
A standardized mortgage application prepared by the buyer with the assistance of the transaction agent (TA) and the lender's representative. [See **RPI** Form 202]

**transaction agent (TA)**
The term lenders use to identify the buyer's agent in a sales transaction.

- a residential tenant on a long-term lease who makes significant **tenant improvements** (TIs) to their residence.

After shopping lenders and selecting one as their primary lender, the buyer authorizes the lender to start the *mortgage packaging process* by preparing and submitting a **Uniform Residential Loan Application (URLA)** with the assistance of their buyer's agent, called a **transaction agent (TA)** by lenders. [See Figure 1]

Typically, the lender who will fund the mortgage is the loan processor, but not always. In some cases the loan processor who receives the loan application is a broker with a mortgage loan originator (MLO) endorsement. If the buyer's broker is affiliated with the lender, whether it is an in-house or independent lender sharing in profits, proper business affiliation disclosures are required since the buyer's broker will share in any profits of the lending operation.

The URLA provides the lender with necessary information about:

- the buyer who is taking out the mortgage; and
- the residence to be encumbered by the mortgage.

The title of the *URLA* implies it is intended to be used to apply for mortgages secured by residential properties, such as:

- a one-to-four unit residential property;
- condominiums (attached or detached); or
- rental property of any size which is exclusively residential.

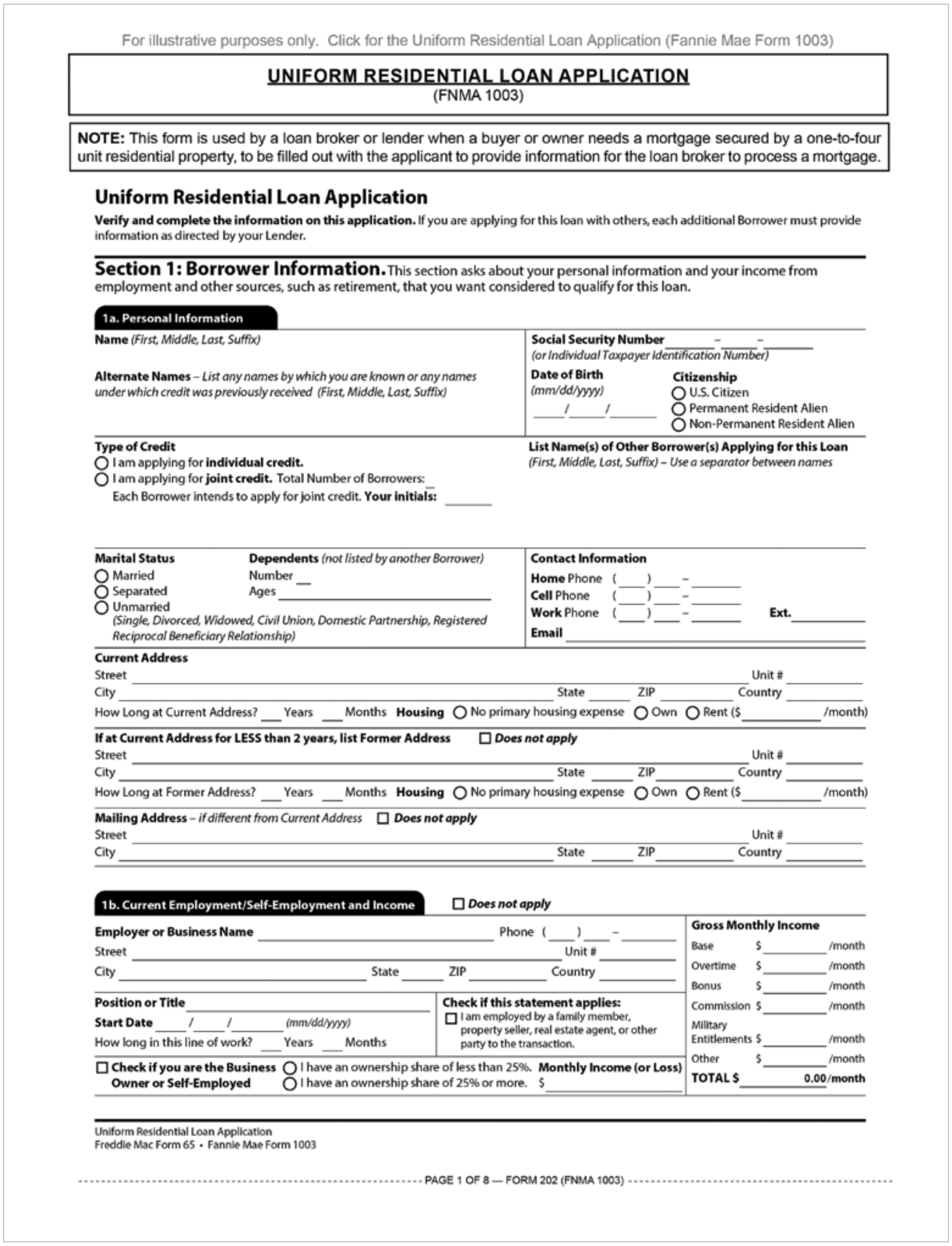
However, the URLA is a generic mortgage application for arranging or making all types of mortgage originations. Thus, it is used by all MLOs and mortgage loan brokers (MLBs) when taking an application for a mortgage funding any purpose, consumer or business/investment/agriculture, secured by any type of property. The URLA contains all the information required for arranging mortgages secured by any type of real estate. The type of property intended to be purchased or improved by use of the mortgage funds is the property described in the mortgage application.

## Components of the URLA

Once the buyer's agent has reviewed the mortgage process with the buyer, all part of a buyer's agent's counseling activity, the application needs to be completed and submitted to the lender.

While the application is designed to be completed with the lender, it is crucial the buyer's agent also be present during this step. The agent's involvement is imperative as completing and submitting the mortgage application is the significant activity remaining for the buyer to acquire the property after entering into a purchase agreement with the seller.

The first component of the URLA is titled **Section 1: Borrower Information**. This section calls for the borrower to enter their *personal identifying information* and income from employment and other sources the borrower



For illustrative purposes only. Click for the Uniform Residential Loan Application (Fannie Mae Form 1003)

**UNIFORM RESIDENTIAL LOAN APPLICATION**
(FNMA 1003)

**NOTE:** This form is used by a loan broker or lender when a buyer or owner needs a mortgage secured by a one-to-four unit residential property, to be filled out with the applicant to provide information for the loan broker to process a mortgage.

**Uniform Residential Loan Application**

**Verify and complete the information on this application.** If you are applying for this loan with others, each additional Borrower must provide information as directed by your Lender.

**Section 1: Borrower Information.** This section asks about your personal information and your income from employment and other sources, such as retirement, that you want considered to qualify for this loan.

**1a. Personal Information**

**Name** *(First, Middle, Last, Suffix)*

**Social Security Number** ___ – ___ – ___
*(or Individual Taxpayer Identification Number)*

**Alternate Names** – *List any names by which you are known or any names under which credit was previously received (First, Middle, Last, Suffix)*

**Date of Birth** *(mm/dd/yyyy)* ___/___/___

**Citizenship**
○ U.S. Citizen
○ Permanent Resident Alien
○ Non-Permanent Resident Alien

**Type of Credit**
○ I am applying for **individual credit.**
○ I am applying for **joint credit.** Total Number of Borrowers: ___
Each Borrower intends to apply for joint credit. **Your initials:** ___

**List Name(s) of Other Borrower(s) Applying for this Loan**
*(First, Middle, Last, Suffix) – Use a separator between names*

**Marital Status**
○ Married
○ Separated
○ Unmarried
*(Single, Divorced, Widowed, Civil Union, Domestic Partnership, Registered Reciprocal Beneficiary Relationship)*

**Dependents** *(not listed by another Borrower)*
Number ___
Ages ___

**Contact Information**
**Home** Phone ( ___ ) ___ – ___
**Cell** Phone ( ___ ) ___ – ___
**Work** Phone ( ___ ) ___ – ___ **Ext.** ___
**Email** ___

**Current Address**
Street ___ Unit # ___
City ___ State ___ ZIP ___ Country ___
How Long at Current Address? ___ Years ___ Months **Housing** ○ No primary housing expense ○ Own ○ Rent ($ ___ /month)

**If at Current Address for LESS than 2 years, list Former Address** ☐ ***Does not apply***
Street ___ Unit # ___
City ___ State ___ ZIP ___ Country ___
How Long at Former Address? ___ Years ___ Months **Housing** ○ No primary housing expense ○ Own ○ Rent ($ ___ /month)

**Mailing Address** – *if different from Current Address* ☐ ***Does not apply***
Street ___ Unit # ___
City ___ State ___ ZIP ___ Country ___

**1b. Current Employment/Self-Employment and Income** ☐ ***Does not apply***

**Employer or Business Name** ___ Phone ( ___ ) ___ – ___
Street ___ Unit # ___
City ___ State ___ ZIP ___ Country ___

**Position or Title** ___
**Start Date** ___/___/___ *(mm/dd/yyyy)*
How long in this line of work? ___ Years ___ Months

**Check if this statement applies:**
☐ I am employed by a family member, property seller, real estate agent, or other party to the transaction.

☐ **Check if you are the Business Owner or Self-Employed**
○ I have an ownership share of less than 25%.
○ I have an ownership share of 25% or more.
**Monthly Income (or Loss)** $ ___

**Gross Monthly Income**
Base $ ___ /month
Overtime $ ___ /month
Bonus $ ___ /month
Commission $ ___ /month
Military Entitlements $ ___ /month
Other $ ___ /month
**TOTAL $ 0.00/month**

Uniform Residential Loan Application
Freddie Mac Form 65 • Fannie Mae Form 1003

PAGE 1 OF 8 — FORM 202 (FNMA 1003)

Figure 1

Excerpt from Form 202 Uniform Residential Loan Application — FNMA 1003

intends to use for the mortgage. Information identifying the borrower, such as their name, alternate names, social security number and date of birth is entered towards the top. Also noted is their citizenship status.

Space is left for any co-borrower information when their income, assets and liabilities are to be considered for the mortgage. Thus, the borrower is asked to indicate whether they are applying for individual credit, or joint credit with a co-borrower. The marital status, number of dependents, contact information and address of the borrower are called for next.

The borrower's, and any co-borrower's, employment information includes:

- the employment currently held by the borrower;

- the borrower's job position or title; and
- years spent at that specific job and within that profession.

If the borrower is self-employed, they check the self-employed box.

The next component of the loan application is titled **Section 2: Financial Information – Assets and Liabilities**. Here, the borrower enters information about their *assets* – such as bank account balances, retirement funds and stocks – and *liabilities* – such as credit card debt, auto or student loans, and alimony.

## Financial information

The next component of the loan application is titled **Section 3: Financial Information – Real Estate**. In this section, the borrower lists all the properties they currently own, and their financial obligations on these properties. If this is the borrower's first property, they check the box stating, "I do not own any real estate." The information called for in this sections includes:

- the property address;
- property value; and
- mortgage loans which encumber the property, including the monthly payment and outstanding balance.

**balance sheet**
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values.

Space is provided for the entry of multiple properties.

The buyer and co-borrower need to prepare a **balance sheet** when their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower prepares a separate asset and liabilities balance sheet for individual consideration by the lender. [See **RPI** Form 209-3]

The buyer also completes a **statement of information**. The *statement of information* discloses confidential information used by the title company to search the general index (GI) for conditions affecting title when held in the name of the buyer. Title companies search for information on the buyer and any co-borrower regarding judgments and other legal conditions that might interfere with the property's title. [See **RPI** Form 401-4]

## Loan and property information

In **Section 4: Loan and Property Information**, the buyer indicates:

- the total dollar amount of the mortgage requested;
- the purpose of the loan, whether it's a purchase, refinance or something else;
- the property's address;
- the property's value; and
- the intended occupancy of the home, be it a primary residence, second home, investment property, or FHA secondary residence.

## Additional components of the application

The next component of the loan application is titled **Section 5: Declarations**. Here, the borrower answers specific questions about their past financial history, the property, and the funding sought.

In **Section 6: Acknowledgments and Agreements**, the borrower signs the application, along with any co-borrower, to acknowledge and agree to the numerous conditions.

These conditions and acknowledgments include:

- the property will be occupied as represented in the application;
- the borrower will amend the application and resubmit it to the lender if the facts originally stated substantially change;
- the lender may report information about the borrower's account to credit bureaus; and
- the lender is authorized to verify all aspects of the mortgage application as represented by the borrower.

In **Section 7: Military Service**, the borrower answers whether they or a deceased spouse served or are currently serving in the US armed forces.

Next, the borrower completes **Section 8: Demographic Information**, which concerns the borrower's ethnicity, sex and race. The borrower may choose not to provide answers to some or all of the demographic questions.

Finally, the URLA concludes with **Section 9: Loan Originator Information**, where the MLO supplies their name, Nationwide Mortgage Licensing System and Registry (NMLS)-ID number and other identifying information.

## RESPA and TILA disclosures

Mortgage lenders active in the secondary mortgage market disclose all **mortgage related charges** on mortgages used to purchase, refinance or improve one-to-four unit residential properties, a mandate of the **Real Estate Settlement Procedures Act (RESPA)**.

*Mortgage related charges* include:

- origination fees;
- credit report fees;
- insurance costs; and
- prepaid interest.

*RESPA* is now administered and enforced by the **Consumer Financial Protection Bureau (CFPB).** The result is a marked improvement in consumer protection action than previously provided by the politically controlled U.S. Department of Housing and Urban Development (HUD).

When the buyer takes out an ARM containing an interest rate that changes periodically, the lender informs the buyer not only of the interest rate, but also the:

- index the rate changes are tied to;

**Real Estate Settlement Procedures Act (RESPA)**
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

- the lender's margin; and
- any payment and interest rate adjustment floors and caps. [See **RPI** Form 320-1]

## Additional disclosures and resources to the buyer

Since a consumer mortgage lender is considered a RESPA lender, they also provide the buyer with:

- a **Loan Estimate** of all mortgage terms quoted by the lender within three business days of the lender's receipt of the buyer's mortgage application (this replaced the old *good faith estimate* of costs and initial Regulation Z (Reg Z) disclosure form previously required);[1]
- a special information booklet published by the CFPB to help the buyer understand the nature and scope of real estate settlement costs within three business days after the lender's receipt of the buyer's application;[2]
- a **Closing Disclosure**, which summarizes the "final" mortgage terms and details, provided by the lender at least three days before they fund the mortgage;[3] and
- a list of **homeownership counseling** organizations.[4]

*Editor's note — A list of homeownership counseling organizations approved by HUD can be found on the CFPB's website.*

When the buyer arranges financing through a mortgage broker, the broker (not the lender) provides a copy of the special information booklet to the buyer.[5]

However, the booklet does not need to be given to the buyer when the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage in which the lender takes a subordinate lien;
- a reverse mortgage; and
- any consumer mortgage used to fund the purchase of other than a one-to-four unit residential property.[6]

The lender is also to provide buyers with a written list of homeownership counseling organizations within three business days of receiving the loan application.[7]

Buyers are not required to take part in the counseling. Homeownership counseling is only compulsory if the mortgage is a Section 32 high-cost mortgage or allows for negative amortization.[8]

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1 12 CFR §1026.37
2 12 CFR §1026.19(g)
3 12 CFR §1026.19(f)(ii)
4 12 CFR §1024.20
5 12 CFR §1024.6(a)(1)
6 12 CFR §1024.6(a)(3)
7 12 CFR §1024.20(a)(1)
8 78 Federal Register 6964-6966

*The typical conventional mortgage is a 30-year amortized mortgage with a fixed rate of interest, known as a fixed rate mortgage (FRM).*

*The buyer's monthly payment remains the same during the life of the FRM. FRMs offer greater long-term stability for the buyer than adjustable rate mortgages (ARMs) where the interest rate and payment amounts changes periodically based on an index for short-term consumer rates, plus a profit margin. ARMs cause the buyer's monthly payment to periodically adjust. [See Chapter 6]*

*Other financing options and features include:*

- *rate buy-downs where the buyer receives an initial interest rate which is periodically increased, along with the monthly payment, to a fixed rate within a few years, called a graduated payment mortgage (GPM);*
- *the length of the mortgage, which is typically 15 or 30 years, although some lenders offer mortgages with irregular terms;*
- *assumable mortgages allowing resale to a creditworthy buyer, with or without a rate adjustment [See Chapter 20];*
- *bi-weekly mortgages with payments made every two weeks to reduce the total amount of interest paid on the mortgage; and*
- *private mortgage insurance (PMI) where a qualifying buyer obtains a mortgage with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 37]*

Types of mortgages

## Property appraisal

On the lender's receipt of a mortgage application, the property is **appraised**. [See **RPI** Form 207]

The *appraisal* determines whether the property is of sufficient value to function as adequate security for recovery of the mortgage amount in the event of a default. Thus, the property needs to support the amount of financing the buyer requests. The lender uses the appraisal to gauge whether the **loan-to-value ratio (LTV)** meets the lender's standards.

**loan-to-value ratio (LTV)**
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

Generally, an acceptable *LTV* for conventional mortgages is 80% of the property's value. An LTV of 80% requires the buyer to make a minimum 20% down payment. When permitted, the buyer might make a lesser down payment using a piggyback mortgage to fund the remainder of the 20% equity beyond the first mortgage amount. A greater LTV than 80% compels the lender to require the buyer to obtain **private mortgage insurance (PMI).** [See Chapter 37]

The 80% LTV ceiling is used to limit mortgage amounts originated during downturns in the market value of real estate, rather than during a rapidly rising market. Thus, swings in values throughout an economic cycle are exacerbated by the volatile conduct of lenders, including their financial accelerator activity. Regulations setting parameters for mortgage lending are designed to narrow the cyclical swings and thus eliminate the economic damage brought on by unregulated lender conduct.

## The mortgage application package

Once a lender approves a property as security for a mortgage amount based on an appraisal, the lender or MLO processing the application assembles a **mortgage package** and sends it to their mortgage underwriter for review.

The *mortgage package* prepared by the lender or MLO includes:

- the URLA [See Figure 1];
- the property appraisal report [See **RPI** Form 200];
- a credit report on the buyer;
- the lender's verification of the information provided on the mortgage application [See **RPI** Form 210, 210-1, 211, 212, 212-1, 213 and 214];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and seller's broker [See **RPI** Form 150, 304 and 401]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements. [See Chapter 53]

## "Willing and able" to pay

**Truth in Lending Act (TILA)**
A federal consumer mortgage law which controls the terms of a consumer mortgage and requires lenders to disclose mortgage rates and charges.

**debt-to-income ratio (DTI)**
The percentage of monthly gross income that goes towards paying debt.

**buyer mortgage capacity**
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

**creditworthiness**
An individual's likelihood of repaying a mortgage, determined by their present income, wealth and previous debt payment history.

A lender evaluating a mortgage package considers a buyer's *willingness* and *capacity* to pay. To comply, buyer/owners applying for a *consumer mortgage* are evaluated by the lender for their **ability-to-repay**, part of *Regulation Z (Reg Z)*, which implements the **Truth in Lending Act (TILA)**.[9] [See Chapter 2]

Generally, the **debt-to-income ratios (DTI)** for conventional mortgages, also called the **debt-to-income standards**, limit the buyer's:

- monthly payments for the maximum purchase-assist mortgage, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and
- monthly payments on long-term debt to a maximum of 43% of the buyer's gross monthly income. [See **RPI** Form 229-1, 229-2 and 230]

Lenders use the *DTI* to evaluate the buyer's ability to make timely mortgage payments. This is referred to as **buyer mortgage capacity**. [See **RPI** Form 230]

The buyer's willingness to make mortgage payments is evidenced by the **credit report**. The credit history demonstrates to the lender whether or not the buyer has sufficient propensity to pay, called **creditworthiness**.

The DTIs can be increased by the lender depending on one or more compensating factors, including whether the buyer has:

- ample cash reserves;
- a low LTV; or
- spent more than five years at the same place of employment.

9 12 CFR §§1026.43 et seq.

## Mortgage approval

A **mortgage approval** issued by a lender is often conditioned on a buyer providing more information or taking corrective actions. For example:

- the *physical condition* of the property may need correction;
- *title* may need to be cleared of defects;
- *derogatory entries* on the buyer's credit report may need to be eliminated; or
- the buyer's *long- or short-term debt* needs to be reduced.

Once conditions for funding are met and verified by the lender, the mortgage is classified as *approved*. Escrow calls on the lender or MLO for mortgage documents and funds, and on receipt of the funds, the sales transaction is closed.

Transaction agents working with buyers need to remind themselves that the degree of risk each lender finds acceptable is different. More often than not, a lender in the stable real estate market does exist who will make a mortgage of some amount under some conditions to nearly *any buyer*. Remember: it is the business of lenders to lend.

## Chapter 33 Summary

The Uniform Residential Loan Application (URLA) prepared by the buyer with the mortgage loan originator (MLO) supplies the lender with necessary information about the buyer and the property securing the mortgage. It also gives the lender authorization to start the mortgage packaging process.

The URLA calls for the buyer, with the assistance of the mortgage representative and MLO, to enter information such as:

- the type of mortgage sought;
- the identity of the property used to secure the mortgage;
- the buyer's name and employment information;
- the buyer's monthly income and housing expenses;
- the buyer's assets and liabilities; and
- relevant miscellaneous creditworthiness issues to be disclosed to the lender.

A Real Estate Settlement Procedures Act (RESPA)-controlled lender needs to provide the buyer with a Loan Estimate and Closing Disclosure.

Federal Truth in Lending Act (TILA) disclosures are also given to the buyer, providing mortgage information in a standardized format for easy comparison of terms between mortgages offered by different lenders.

Once a lender approves a property as security for a mortgage amount based on an appraisal, the lender or MLO processing the application assembles a mortgage package and sends it to their mortgage underwriter for review.

Once mortgage conditions are met and verified, the mortgage is classified as approved. Escrow calls for mortgage documents and funds. On funding, the sales transaction is closed.

## Chapter 33 Key Terms



**Quiz 9 Covering Chapters 33-35 is located on page 629.**

# Chapter 34

# A lender's oral promises as commitments

## Learning Objectives

After reading this chapter, you will be able to:

- identify the unenforceability of a lender's oral or unsigned mortgage commitment;
- understand the conditionality of a written commitment or rate lock for a mortgage; and
- increase your buyer's chance of closing with the best rates and terms possible by submitting mortgage applications to at least two lenders.

## Key Terms

**mortgage commitment** **rate lock**

## No responsibility for oral or conditional promises

Consider the financing needed by an owner of industrial property to fund construction of improvements on the property. The owner intends to:

- upgrade the facilities;
- add equipment; and
- construct additional buildings.

The owner submits a loan application to an institutional lender with whom they have borrowed before.

The loan officer processing the loan **orally assures** the owner they will provide permanent long-term mortgage financing to refinance any short-term financing the owner may arrange to initially fund the improvements. None of the loan officer's assurances are formalized in writing, nor signed by any representative of the lender.

## (Mis)reliance on an oral assurance

Continuing out previous example, relying on the lender's oral assurances and past conduct, the owner enters into a series of short-term loans and credit sale arrangements to acquire equipment and labor and materials for improvements to the property.

The loan officer visits the owner's facilities while improvements are being installed and constructed. The officer again orally assures the owner they will provide long-term financing.

On completion of the improvements, the owner makes a demand on the lender to fund the permanent financing. However, on review of the property and owner's business, the lender refuses to originate the financing, telling the owner  it no longer considers the owner's business to have sufficient value to secure the financing.

The owner is unable to obtain permanent financing through another lender. Without amortized long-term mortgage financing to supply necessary capital, the business fails for lack of ability to pay off the short-term loans.

The business and property are eventually lost through foreclosure to the holders of the short-term financing. The owner seeks to recover their money losses from the lender, claiming the lender breached its commitment to provide mortgage financing.

Can the owner recover for the loss of their business and property from the lender?

**mortgage commitment**
A lender's commitment to make a mortgage, enforceable only when written, unconditional and signed by the lender for consideration.

No! The lender never entered into an enforceable **mortgage commitment**. Nothing was placed in writing or signed by the lender which unconditionally committed the lender to specific terms for originating a mortgage.

Even though the loan officer orally assured the owner multiple times they will fund a permanent mortgage to take out the interim financing of their project — and despite the owner's reliance on their  previous relationship with the lender —the owner may not rely on the oral commitments made by the loan officer.[1]

The only other course of action the owner may take is to purchase a *written loan commitment*, paying for the assurance funds will be provided on request.

## Enforceable agreement to grant a permanent modification

Now consider a mortgage holder who enters into a **Servicer Participation Agreement** with the U.S. Department of Treasury under the Home Affordable Modification Program (HAMP) regarding defaulted consumer mortgages. The mortgage holder agrees to follow the Treasury's guidelines and procedures in modifying the consumer mortgages they service.

1 **Kruse** v. **Bank of America** (1988) 202 CA3d 38

A distressed homeowner applies to the mortgage holder for a modification. The lender prepares a written *Trial Period Plan (TPP)* which states the homeowner will receive a **permanent mortgage modification** if they timely make trial modification payments and submit qualifying documents.

The homeowner signs the TPP and returns it. All trial modification payments are timely received by the mortgage holder and the required documentation to confirm eligibility for the permanent modification is submitted.

The mortgage holder does not provide the homeowner with a permanent mortgage modification nor notify the homeowner of any failure to qualify. However, under HAMP arrangements, the mortgage holder is obligated to enter into a mortgage modification when the homeowner meets all the requirements under the TPP. The homeowner makes a demand on the mortgage holder to provide the permanent modification since the owner complied with all the terms of the written TPP.

Is the mortgage holder compelled to grant a permanent modification?

Yes! The borrower followed all the terms of the *written* TPP. Thus, the mortgage holder is compelled by the government to grant the permanent modification since they entered into the *Servicer Participation Agreement* under HAMP.[2]

Once a mortgage holder signs a written agreement, they are bound to follow it, even though that is not their custom. This scenario on HAMP modifications is an example of the reason lenders and mortgage holders rarely enter into signed written promises regarding a mortgage application. When receiving an application for a consumer mortgage, they need do nothing more than the limited federally mandated nonbinding disclosures on single family residence (SFR) mortgages under **Regulation Z (Reg Z)**, codified in the **Truth-in-Lending Act (TILA).**

## Escape from an oral commitment

Lenders customarily process applications and prepare mortgage documents. However, at all steps in the origination process, these documents are signed only by the buyer. The lender orally advises the buyer whether the mortgage has been approved, but signs nothing that binds it to fund the mortgage.

The first and only act committing the lender to originate a mortgage is its actual *release of funds* — at the time of closing.

Thus, lending is an **asymmetrical power relationship**, not one of a willing lender and a willing borrower sharing a common goal and rooted in mutual consent. Until the lender literally delivers funds and a closing has occurred, the lender may back out of its oral or unsigned written commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Borrowers rely solely on the lenders' *verbal assurances* and proposals (such as *pre-approval*

2 **Corvello** v. **Wells Fargo Bank** (9th Cir. 2013) 728 F3d 878

letters and *rate locks*) to get a mortgage. Conversely, the lender bears no burden and suffers no adverse consequences for failure to follow through on any of their oral or unsigned written promises.

When a lender breaches its oral commitment to lend, the borrower's reliance on anything less than an **unconditional written mortgage commitment** is not legally justified — even though the buyer had no realistic choice other than to rely on the lender's oral promises.

## Agents provide protection for their buyers

To prepare a homebuyer for the adversarial mortgage application process, their agent needs to advise their buyer of the likely scenarios they will encounter in the mortgage application process. Thus, the informed buyer is best able to anticipate and defend themselves when confronted with eleventh-hour lender tactics to increase earnings.

Always advise buyers seeking a purchase-assist mortgage to consider a "double app;" that is, submit mortgage applications to a minimum of two lenders as recommended by the U.S. Department of Housing and Urban Development (HUD) and the California Department of Real Estate (DRE).

To assist the homebuyer with the task of comparing the consumer mortgage products of two or more lenders, agencies such as the California Department of Financial Protection and Innovation publish **Mortgage Shopping Worksheets.** These *Mortgage Shopping Worksheets* contain a list of mortgage variables occurring on origination and during the life of the mortgage.

Once the Worksheet has been completed based on information received from each lender processing a separate application, the buyer and their agent can easily compare the terms offered by the competing lenders. Then the buyer turns to the lender providing the best rates and terms at the time of closing (and with a backup still in place).

The California Department of Financial Protection and Innovation (DFPI) Mortgage Shopping Worksheet can be obtained through their website at *www.dfpi.ca.gov*.

Multiple applications keep lenders competitive to vie for your buyer's business up to the very last minute – the ultimate moment of funding, when commitments truly are commitments.

## Rate locks: tin shields or the real deal?

A **rate lock** is classified as a lender's mortgage commitment. A *rate lock* is a lender's conditional commitment to fund a mortgage at a quoted interest rate, origination fee and points, regardless of whether interest rates rise or fall prior to funding the mortgage.

At first glance, rate locks seem like a brilliant idea; a personal favor from a lender to a homebuyer, if you will. However, mortgage lending is not a charity. It's business.

A rate lock as issued by lenders in the mortgage process is NOT a commitment to lend money. To be enforceable, a mortgage commitment needs to be:

- in writing;
- signed; and
- given in exchange for consideration (read: money).[3]

Even then, no lender guarantees a mortgage until it is funded and closed.

## A litany of contingencies

A *rate lock* is not a guarantee your buyer will receive the rate stated on the rate lock statement as it needs to be signed and in writing, and even then, is **contingent** on all other lender requirements being met at time of funding.

**rate lock**
A lender's conditional, unsigned commitment to fund a mortgage at a quoted interest rate, origination fee and points, regardless of whether interest rates rise or fall prior to funding.

A long list of contingencies to the rate lock provides the lender with an equal number of opportunities to escape from the rate lock agreement even if it were binding. Your buyer's interests are best served by expediting the mortgage process as much as possible, lock or no lock, with submission of multiple loan applications to assure competitive rates and charges at closing.

To close the mortgage as quickly as possible, direct your buyer to collect the following information before asking for a lock on the rate and points quoted:

- bank account numbers;
- latest bank statement;
- latest pay stubs;
- W2 and tax forms;
- tax returns for the past two years;
- mortgage and credit card account numbers;
- names and addresses of creditors;
- name and contact information for their new homeowners insurance company; and
- evidence of mortgage or rent payments.

However, even if your buyer gets the agreed-to rate at closing, rate locks are a *gamble* — your buyer has to ante up just to get a chance at keeping a lower rate, but only in a rising market.

By their nature, a rate lock is never an assurance your buyer will receive the most advantageous mortgage terms available at the time of funding, particularly if mortgage rates drop before closing. Thus, prudent buyers on advice from their agents submit mortgage applications to a minimum of two lenders to guard against last-minute surprises.

3 Calif. Civil Code §2922

## Chapter 34 Summary

A lender's oral or unsigned mortgage commitment is unenforceable by a buyer. A mortgage commitment is only enforceable when it is placed in writing and signed by the lender, unconditionally committing the lender to the specific terms of a mortgage in exchange for consideration.

Lenders customarily process applications and prepare mortgage documents. However, these documents are signed only by the buyer. The first and only act committing the lender is its actual funding of the mortgage, which occurs at the time of closing. Thus, until the lender delivers funds and a closing has occurred, the lender may back out of its oral commitment at any time without liability.

Similarly, a rate lock is a lender's conditional commitment to fund a mortgage at a quoted interest rate, origination fee and fixed number of points, regardless of whether interest rates rise or fall prior to funding the mortgage. However, a rate lock is always contingent upon all other lender requirements being met at time of funding, providing the lender with a number of opportunities to escape from the rate lock agreement.

To better your buyer's chance of closing with the best rate and terms possible, counsel them to submit applications for a mortgage to at least two institutional lenders. A second application with another institution gives the buyer additional leverage in mortgage negotiations needed at closing.

## Chapter 34 Key Terms



**Quiz 9 Covering Chapters 33-35 is located on page 629.**

# Chapter 35

# Mortgage fees regulated, disclosed

## Learning Objectives

After reading this chapter, you will be able to:

- differentiate between lawful and unlawful charges on consumer mortgages;
- determine allowable and non-allowable MLO compensation on a consumer mortgage transaction;
- identify MLO-prohibited activities under steering prohibitions; and
- recognize and avoid unnecessary lender fees when obtaining a consumer mortgage.

## Key Terms

**discount point**
**federally related mortgage**
**kickback**
**Loan Estimate**
**mortgage steering**
**service provider**
**upcharging**

## RESPA origins and general purpose

Beginning in 1974, homebuyers taking out purchase-assist consumer mortgages were given legal protection against abusive fee-charging practices of **service providers** by passage of the **Real Estate Settlement Procedures Act (RESPA)**. RESPA rules are implemented by *Regulation X (Reg X)*.

*Service providers* in transactions involving a consumer mortgage origination include:

- mortgage loan originators (MLOs);
- mortgage lenders;
- real estate brokers and agents acting as transaction agents (TAs);
- escrow agencies; and

**service provider**
An individual or company which offers services connected with a prospective or actual consumer mortgage origination.

**federally related mortgage**
A consumer mortgage made, insured, guaranteed, assisted or otherwise connected to the federal government, controlled by the Real Estate Settlement Procedures Act (RESPA).

- title companies.[1]

*RESPA* governs the behavior of service providers on transactions involving consumer mortgages, called **federally related mortgages** by RESPA.[2]

A *federally related mortgage* is a mortgage secured by a one-to-four unit residential property or manufactured housing which meets any one of the following criteria:

- the mortgage is made by a federally regulated lender whose deposits are insured by the federal government;
- the mortgage is made, insured, guaranteed, supplemented or assisted by the federal government;
- the mortgage will be sold to the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae);
- the mortgage is made by a private lender who makes or invests in mortgages secured by residential properties totaling over $1,000,000 per year;
- the mortgage is originated by a mortgage broker and assigned to any of the above entities;
- the mortgage is originated by a seller, contractor or supplier of goods; or
- the mortgage is a home equity conversion mortgage (HECM) made by one of the entities listed in the first four bullet points above.[3]

## Exemptions

However, the following mortgages are exempt from RESPA coverage:

- a mortgage on property of 25 acres or more;
- a mortgage made *primarily for business, commercial or agricultural purpose*;
- temporary financing, such as a construction loan;
- a mortgage secured by unimproved or vacant land, unless a one-to-four unit residential property will be built on the land using the mortgage funds within two years of closing;
- an assumption of a consumer mortgage in which the lender does not have the right to approve a subsequent homebuyer;
- the conversion of a consumer mortgage to different terms which are consistent with provisions of the original mortgage, as long as a new note is not required; and
- bona fide secondary market transactions selling a consumer mortgage in the secondary market.[4]

*Editor's note — This chapter discusses charges, fees and disclosures in the context of purchase-assist consumer mortgage financing sought by a*

1 12 Code of Federal Regulations §1024.2
2 12 CFR §§1024 et seq.
3 12 CFR §1024.2(b)
4 12 CFR §1024.5(b)

*buyer-occupant of a one-to-four unit residential property. However, Reg X and Regulation Z (Reg Z) rules and disclosure requirements also apply to refinancing of consumer mortgages.*

## Fees charged for services rendered

A fee qualifies as a charge for a **settlement service**, whether paid by a homebuyer, seller or owner, when the service is performed:

- directly for the benefit of the homebuyer, seller or owner; or
- at or before the closing.[5]

Service providers may charge a fee in any amount reasonably related to the performance of a *settlement service*, such as:

- brokerage activities;
- escrowing;
- mortgage processing;
- generating appraisal reports, pest control reports or home inspection reports; or
- conducting a title search.

Neither Reg X nor Reg Z limit the amount a service provider may charge for a settlement service actually rendered. Competition is encouraged among providers offering the same services to keep prices in check and avoid price gouging for services rendered to the homebuyer, seller or owner.

## Corrupted practice

However, some lenders, brokers/agents and other service providers collude to "buy business" — manifested by the closed brokerage office syndrome — or make additional profits off the homebuyer, seller or owner in the form of **kickbacks** between providers.

**kickback**
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

*Kickbacks* are a **corrupting business policy**. Legitimate service providers find it difficult to compete with fraudulent competitors without also resorting to the same fraudulent actions.

Kickbacks to brokers, in the form of referral or split fees or other indirect benefits (e.g., space rent, paid vacations, dividends, equipment) used to steer or capture business, deliberately interfere with the availability of lower and fewer charges by all providers involved.[6]

In this tortured closed-office business environment, a broker or their agent refers their homebuyer to the lender or servicer provider who promises the largest kickback for the referral. In the process, this navigates the homebuyer away from the legitimate non-participating competition who will not take part in the consumer fraud of paying referral fees to brokers and agents to direct business their way.

5 **Cohen** v. **J.P. Morgan Chase & Co.** (2nd Cir. 2007) 498 F3d 111
6 12 CFR §1024.14(d)

These are the corrosive activities Reg X seeks to prevent, by prohibiting:

- fees or other financial/economic benefits for referring the homebuyer or seller to a service provider such as a mortgage lender, MLO, escrow or title company; and
- split fees between providers, other than for valuable provider services *actually performed* for the share of the fee received.[7]

Additionally, while high fees are not alone proof of a RESPA violation, the Consumer Financial Protection Bureau (CFPB) will investigate high fees to determine when they are the result of an unlawful referral or kickback scheme. The value of any additional business garnered from the referral scheme is not a consideration when determining the kickback's prohibition.[8]

## A referral is not a compensable service

No person in a transaction which includes the origination of a consumer mortgage, including brokers, agents or other third-party service providers, may give or *accept a kickback* or any other thing of value for advising a homebuyer, seller or owner participating in the transaction to employ a particular service provider.

The act of referring is not a service, and no service provider, such as a transaction agent, may collect a fee for a referral.

However, an exception exists for broker solicitation of sellers and buyers as clients for transactions that may include a consumer mortgage origination. Fees paid by a broker for referring buyers and sellers to a real estate broker or agent are allowable when paid by a real estate broker to:

- one of their employees, such as a finder they retain; or
- another real estate broker (whose agent may have referred a prospective client to the broker paying the referral fee).[9] [See **RPI** Form 114]

This exception for a broker paying others for a referral absolutely does not apply in reverse to a broker who receives a referral fee paid by a different service provider in a transaction, an unlawful kickback.

Worse, when a consumer mortgage lender pays a broker a fee — and the broker's only service is as a TA acting on behalf of the seller or buyer — the broker is deemed an MLO by the very receipt of a fee.

Thus, by the acceptance of a kickback referral fee from a lender, they subject themselves to all federal and state MLO registration, licensing, endorsement and compensation rules.[10]

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7 12 CFR §1024.14(b)-(c)

8 12 CFR §1024.14(g)(2)

9 12 CFR §1024.14(g)

10 12 CFR §1026.36(a)(1)(i)(C); Official Interpretation of 12 CFR §1026.36(a)-(1)(iv)

## Split fees

Another type of unlawful kickback comes in the form of an otherwise legitimate settlement service charge, when it is split between:

- a person who provides a specific closing settlement service, say, title insurance, escrow or an MLO service; and
- a person who does not render any significant part of the service provider's services, say, a real estate broker or their agents.

The split of a settlement service charge with any person who has not provided a significant portion of the other provider's service in exchange for the split is unlawful.

However, a broker is in compliance when the fee the broker is to receive on the split for the **second service** is due as:

- payment for **goods**; or
- payment for **services actually rendered** (recall that a referral is not a fee-earning service).[11]

For example, a broker and their agent are entitled to a **second fee** in a sales transaction when the fee is for their handling the mortgage escrow. The mortgage escrow service is a significant service since a broker does not normally perform the service as part of their representation of buyers and sellers when negotiating a sales transaction.

Here, handling the mortgage escrow is an additional closing service provided under a separate contract different from the listing employment in a sales transaction.

## MLO services to justify the fee split

Guidance issued by the U.S. Department of Housing and Urban Development (HUD) creates an informal rule of thumb for determining the whether a fee is justified. A broker or agent acting as a TA on a sale and receiving any type of fee from a lender needs to perform at least **five** mortgage origination activities normally performed by the lender or an MLO broker to justify receipt of the fee.

Thus, the broker needs to act as an MLO and be MLO endorsed, as does any agent involved in the fee. Normally, MLO services include:

1. pre-qualifying the homebuyer to determine the maximum mortgage amount they can afford by analyzing their income and debt [See **RPI** Form 230];
2. advising the homebuyer on the purchase-assist consumer mortgage process, about the different types of mortgages available and the variations in costs, rates and payments on the various mortgage options;
3. gathering financial information from the homebuyer such as tax returns, profit and loss statements, bank statements and balance sheets needed to complete the application process [See Chapter 53];

11 12 United States Code §2607(c)

4. making requests for verifications of employment and cash deposits [See **RPI** Form 210, 210-1 and 211];
5. making requests for verification on other debts owed by the homebuyer [See **RPI** Form 212, 212-1 and 213];
6. ordering the appraisal to determine the property's fair market value (FMV) [See **RPI** Form 200 and 207];
7. ordering property inspection and engineering reports [See **RPI** Form 130];
8. reviewing with the homebuyer the process for clearing credit problems which arise;
9. apprising the homebuyer, broker and lender of the status of the application, and what further information or documentation each transaction participant needs to timely close, by continuing to conduct regular contacts after taking the mortgage application until the close of the transaction [See Figure 1, **RPI** Form 339];
10. ordering legal documents (statements) which are required for escrow to close, or a policy of title insurance to be issued;
11. ordering a flood hazard report on whether the property is located in a flood zone; and
12. assisting as an active participant in the closing of the mortgage.[12]

## Unearned duplicate charges but no split

Splitting fees with any person — such as a mortgage lender paying a sales agent for a referral — who has not performed significant services for the fee is unlawful activity.

But what about the provider, such as a broker or escrow officer, charging twice for the same service when the charge is not split with others?

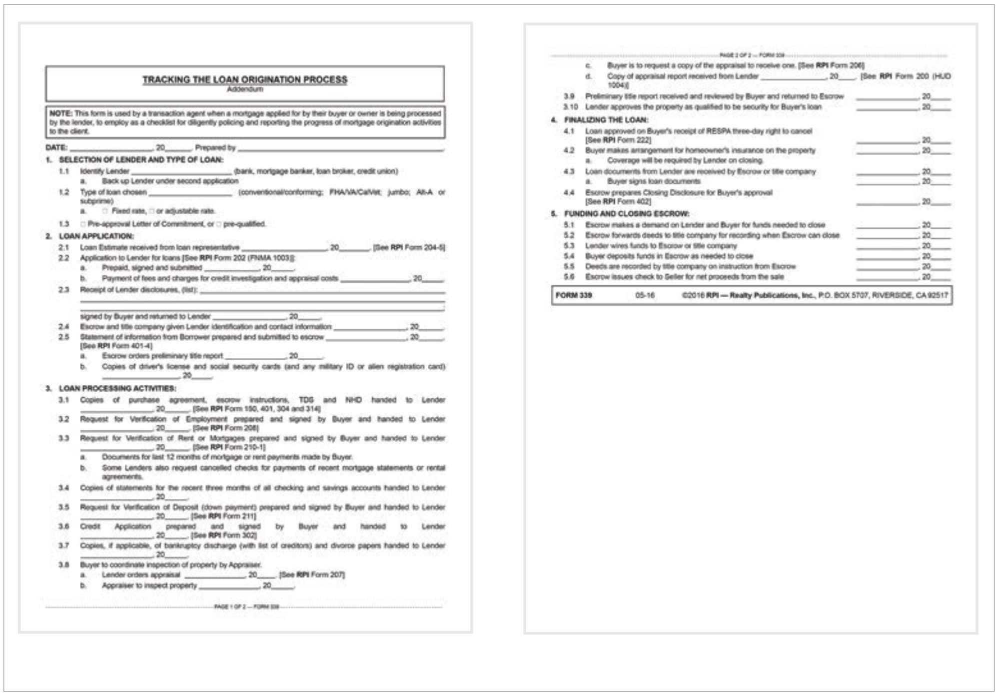
Consider a prospective homebuyer who enters into a buyer's listing agreement employing a broker to locate a property suitable for the homebuyer to occupy. The broker locates a suitable one-to-four unit residential property. The purchase price will be funded a consumer mortgage.

The buyer's broker negotiates a 3% broker fee due on closing and paid by the seller.

On closing, the broker charges the homebuyer a second fee in addition to the agreed-to 3% broker fee, a surcharge such as a transaction coordinator fee to help defray their overhead costs. The homebuyer refuses to pay the surcharge fee, claiming it violates RESPA since the broker provided no additional beneficial service to support the fee. The broker charged the fee for a service necessarily included when handling any sales transaction.

Can the broker collect an additional surcharge fee from the homebuyer for basic services which are normally provided when representing a homebuyer?

12 HUD Policy Statement 1991-1, Section C



TRACKING THE LOAN ORIGINATION PROCESS
Addendum

**NOTE:** This form is used by a transaction agent when a mortgage applied for by their buyer or owner is being processed by the lender, to employ as a checklist for diligently policing and reporting the progress of mortgage origination activities to the client.

DATE: ____________, 20____, Prepared by ____________

1. SELECTION OF LENDER AND TYPE OF LOAN:
   1.1 Identify Lender ____________ (bank, mortgage banker, loan broker, credit union)
      a. Back up Lender under second application
   1.2 Type of loan chosen ____________ (conventional/conforming; FHA/VA/CalVet; jumbo; Alt-A or subprime)
      a. ☐ Fixed rate, ☐ or adjustable rate.
   1.3 ☐ Pre-approval Letter of Commitment, or ☐ pre-qualified.
2. LOAN APPLICATION:
   2.1 Loan Estimate received from loan representative ____________, 20____. [See RPI Form 204-5]
   2.2 Application to Lender for loans [See RPI Form 202 (FNMA 1003)]:
      a. Prepaid, signed and submitted ____________, 20____.
      b. Payment of fees and charges for credit investigation and appraisal costs ____________, 20____.
   2.3 Receipt of Lender disclosures, (list): ____________
   signed by Buyer and returned to Lender ____________, 20____.
   2.4 Escrow and title company given Lender identification and contact information ____________, 20____.
   2.5 Statement of information from Borrower prepared and submitted to escrow ____________, 20____. [See RPI Form 401-4]
      a. Escrow orders preliminary title report ____________, 20____.
      b. Copies of driver's license and social security cards (and any military ID or alien registration card) ____________, 20____.
3. LOAN PROCESSING ACTIVITIES:
   3.1 Copies of purchase agreement, escrow instructions, TDS and NHD handed to Lender ____________, 20____. [See RPI Form 150, 401, 304 and 314]
   3.2 Request for Verification of Employment prepared and signed by Buyer and handed to Lender ____________, 20____. [See RPI Form 208]
   3.3 Request for Verification of Rent or Mortgages prepared and signed by Buyer and handed to Lender ____________, 20____. [See RPI Form 210-1]
      a. Documents for last 12 months of mortgage or rent payments made by Buyer.
      b. Some Lenders also request cancelled checks for payments of recent mortgage statements or rental agreements.
   3.4 Copies of statements for the recent three months of all checking and savings accounts handed to Lender ____________, 20____.
   3.5 Request for Verification of Deposit (down payment) prepared and signed by Buyer and handed to Lender ____________, 20____ [See RPI Form 211]
   3.6 Credit Application prepared and signed by Buyer and handed to Lender ____________, 20____. [See RPI Form 302]
   3.7 Copies, if applicable, of bankruptcy discharge (with list of creditors) and divorce papers handed to Lender ____________, 20____.
   3.8 Buyer to coordinate inspection of property by Appraiser.
      a. Lender orders appraisal ____________, 20____. [See RPI Form 207]
      b. Appraiser to inspect property ____________, 20____.

PAGE 1 OF 2 — FORM 339

PAGE 2 OF 2 — FORM 339

      c. Buyer is to request a copy of the appraisal to receive one. [See RPI Form 206]
      d. Copy of appraisal report received from Lender ____________, 20____. [See RPI Form 200 (HUD 1004)]
   3.9 Preliminary title report received and reviewed by Buyer and returned to Escrow ____________, 20____
   3.10 Lender approves the property as qualified to be security for Buyer's loan ____________, 20____
4. FINALIZING THE LOAN:
   4.1 Loan approved on Buyer's receipt of RESPA three-day right to cancel [See RPI Form 222] ____________, 20____
   4.2 Buyer makes arrangement for homeowner's insurance on the property ____________, 20____
      a. Coverage will be required by Lender on closing.
   4.3 Loan documents from Lender are received by Escrow or title company ____________, 20____
      a. Buyer signs loan documents ____________, 20____
   4.4 Escrow prepares Closing Disclosure for Buyer's approval [See RPI Form 402] ____________, 20____
5. FUNDING AND CLOSING ESCROW:
   5.1 Escrow makes a demand on Lender and Buyer for funds needed to close ____________, 20____
   5.2 Escrow forwards deeds to title company for recording when Escrow can close ____________, 20____
   5.3 Lender wires funds to Escrow or title company ____________, 20____
   5.4 Buyer deposits funds in Escrow as needed to close ____________, 20____
   5.5 Deeds are recorded by title company on instruction from Escrow ____________, 20____
   5.6 Escrow issues check to Seller for net proceeds from the sale ____________, 20____

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Figure 1

Form 339

Tracking the Loan Origination Process

Yes! Prior to 2012, RESPA was interpreted broadly to prohibit any fees for which no new service was provided, called the *no-new-service, no-second-fee rule*.

However, in the 2012 **Freeman v. Quicken Loans**, a federal appeals court ruled that RESPA only prohibited the charging of a second, unearned fee when the fees were split. In other words, RESPA only prohibits kickbacks paid between service providers when one provides no service other than a referral. RESPA does not extend to prohibiting "junk fees" charged by escrow, title insurance and brokers, sometimes called garbage fees.[13]

## RESPA disclosures

When lenders and MLOs accept a homebuyer's application for a purchase-assist consumer mortgage, they must hand the buyer a written list of at least ten HUD-approved homeownership counseling organizations located in the homebuyer's area. This written disclosure is delivered within three business days after receiving the mortgage application.[14]

Homebuyers need not partake in the counseling unless the mortgage:

- is a Section 32 high-cost mortgage; or
- has a negative amortization feature.[15]

## Who is subject to the MLO compensation rules?

In response to MLO abuses during the mortgage and housing boom, Reg Z was amended to prohibit any person from compensating an individual MLO or MLO broker based on the terms or conditions of a consumer mortgage.

13 **Freeman et al.** v. **Quicken Loans, Inc.** (5th Cir. 2012) 626 F3d 799

14 12 CFR §1024.20(a)

15 12 CFR §§1026.34(a)(5), 1026.36(k)

MLO status includes:

- mortgage brokers and their employees who perform MLO services;
- a mortgage lender's employees who perform MLO services;
- warehouse lenders, sometimes called mortgage bankers; and
- any lender who makes mortgages using funds which it does not own, e.g., deposits.[16]

To distinguish, a *mortgage broker* is an MLO who is not an employee of a lender. MLO status includes California Department of Real Estate (DRE)-licensed and MLO-endorsed brokers who engage in the practice of originating consumer mortgages, and any employees of those brokers who engage in the practice of originating consumer mortgages such as licensed agents and broker-associates who hold MLO endorsements.[17]

Further, MLOs are either:

- **individual MLOs**, defined as natural persons who meet the definition of an MLO such as agents and brokers individually licensed and MLO-endorsed by the DRE;[18] or
- **MLO brokers**, defined as MLOs other than natural persons such as corporate brokers licensed and MLO-endorsed by the DRE.[19]

Individual MLOs do *not* include:

- individuals who performs purely *administrative or clerical tasks* on behalf of an MLO broker or agent;
- the employee of a *manufactured home retailer* who does not take an application or advise consumers on credit terms;
- an individual or entity who only performs real estate brokerage activities as a transaction agent on the sale of a home, unless they are also compensated by an MLO or mortgage lender; and
- mortgage servicers or their employees, as long as they do not offer or negotiate a transaction that constitutes a refinance.[20]

In California, a **carryback seller** of a home to a buyer who will occupy the property is not an MLO unless they bargain for or receive additional compensation beyond the sales price and interest for agreeing to carryback a mortgage.[21]

## Prohibited compensation

When an MLO originates a consumer mortgage, no part of the compensation paid by any person and received by an MLO may be based on:

- the terms or conditions of a mortgage transaction;
- the terms of multiple mortgage transactions by the MLO; or

16 12 CFR §1026.36(a)(1)
17 12 CFR §1026.36(a)(2); Official Interpretation of 12 CFR §1026.36(a)-2
18 12 CFR §1026.36(a)(1)(ii)
19 12 CFR §1026.36(a)(1)(iii)
20 12 CFR §1026.36(a)(1)(i)
21 Bus & P C §10166.01(b)(1

- the terms of multiple mortgage transactions by multiple individual MLOs.[22]

The rule prohibits compensation of a corporate or individual MLO based on the terms of the mortgage, which include:

- the interest rate of the mortgage originated;
- whether the mortgage contains a prepayment penalty;
- the annual percentage rate (APR);
- the loan-to-value ratio (LTV); or
- whether the homebuyer's title insurance was purchased from an affiliate of the broker.[23]

The terms of a consumer mortgage do not include the principal amount of the mortgage. Thus, MLO compensation may be based on the amount of the mortgage or mortgages the MLO originates. While the MLO's compensation may be a percentage of the mortgage amount, the percentage may not vary from one mortgage to the next based on the differing mortgage amounts.[24]

For example, a lender or MLO broker who offers an MLO 1% of the mortgage amount on **all mortgages** arranged by the MLO conforms to regulations.

However, a lender who offers an MLO 1% of the loan amount for mortgages of $300,000 or more and 2% of the loan amount for mortgages less than $300,000 violates the prohibitions.[25]

## Allowable compensation

MLO compensation includes salaries, fees, commissions or annual or periodic bonuses, awards of merchandise, services, trips, i.e., any compensation collected which the MLO retains. The name given a fee is irrelevant for determining whether it is compensation.[26]

Costs collected by an MLO from the homebuyer to pay third-party charges such as for an appraisal or title insurance are not compensation. They are trust funds held by the MLO but belonging to the homebuyer.

However, when the MLO marks-up the price of third-party services and pockets the difference, a practice called **upcharging**, the difference is MLO compensation. When an MLO estimates a third-party service charge within a reasonable range and the third-party service charge turns out to be less than the estimate, the difference between the two charges while being trust funds is not considered compensation if taken as additional compensation.[27]

**upcharging**
The practice of marking up the price of a third-party service and keeping the difference.

Other examples of allowable bases for a lender to compensate an MLO broker include:

- the MLO broker's overall dollar volume delivered to the lender;

22 12 CFR §1026.36(d)(1)
23 12 CFR §1026.36(d); Official Interpretation of 12 CFR §1026.36(d)(1); 12 CFR §1026.36(d)(1)
24 12 CFR §1026.36(d)(1)(ii)
25 Official Interpretation of 12 CFR §1026.36(d)(1)-9
26 Official Interpretation of 12 CFR §1026.36(a)-5(ii)
27 Official Interpretation of 12 CFR §1026.36(a)-5(v)

- the long-term performance of a an MLO's mortgages;
- hourly pay for the actual number of hours worked for the lender;
- pay dependent on whether the homebuyer is a new or existing customer;
- a payment fixed in advance for the volume of mortgages originated with the lender (e.g., $1,000 for the first 100 mortgages originated, and $1,500 for all mortgages above the 100-mortgage threshold);
- the percentage of closed mortgages to mortgage applications submitted to the lender; and
- the accuracy and completeness of the submitted mortgage files.[28]

These MLO compensation rules also apply to an MLO or MLO broker who pays individual MLOs, such as MLOs they employ.

For example, an MLO broker may not pay another MLO, such as an MLO employee, more for generating a mortgage with a 7% interest rate than they would pay for a mortgage of the same amount with a 6% interest rate. Thus, an MLO may not be paid by the lender or their MLO broker based on the yield spread premium, a type of kickback commonly paid to MLOs before the Great Recession.[29]

Occasionally, a homebuyer pays a fee to the MLO. However, when an MLO receives any compensation for their mortgage services from the homebuyer, the MLO may not receive compensation for mortgage services from anyone else in the same mortgage transaction.

An MLO broker may not base fees paid to their MLO employees on the terms of the mortgage, other than a percentage of the mortgage amount.[30]

## Steering prohibitions

MLOs may not direct or "steer" a homebuyer to a consumer mortgage product with terms or conditions which will generate greater compensation for the MLO — unless the mortgage is in the homebuyer's interest.

To avoid **mortgage steering**, an MLO will present the homebuyer with mortgage options for all types of mortgages the homebuyer expresses an interest in, including:

- a fixed rate mortgage (FRM);
- an adjustable rate mortgage (ARM); and
- reverse mortgages.[31]

**mortgage steering**
A mortgage loan originator (MLO) practice of directing a homebuyer to a consumer mortgage with less favorable terms in order to obtain greater compensation.

The MLO broker needs to make available mortgage products from at least three lenders the MLO does business with regularly, and needs to present to the homebuyer themselves or through their MLO agents:

- the mortgage with the lowest interest rate;

28 Official Interpretation of 12 CFR §1026.36(d)(1)-2(i)
29 Official Interpretation of 12 CFR §1026.36(d)
30 12 CFR §1026.36(d)(2)
31 12 CFR §1026.36(e)(2)

- the mortgage with the lowest interest rate without:
  - negative amortization;
  - a prepayment penalty;
  - a balloon payment within the initial seven years of the mortgage;
  - a demand feature; or
  - shared equity or appreciation; and
- the mortgage with the lowest total dollar amount for origination points and/or **discount points**.[32]

**discount point**
The amount of money the borrower or seller must pay the lender to get a mortgage at a stated interest rate.

The mortgages an MLO presents to a homebuyer need to be based on the homebuyer's *ability to repay* to comply with anti-steering rules.[33]

Additionally, an MLO is charged with conducting negotiations and arrangements with homebuyers not to:

- steer a homebuyer into a mortgage with terms the homebuyer is not reasonably able to pay back;
- steer a homebuyer into a mortgage with predatory terms such as excessive fees or rates;
- steer a homebuyer away from *qualified mortgages* to *non-qualified mortgages*, as defined by the Truth in Lending Act (TILA);
- discriminate against homebuyers based on race, ethnicity, gender or age;
- misrepresent the credit history of a homebuyer;
- misrepresent the availability of a residential mortgage to a homebuyer;
- misrepresent the appraised value of a property; or
- discourage homebuyers from seeking less expensive mortgages from competing MLOs.[34]

To satisfy these requirements against steering, the MLO need not actually receive an offer from the lender to fund the mortgage disclosed to the homebuyer. The MLO may independently determine what their lender will accept in terms and conditions based on a reasonable review of the homebuyer's creditworthiness and available lender requirements.[35]

**Home equity lines of credit (HELOCs)** are exempt from these requirements, as are mortgages on timeshare plans.[36]

## Advance fees prohibited

An **advance fee** is a fee an MLO receives before the service is fully completed.[37]

In California, *advance fees* are trust funds when received. Also, before an MLO collects an advance fee they must first submit form agreements and

32 Official Interpretation of 12 CFR §1026.36(e)(3)-1; 12 CFR §1026.36(e)(3)
33 12 CFR §1026.36(e)(4)
34 15 USC §1639b(c)(3)
35 Official Interpretation of 12 CFR §1026.36(e)(1)-2
36 12 CFR §1026.36(b)
37 Bus & P C §10026

receive approval from the DRE. The MLO seeking to collect an advance fee needs to submit all materials used to obtain an advance fee agreement at least ten calendar days before use. The DRE has ten days from the date of receipt to determine whether the materials are misleading.[38]

An MLO who collects an advance fee needs to deposit the full amount in a trust account with a bank. These funds are only to be withdrawn for benefit of the agent after the advance-fee services have been completed and an itemized billing presented to the homebuyer. Until that time, the funds remain the property of the person paying the fee.[39]

However, an MLO negotiating, attempting to negotiate or arranging the modification or forbearance of a consumer mortgage is barred from collecting any advance fees.[40]

## Escrow fees: the result of "extras"

Escrow is often the source of hidden costs when a one-to-four unit residential property is the subject of their sales or mortgage escrow.

Rather than openly admitting to fee hikes and risk losing business to competitive escrow officers, escrow companies generally advertise a low rate for **basic services**, then upon closing, charge for services proclaimed as **extras**.

However, *extras* are most frequently **fundamental services** necessary to the escrowing of every transaction. These necessary services are often separately itemized as additional charges as though the service was especially unique to this transaction and not a service traditionally performed as a necessary step.

Some escrow companies are vague with their definition of what services are included in a basic escrow transaction. However, basic escrow service includes any activity required of escrow in the routine services expected and rendered in most every transaction.

## Commonly charged duplicate escrow fees

Duplicate fees commonly charged by escrow agents include:

- fees for drawing deeds and notes;
- a fee for complying with lender instructions and handling the lender's documents;
- an Internal Revenue Service (IRS) §1099 processing fee charged for filing a tax form (which is also separately prohibited);[41] and
- fees for notarizing signatures.[42]

38 Bus & P C §10085
39 Bus & P C §10146
40 Bus & P C §10085.6
41 26 USC §6045(e)(3)
42 Calif. Government Code §8211

## Customary escrow services

The fundamental events which constitute an escrow include:

- the receipt of funds from the buyer and lender (and, if deposited with a title company instead, any sub-escrow charge is best absorbed by escrow as a deduction from the client's escrow fee since the escrow did not handle the money which is the customary function of escrow);
- preparation of the seller's grant deed and any carryback note and trust deed; and
- preparation of instructions for escrow's delivery of funds and documents on satisfaction of conditions.[43] [See **RPI** Form 401]

Thus, the most basic escrow services — after preparing written instructions — are preparing deeds, notes and trust deeds, handling funds and documents from the buyer and the buyer's lender, ordering out reports and statements needed by escrow to comply with instructions and releasing all instruments on the close of escrow.

One can recognize inclusive services by reviewing the boilerplate escrow instructions.

An escrow officer is to be asked to provide a notary seal at their office. The office-place notary acknowledgment is capped by law at $15 per signature. However, notaries may agree to meet at the buyer's place of business or home and charge $100.00 or more as additional *travel fees*. [44]

Any escrow company itemizing the above services separately from the basic service is double charging for a single basic service. These services by an escrow agent are simply the minimum activities required to open, process and close an ordinary sales escrow.

## The Loan Estimate

The **Loan Estimate** is delivered by Reg Z lenders to consumer mortgage applicants as an initial disclosure of the terms, features and costs of the mortgage they are offering. The *Loan Estimate* is required on all closed-end consumer mortgages.[45] [See Figure 2]

**Loan Estimate**
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

Homebuyers use the *Loan Estimate* to:

- compare the mortgage terms offered by several lenders while shopping for a mortgage; and
- compare the initial mortgage terms and costs with the lender's final mortgage terms and costs later disclosed on the Closing Disclosure for any changes.[46]

Information disclosed on the Loan Estimate includes:

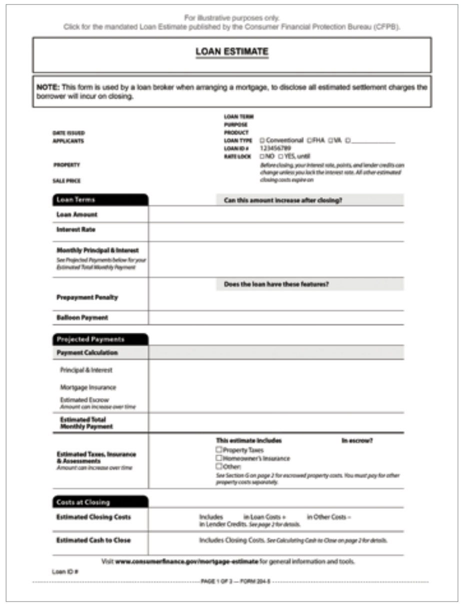
- identification of the homebuyer, lender and MLO;

43 Calif. Civil Code §1057
44 Gov C §8211
45 12 CFR §1026.37(e)
46 12 CFR §1026.37

Figure 2

Form 204-5

Loan Estimate



For illustrative purposes only.
Click for the mandated Loan Estimate published by the Consumer Financial Protection Bureau (CFPB).

**LOAN ESTIMATE**

**NOTE:** This form is used by a loan broker when arranging a mortgage, to disclose all estimated settlement charges the borrower will incur on closing.

DATE ISSUED
APPLICANTS
PROPERTY
SALE PRICE

LOAN TERM
PURPOSE
PRODUCT
LOAN TYPE ☐ Conventional ☐FHA ☐VA ☐__________
LOAN ID # 123456789
RATE LOCK ☐NO ☐YES, until
*Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on*

**Loan Terms** | **Can this amount increase after closing?**

| Loan Terms | |
|---|---|
| **Loan Amount** | |
| **Interest Rate** | |
| **Monthly Principal & Interest** *See Projected Payments below for your Estimated Total Monthly Payment* | |
| | **Does the loan have these features?** |
| **Prepayment Penalty** | |
| **Balloon Payment** | |

**Projected Payments**

| **Payment Calculation** | |
|---|---|
| Principal & Interest | |
| Mortgage Insurance | |
| Estimated Escrow *Amount can increase over time* | |
| **Estimated Total Monthly Payment** | |
| **Estimated Taxes, Insurance & Assessments** *Amount can increase over time* | **This estimate includes** **In escrow?** ☐Property Taxes ☐Homeowner's Insurance ☐Other: *See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.* |

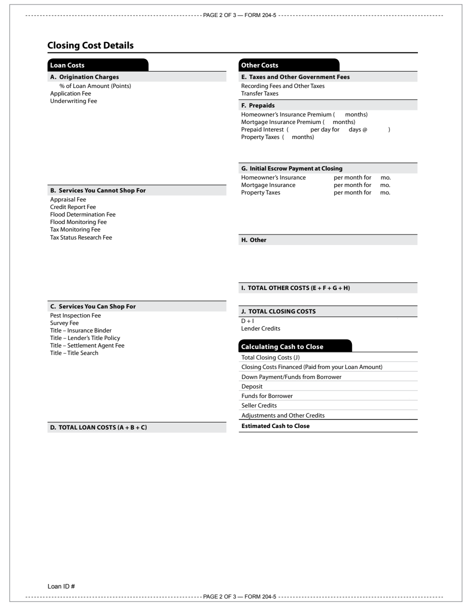
**Costs at Closing**

| | |
|---|---|
| **Estimated Closing Costs** | Includes in Loan Costs + in Other Costs – in Lender Credits. *See page 2 for details.* |
| **Estimated Cash to Close** | Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.* |

Visit **www.consumerfinance.gov/mortgage-estimate** for general information and tools.

Loan ID #

PAGE 1 OF 3 — FORM 204-5



PAGE 2 OF 3 — FORM 204-5

**Closing Cost Details**

**Loan Costs**

**A. Origination Charges**
% of Loan Amount (Points)
Application Fee
Underwriting Fee

**B. Services You Cannot Shop For**
Appraisal Fee
Credit Report Fee
Flood Determination Fee
Flood Monitoring Fee
Tax Monitoring Fee
Tax Status Research Fee

**C. Services You Can Shop For**
Pest Inspection Fee
Survey Fee
Title – Insurance Binder
Title – Lender's Title Policy
Title – Settlement Agent Fee
Title – Title Search

**D. TOTAL LOAN COSTS (A + B + C)**

**Other Costs**

**E. Taxes and Other Government Fees**
Recording Fees and Other Taxes
Transfer Taxes

**F. Prepaids**
Homeowner's Insurance Premium ( months)
Mortgage Insurance Premium ( months)
Prepaid Interest ( per day for days @ )
Property Taxes ( months)

**G. Initial Escrow Payment at Closing**
Homeowner's Insurance per month for mo.
Mortgage Insurance per month for mo.
Property Taxes per month for mo.

**H. Other**

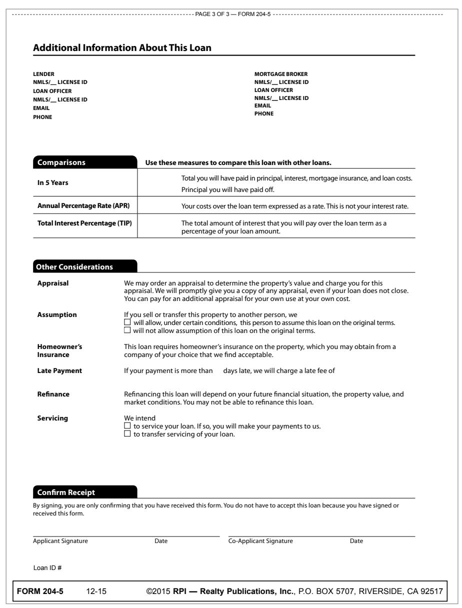
**I. TOTAL OTHER COSTS (E + F + G + H)**

**J. TOTAL CLOSING COSTS**
D + I
Lender Credits

**Calculating Cash to Close**
Total Closing Costs (J)
Closing Costs Financed (Paid from your Loan Amount)
Down Payment/Funds from Borrower
Deposit
Funds for Borrower
Seller Credits
Adjustments and Other Credits
**Estimated Cash to Close**

Loan ID #

PAGE 2 OF 3 — FORM 204-5



PAGE 3 OF 3 — FORM 204-5

**Additional Information About This Loan**

LENDER
NMLS/__ LICENSE ID
LOAN OFFICER
NMLS/__ LICENSE ID
EMAIL
PHONE

MORTGAGE BROKER
NMLS/__ LICENSE ID
LOAN OFFICER
NMLS/__ LICENSE ID
EMAIL
PHONE

| **Comparisons** | **Use these measures to compare this loan with other loans.** |
|---|---|
| **In 5 Years** | Total you will have paid in principal, interest, mortgage insurance, and loan costs. Principal you will have paid off. |
| **Annual Percentage Rate (APR)** | Your costs over the loan term expressed as a rate. This is not your interest rate. |
| **Total Interest Percentage (TIP)** | The total amount of interest that you will pay over the loan term as a percentage of your loan amount. |

**Other Considerations**

| | |
|---|---|
| **Appraisal** | We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost. |
| **Assumption** | If you sell or transfer this property to another person, we ☐ will allow, under certain conditions, this person to assume this loan on the original terms. ☐ will not allow assumption of this loan on the original terms. |
| **Homeowner's Insurance** | This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable. |
| **Late Payment** | If your payment is more than days late, we will charge a late fee of |
| **Refinance** | Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan. |
| **Servicing** | We intend ☐ to service your loan. If so, you will make your payments to us. ☐ to transfer servicing of your loan. |

**Confirm Receipt**

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature Date Co-Applicant Signature Date

Loan ID #

FORM 204-5 12-15 ©2015 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

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

- the core features of the consumer mortgage, including its purpose, sale price or property value of the security, mortgage term, type of mortgage product and interest rate;[47]
- the existence and effect of any rate lock;[48]
- the monthly payment, and whether this amount may change after closing;[49]
- the existence and terms of any prepayment penalty;[50]

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47 12 CFR §1026.37(a)
48 12 CFR §1026.37(a)(13)
49 12 CFR §1026.37(b)(1)-(3), (6)
50 12 CFR §1026.37(b)(4)-(5)

- the existence and terms of any balloon payment;[51]
- a breakdown of the monthly payment into principal and interest, mortgage insurance payments and impounds for estimated taxes, insurance and assessments;[52]
- total closing costs, including a detailed itemization of costs and differentiation between closing costs the homebuyer may and may not shop for and place elsewhere;[53]
- cash needed to close, including a table showing how the amount is calculated;[54]
- for ARMs, an adjustable interest rate (AIR) table with relevant information about how the interest rate will change;[55]
- a summary of the total payments, APR and the total interest paid over the life of the mortgage as a percentage of the mortgage amount, called the total interest percentage (TIP), to be used when comparison shopping; and
- information about the appraisal, assumption policies, homeowner's insurance, late payments, refinancing and servicing.[56]

## Prohibited activities before disclosure

The only fee a lender may charge and receive before the Loan Estimate is delivered to the homebuyer is a reasonable credit report fee.

Otherwise, the lender may not collect any fees from a homebuyer as an applicant, even in the form of a post-dated check, until after:

- the Loan Estimate has been delivered to the homebuyer; and
- the homebuyer has indicated they will proceed with the consumer mortgage covered by the Loan Estimate.[57]

A homebuyer may indicate their intent to proceed in any manner. However, a written document indicating the homebuyer's intent to proceed allows a lender or MLO to document their compliance with the Reg Z requirements.[58]

Further, the lender is barred from calling for the homebuyer to provide information verifying facts in the mortgage application until the Loan Estimate has been delivered.[59]

51 12 CFR §1026.37(b)(7)]
52 12 CFR §1026.37(c)
53 12 CFR §1026.37(f)-(g)
54 12 CFR §1026.37(d), (h)
55 12 CFR §1026.37(j)
56 12 CFR §1026.37(k), (m)
57 12 CFR §1026.19(e)(2)(i)
58 12 CFR §1026.19(e)(2)(i)(A)
59 12 CFR §1026.19(e)(2)(iii)

## Triggering events and delivery

Reg Z lenders provide homebuyers with a Loan Estimate within three business days after a homebuyer submits a consumer mortgage application.[60]

For timely delivery of the Loan Estimate, a business day is any day on which the lender's offices are open to the public, carrying out substantially all of its business functions.[61]

To trigger the lender's preparation and delivery of the Loan Estimate, the consumer mortgage application needs to include:

- the homebuyer's name;
- the homebuyer's income;
- the homebuyer's Social Security number, to obtain a credit report;
- the property address;
- the price or an estimate of the value of the property; and
- the mortgage amount sought.[62]

As soon as all six pieces of information are received, the three-business-day countdown for delivery of the Loan Estimate form begins. A lender may not delay delivery of the Loan Estimate form based on any information other than these six listed items.[63]

The homebuyer is required to acknowledge receipt of the disclosure — not an acceptance of the consumer mortgage — by signing and dating the disclosure.[64]

When an MLO is negotiating the consumer mortgage on behalf of a homebuyer, the MLO may provide the Loan Estimate on behalf of the lender. The lender is bound to the Loan Estimate, and may not issue a "revised" Loan Estimate to correct any errors made by the MLO.[65]

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60 12 CFR §1026.19(e)(1)(iii),12 CFR §1026.19(e)(1)(iv)

61 Official Interpretation of 12 CFR §1026.19(e)(1)(iii)-1; 12 CFR §1026.2(a)(6)

62 12 CFR §1026.2(a)(3)

63 Official Interpretation of 12 CFR §1026.2(a)(3)-1

64 12 CFR §1026.37(n)

65 12 CFR §1026.19(e)(1)(ii); Official Interpretation of 12 CFR §10269.19(e)(1)(ii)-1-2

## Chapter 35 Summary

Beginning in 1974, homebuyers taking out purchase-assist consumer mortgages were given legal protection against abusive fee-charging practices of service providers by passage of the Real Estate Settlement Procedures Act (RESPA). RESPA rules are implemented by Regulation X (Reg X).

A fee qualifies as a charge for a settlement service, whether paid by a homebuyer, seller or owner, when the service is performed:

- directly for the benefit of the homebuyer, seller or owner; or
- at or before the closing.

However, some lenders, brokers/agents and other service providers collude to "buy business" or make additional profits off the homebuyer, seller or owner in the form of kickbacks between providers.

No person in a transaction which includes the origination of a consumer mortgage, including brokers, agents or other third-party service providers, may give or accept a kickback or any other thing of value for advising a homebuyer, seller or owner participating in the transaction to employ a particular service provider.

Further, the split of a settlement service charge with any person who has not provided a significant portion of the other provider's service in exchange for the split is unlawful.

When an mortgage loan originator (MLO) originates a consumer mortgage, no part of the compensation paid by any person and received by an MLO may be based on:

- the terms or conditions of a mortgage transaction;
- the terms of multiple mortgage transactions by the MLO; or
- the terms of multiple mortgage transactions by multiple individual MLOs.

MLOs may not direct or "steer" a homebuyer to a consumer mortgage product with terms or conditions which will generate greater compensation for the MLO — unless the mortgage is in the homebuyer's interest.

The Loan Estimate is delivered to consumer mortgage applicants as an initial disclosure of the terms, features and costs of the mortgage they are offering.

## Chapter 35 Key Terms

**Quiz 9 Covering Chapters 33-35 is located on page 629.**

Chapter 36

# The FHA-insured consumer mortgage

## Learning Objectives

After reading this chapter, you will be able to:

- understand how purchase-assist mortgages insured by the Federal Housing Administration (FHA) enable consumers to become homeowners;
- explain the minimum down payment and loan-to-value ratio (LTV) for FHA-insured mortgages;
- apply FHA guidelines setting the thresholds for mortgage insurance premiums (MIPs);
- determine whether a buyer and property qualify for an FHA-insured mortgage;
- counsel a seller on their liability when they sell their home subject to an existing FHA-insured mortgage; and
- advise buyers on the use of an FHA Energy Efficient Mortgage to finance energy efficient improvements.

## Key Terms

**Energy Efficient Mortgage (EEM)**

**Federal Housing Administration (FHA)-insured mortgage**

**fixed payment ratio**

**loan-to-value ratio (LTV)**

**mortgage insurance premium (MIP)**

**mortgage payment ratio**

## Enabling tenants to become homeowners

Consider a residential tenant who is solicited by a real estate agent to buy a home. The financial and tax aspects of homeownership, together with its social benefits, are reviewed and compared to the corresponding benefits and mobility provided by renting shelter.

The tenant indicates they have considered buying and are ready and willing to become a homeowner. However, they have not accumulated enough cash reserves for the **down payment** needed to qualify for a mortgage needed to fund the purchase of a home.

The agent assures the tenant that first-time homebuyers with little cash available for a down payment may buy a home by qualifying for a *purchase-assist mortgage* insured by the **Federal Housing Administration (FHA)**.

**Federal Housing Administration (FHA)-insured mortgage**
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value ratio (LTV) and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

By insuring mortgages made with a less demanding cash down payment requirement and a higher **loan-to-value ratio (LTV)** of up to 96.5% of the price paid, the FHA enables prospective buyers to become homeowners.

The FHA does not lend money to buyers. Rather, the FHA insures mortgages originated by approved *direct endorsement lenders* to qualified buyers who will occupy the property as their principal residence. For issuing insurance to the lender covering losses on a default, the buyer will pay premiums to the FHA for the coverage.

To qualify for an FHA-insured fixed-rate mortgage (FRM), a first-time homebuyer is required to make a down payment of at least 3.5% of the purchase price. The interest rate and other terms of the purchase-assist mortgage are negotiated between the buyer and the lender.[1]

## Buyer liability on a default

If a buyer defaults on an FHA-insured mortgage, the FHA covers the lender against any loss on the balance of the mortgage. This is riskier for the buyer than **private mortgage insurance (PMI)** and the mortgage guarantee from the **Department of Veterans Affairs (VA)**, which only guarantee a portion of the total mortgage amount.

After the lender acquires the property through foreclosure and conveys the property to the FHA, the FHA pays the lender the amount of the unpaid principal balance remaining on the mortgage.[2]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any **waste**. The FHA then sells the property to recoup what it can of the amount it paid to the lender.

Unlike conventional home mortgages where only a lender is involved, a buyer who takes out an FHA-insured mortgage with a lender is *personally liable* to the FHA for any loss the FHA suffers as a result of the homebuyer's default.

When the FHA suffers a loss on a mortgage they insured, the FHA can obtain a money judgment against the homebuyer for the difference between:

- the amount the FHA paid the lender; and
- the price received from the sale of the property on foreclosure.

1 24 Code of Federal Regulations §203.20

2 24 CFR §203.401

Mortgage documentation

*An FHA–approved direct endorsement lender processing a mortgage application submitted by a homebuyer requests or generates the following list of documents:*

- *Uniform Residential Loan Application signed and dated by all buyers and the lender [See **RPI** Form 202 (HUD Form 1003); see Chapter 33];*
- *FHA Loan Underwriting and Transmittal Summary [Form HUD-92900-LT];*
- *Social Security Number evidence for each buyer;*
- *Residential Mortgage Credit Report for each buyer;*
- *verification of employment and most recent pay stub [See **RPI** Form 210 and 210-1];*
- *verification of deposit (VOD) and most recent bank statement [See **RPI** Form 211];*
- *federal income tax returns (individual and business) for the past two years for self-employed borrowers [See **RPI** Forms 215 and 215-1];*
- *purchase agreement, any additional agreements, and the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **RPI** Form 152 and 304];*
- *verification of payment history of rent payments or mortgages [See **RPI** Forms 212 and 212-1];*
- *Residential Appraisal Report – Detached Single Family Unit or PUD [See **RPI** Form 200 (HUD Form 1004)]; and*
- *Lead-Based Paint Disclosure signed by the buyer. [HUD Handbook 4155.1 1.B.2.a; See **RPI** Form 313]*

*If the buyer is self-employed, they will also need to submit:*

- *individual tax returns, signed and dated, for the most recent two years;*
- *for a corporation, "S" corporation or partnership (LLC), copies of Federal business income tax returns for the last two years;*
- *a profit and loss (P&L) Balance Sheet; and*
- *a business credit report for a "C" corporation and "S" corporations. [HUD Handbook 4155.1 4.D.4.d]*

**mortgage insurance premium (MIP)** Default insurance premiums required on a Federal Housing Administration (FHA)-insured mortgage, paid both up-front and annually.

California *anti-deficiency mortgage laws* do not apply to FHA-insurance coverage for their losses claimed on insured mortgages.[3] [See Chapter 40]

## One-to-four unit mortgage default insurance

The most commonly used FHA-insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, **Section 203(b).**

The purpose of *Section 203(b)* is to enable tenants to become homeowners. The program allows qualifying first-time buyers to make a smaller down payment than required for conventional mortgages originated by portfolio lenders. Buyers obtaining a Section 203(b) mortgage need to occupy the property as their **primary residence**.

For the privilege of making a **small down payment**, the buyer needs to pay a **mortgage insurance premium (MIP)** to the FHA. This essentially increases the annual cost of borrowing as the annual rate charged for MIP

3 24 CFR §203.369

is added to monthly principal and interest payments. Together, the MIP and interest equal the *annual cost* incurred to borrow FHA-insured funds for the purchase of a home.

*MIP*, which is paid monthly, is set and charged at the following rates:

- for mortgage terms greater than 15 years, the annual MIP rates are:
  - .5% for mortgages no greater than $726,200 with a mortgage to value ratio (LTV) less than or equal to 95%;
  - .55% for mortgages no greater than $726,200 with an LTV greater than 95%;
  - .7% for mortgages greater than $726,200 with an LTV less than or equal to 95%; and
  - .75% for mortgages greater than $726,200 with an LTV greater than 95%.
- for mortgage terms of 15 years or less, the MIP annual rates are:
  - 0.15% for mortgages no greater than $726,200 with an LTV less than or equal to 90%;
  - 0.4% for mortgages no greater than $726,200 with an LTV greater than 90%;
  - 0.15% for mortgages greater than $726,200 with an LTV less than or equal to 78%
  - 0.4% for mortgages greater than $726,200 with an LTV of 78.01-90%; and
  - 0.65% for mortgages greater than $726,200 with an LTV greater than 90%.[4]

FHA guidelines include:

- manual underwriting for homebuyers whose debt-to-income ratio (DTI) exceeds 43% and whose credit scores are below 580;
- 3.5% minimum down payments on FHA mortgages with a minimum credit score of 580; and
- MIP to continue through the life of the mortgage (previously it was cancelled once the homeowner reached a 78% LTV).

Further, an *upfront premium*, paid once at the time the mortgage is originated, is calculated as 1.75% of the funded mortgage amount.

## Public policy rationale

The public policy rationale behind the FHA Section 203(b) program is based on the proposition that homeowners are less of a financial burden on the government in their later years than lifetime tenants.

However, no consideration is given to the financial *risks of loss* a buyer takes on by the debt burden accompanying any leveraged purchase of a home, or the reduced mobility brought on by homeownership.

4 HUD Handbook 4000.1 V Appendix 1.0

*Acceptable sources of cash down payment include:*

- ***Savings and checking accounts**: Lenders need to verify the account balance is consistent with the buyer's typical recent balance and no large increase occurred just prior to the mortgage application. [See **RPI** Form 211]*
- ***Gift funds**: The donor of the gift needs to have a clearly defined interest in the buyer and be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are kickbacks considered an inducement to buy and result in a reduction in the mortgage amount.*
- ***Collateralized mortgages**: Any money borrowed to make the down payment needs to be fully secured by the buyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which may not include the home being financed. For example, cash advances on a credit card are not acceptable sources for down payment funds.*
- ***Broker fees**: If the buyer is also a real estate agent involved in the sales transaction, the fee received on the sale may be part of the buyer's down payment.*
- ***Exchange of equities**: The buyer may trade property they own to the seller as the down payment. The buyer needs to produce evidence of value and ownership before the exchange will be approved.*
- ***Sale of personal property**: Proceeds from the sale of the buyer's personal property may be part of the down payment if the buyer provides reliable estimates of the value of the personal property sold.*
- ***Undeposited cash** is an acceptable source of down payment funds if the buyer can explain and verify the accumulation of the funds. [HUD Handbook 4155.1 Rev-5 Ch-5 §B.1]*

Acceptable sources of cash down payment

## FHA-insured dollar limits by regions

The maximum FHA-insured mortgage available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and
- the county in which the property is located.

A list of counties and their specific mortgage ceilings is available from the FHA or an FHA direct endorsement lender, or online from the Department of Housing and Urban Development (HUD) at *http://www.hud.gov*.

## Loan-to-value (LTV) ceilings and costs

The FHA sets limitations on the amount of a mortgage it will insure. The limit is a ceiling set as a percentage of the appraised value of the property, called the **loan-to-value ratio (LTV)**.

**loan-to-value ratio (LTV)**
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

The *LTV ratio* on an FHA-insurable mortgage is capped at a ceiling of 96.5% of the property's fair market value. Thus, the minimum down payment is 3.5%.[5]

Additionally, even after including buyer-paid closing costs in the LTV calculations, the insurable mortgage amount cannot exceed the ceiling of 96.5% of the property's appraised value.

5 HUD Handbook 4000.1 II(A)(2)(b)(ii)

The maximum mortgage amount the FHA will insure is the LTV ratio's percentage amount of the lesser of:

- the property's sales price; or
- the appraised value of the property.[6]

**Closing costs** may not be used to help meet the 3.5% minimum down payment requirement. Also, closing costs are not deducted from the sales price before setting the maximum mortgage amount.[7]

Closing costs on a buyer's purchase involving an FHA-insured mortgage include:

- the lender's origination fee;
- appraisal fees;
- credit report charges;
- home inspection fees;
- recording fees;
- survey fees; and
- the cost of title insurance.

The lender's origination fee included as a closing cost is limited to 1% of the mortgage amount, excluding any competitive discount points and the 1.75% upfront MIP.

Either the buyer or seller may pay the buyer's closing costs, called **non-recurring closing costs**. The lender may also advance closing costs on behalf of the buyer.

## Credit approval

**mortgage payment ratio**
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's mortgage payment to 31% of the buyer's gross effective income.

Before the FHA will insure a mortgage, the lender needs to determine if the buyer (and any co-borrowers) is creditworthy.[8]

For a buyer to be creditworthy for an FHA-insured mortgage, the following debt-to-income (DTI) ratios need to be met:

- the buyer's *mortgage payment* may not exceed 31% of their gross effective income, called the **mortgage payment ratio**; and
- the buyer's *total fixed payments* may not exceed 43% of their gross effective income, called the **fixed payment ratio**.[9]

A buyer's income consists of salary and wages. Social security, alimony, child support, and government assistance are factored into the buyer's income to determine *effective income*. The buyer's effective income before any reduction for the payment of taxes is referred to as **gross effective income**.

The maximum *mortgage payment ratio* of 31% of the *gross effective income* determines the maximum amount of **principal, interest, taxes and insurance (PITI)** the buyer is able to pay on the mortgage.

6 HUD Handbook 4000.1 II(A)(2)(a)
7 HUD Handbook 4000.1 II(A)(4)(d)(i)
8 24 CFR §203.512(b)
9 HUD Handbook 4000.1 II(A)(II)(5)(d)(vii)

Lenders use the maximum *fixed payment ratio* of 43% of the gross effective income. Applying this ratio, they determine whether a buyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments the buyer is obligated to pay.

**fixed payment ratio**
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's total fixed payment on all debts to 43% of the buyer's gross income, also called the DTI back end ratio.

When computing the fixed-payment ratio, the lender adds the buyer's total mortgage payment to all the buyer's recurring monthly obligations.

This includes debts extending ten months or more, such as:

- all installment loans;
- alimony payments; and
- child support payments.[10]

However, even if the buyer's ratios exceed FHA requirements, the mortgage may be approved if the buyer:

- makes a large down payment;
- has a good credit history;
- has substantial cash reserves; or
- demonstrates potential for increased earnings due to job training or education.

Taken together, these are referred as to **compensating factors**.[11]

## Liability of the seller on an assumption

When a home is sold with the buyer taking title subject to an existing FHA-insured mortgage under some arrangement to pay for the seller's equity, the seller is released from personal liability, if:

- they request a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer assumes the mortgage; and
- the lender releases the seller from personal liability by use of an FHA-approved form.[12]

If the conditions for release from personal liability are not satisfied, the seller remains liable for any FHA loss on their insurance coverage for five years after the sale.[13]

However, if five years pass from the time the property is resold, the seller is then released from personal liability if:

- the mortgage is not in default by the end of the five-year period;
- the buyer assumes the mortgage with the lender; and
- the seller requests the release of liability from the lender.[14]

10 HUD Handbook 4000.1 II(A)(5)(d)(ix)(D)(1)
11 HUD Handbook 4000.1 II(A)(5)(d)(ix).
12 HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4000.1 III(C)(1)(c)(i), (ii).
13 12 USC §1709(r)
14 24 CFR §203.510(b)

## Energy Efficient Mortgage

Homebuyers and homeowners have a way to finance energy efficient improvements under the FHA's **Energy Efficient Mortgage (EEM)** program.

The goal of the EEM program is to reduce utility charges, allowing applicants to make higher monthly mortgage payments to fund the cost of the energy efficient improvements.

**Energy Efficient Mortgage (EEM)**
A Federal Housing Administration (FHA) mortgage which finances energy-efficient improvements.

Financeable energy efficient improvements funded under FHA's program include:

- purchasing energy efficient appliances or heating and cooling systems;
- installing solar panels;
- installing energy efficient windows;
- installing wall or ceiling insulation; and
- completing repairs of existing systems to improve energy efficiency.

Under the EEM program, the costs of fundable energy improvements are added to the base FHA maximum mortgage amount on a purchase or refinance.[15]

Like most FHA mortgage programs, the EEM is not funded by the FHA. It is funded by a lender, and insured to guarantee repayment by the FHA.

An EEM may be used in connection with either an FHA-insured purchase or refinance mortgage (including streamline refinances), under the:

- "standard" 203(b) program for one-to-four unit residential properties;
- 203(k) rehabilitation program;
- 234(c) program for condominium projects; and
- 203(h) program for mortgages made to victims of presidentially declared disasters.[16]

Eligible property types include new and existing:

- one-to-four unit residential properties for the 203(b) and 203(k) programs;
- one-unit condominiums; and
- manufactured housing.[17]

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15 HUD Handbook 4000.1 II(A)(8)(c)(vi)
16 HUD Handbook 4000.1 II(A)(8)(c)(ii)(A), (B)
17 HUD Handbook 4000.1 II(A)(8)(c)(ii)(A)

## Chapter 36 Summary

The Federal Housing Administration (FHA) insures mortgages originated by approved direct endorsement lenders to qualified buyers to fund the purchase of their principle residence.

FHA-insured mortgages provide for a down payment as low as 3.5% and a higher loan-to-value ratio (LTV) than conventional mortgages. For the privilege of making a small down payment, the buyer pays a mortgage insurance premium (MIP) to the FHA, effectively increasing the annual cost of borrowing as an addition to interest.

If a buyer defaults on an FHA-insured mortgage, the FHA covers the lender against loss on the entire remaining balance of the mortgage. The most commonly used FHA-insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, Section 203(b).

The maximum FHA-insured mortgage amount available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and
- the county in which the property is located.

Further, the FHA limits the amount of a mortgage it will insure based on the loan-to-value (LTV) ratio. The LTV ratio on an FHA-insurable mortgage is capped at 96.5%, corresponding with the minimum 3.5% down payment. To determine the mortgage amount the FHA will insure, the LTV ratio is multiplied by the lesser of the property's:

- sales price; or
- the appraised value of the property

Before the FHA will insure a mortgage, the lender needs to determine the buyer's creditworthiness. For a buyer to be creditworthy for FHA mortgage insurance, the following debt-to-income ratios (DTI) need to be met:

- the buyer's mortgage payment ratio may not exceed 31% of their gross effective income; and
- the buyer's fixed payment ratio for all installment debts may not exceed 43% gross effective income.

When a property subject to an existing FHA-insured mortgage is sold and the buyer takes over the mortgage, the seller is released from personal liability for the mortgage if:

- the seller requests a release;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the mortgage; and
- the lender releases the seller from personal liability.

Homebuyers and homeowners may finance energy efficient improvements under the FHA's Energy Efficient Mortgage (EEM) program. With reduced utility charges, buyers and owners may make higher monthly mortgage payment to fund the cost of the energy efficient property improvements.

## Chapter 36 Key Terms

**Energy Efficient Mortgage (EEM)** .......... **pg. 424**
**Federal Housing Administration (FHA)-insured mortgage** .......... **pg. 418**
**fixed payment ratio** .......... **pg. 423**
**loan-to-value ratio (LTV)** .......... **pg. 421**
**mortgage insurance premium (MIP)** .......... **pg. 419**
**mortgage payment ratio** .......... **pg. 422**

**Quiz 10 Covering Chapters 36-37 is located on page 630.**

# Chapter 37

# Private mortgage insurance

## Learning Objectives

After reading this chapter, you will be able to:

- advise your homebuyers who have a down payment smaller than 20% about the availability of private mortgage insurance (PMI) on consumer mortgages;
- review the qualification and approval process for your buyer to obtain PMI; and
- explain the cost differences between PMI and FHA mortgage insurance premiums (MIP) for a consumer mortgage.

## Key Terms

**lender-paid mortgage insurance (LPMI)**

**private mortgage insurance (PMI)**

## Risk reduction for the mortgage lender

A lender originating a mortgage takes on the risk they might lose on their investment in the mortgage if the buyer defaults. To shift this risk, **private mortgage insurance (PMI)** coverage is taken out to indemnify the mortgage lender in case of a loss.[1]

The lender's recoverable losses under PMI cover include:

- principal on the debt;
- any deficiency in the value of the mortgaged property; and
- foreclosure costs.

1 Calif. Insurance Code §12640.02

**private mortgage insurance (PMI)**
Default mortgage insurance coverage provided to a mortgage holder by private insurers on conventional mortgages with loan-to-value (LTV) ratios higher than 80%.

*PMI* insurers are privately owned, unrelated to government-created insurance agencies which also insure or guarantee mortgages. The government insurance agencies which cover losses on mortgages made to qualified buyers include:

- the Federal Housing Administration (FHA); and
- the U.S. Department of Veterans Affairs (VA). [See Chapters 36]

PMI is not **mortgage life insurance.** Life insurance pays off the insured mortgage in the event a buyer dies, becomes disabled, or loses their health or income.

## PMI coverage

PMI insures the lender for losses incurred up to a percentage of the mortgage amount. In turn, the mortgage amount represents a percentage of the property's value, called the **loan-to-value ratio (LTV)**, which is used to judge risk.

PMI is available in California through two primary insurers:

- *MGIC Investment Corp. (MGIC)*; and
- *Genworth Financial.*

## Who pays for PMI coverage?

The buyer usually pays the PMI premiums, not the lender (although the lender is the insured party and is the holder of the policy).

**lender-paid mortgage insurance (LPMI)**
Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

However, some lenders and PMI insurers offer a **lender-paid mortgage insurance (LPMI)** program. When LPMI is issued by the PMI insurer, the lender pays the mortgage insurance premium and charges the buyer a higher interest rate on their principal payments to pass on the cost of the coverage. When a lender is willing to absorb the risk of loss on high LTV mortgages, they will charge a higher interest rate (the risk premium), and simply retain the increase over a par rate to cover losses PMI covers.

Further, LPMI cannot be cancelled, while buyer-paid PMI may be cancelled or automatically terminated. LPMI only terminates upon a refinance or other total payoff of the mortgage.[2]

*Editor's note — The discussion of PMI in this chapter assumes the traditional buyer-paid PMI, unless otherwise noted.*

## PMI cancellation

Premium rates for PMI coverage are set as a percentage of the mortgage balance. PMI premiums are calculated in the same manner as interest rates on the mortgage balance.

When the owner is current on PMI payments and has not taken out other mortgages on their property, they may terminate their PMI coverage when the equity in their property reaches 20% of its value at the time the mortgage

2 12 United States Code §4905(c)(1)

was originated. Once the equity in the property reaches 22% of the home's value, PMI is automatically cancelled (unless the mortgage is a piggyback 80-10-10).[3]

Premiums charged by PMI insurers do not include an up-front fee on origination like FHA, only an *annual fee* calculated as a percentage of the mortgage balance and payable monthly with principal and interest payments.

## Buyer PMI qualification standards

Depending on the specific guidelines unique to each insurer, the buyer needs to meet PMI qualification standards such as:

- a minimum credit score of upwards of 620;
- a back-end debt-to-income ratio between 41% and 45%;
- two months principal, interest, taxes and insurance (PITI) payments in cash reserves;
- employment full time during the past two years, a current pay stub, written *verification by employer* (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- financial statements when self-employed for the two prior years and year-to-date, plus federal tax returns;
- legal residence in the United States;
- all documents and title vestings to be in the name of the buyer as an individual;
- a limit of two mortgages with PMI coverage in the name of the buyer;
- completion of a homeowners' course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances;
- no short sale within four to seven years; and
- no foreclosure or deed in-lieu within five to seven years.

The PMI investigation and documentation takes place after submission of a mortgage application. Documentation is generally limited to verification of all the buyer's representations on the application.

## PMI's type of property

The availability of PMI coverage for different types of California real estate is limited. Generally, PMI covers:

- single family residences (SFRs);
- two-unit properties;
- co-operatives; and
- manufactured housing.

3 12 USC §4902(b)

Also, SFRs are further categorized as either:

- *detached*; or
- *condos*.

The distinction between types of properties is reflected in the amount of down payment required for PMI.

For a mortgage to qualify for PMI, its terms and conditions need to meet the insurer's criteria, such as:

- a mortgage amount no greater than $417,000;
- 97% LTV for a detached or attached SFR, which may be located within a common interest development (CID); and
- for adjustable interest rate mortgages (ARMs), the rate is fixed for the first three years and the ARM has no possibility of negative amortization.

## Defaulting buyer and PMI recourse

Most PMI contracts do not authorize the insurer to seek **indemnity** from the buyer for claims made on the policy by the lender. This is distinct from FHA insurance programs which place homeowners at a risk of loss beyond the amount of their down payment.

Most insured mortgages are **nonrecourse mortgages** made to buyer-occupants to acquire their principal residence. As a *nonrecourse mortgage*, recovery is limited to the value of the real estate securing the mortgage.[4]

In the case of *fraud* on recourse or nonrecourse mortgages, the PMI insurer is not barred by anti-deficiency statutes from recovering losses. Thus, they may enforce collection of their losses against the buyer for material misrepresentations, such as the property's value or employment status or income of the buyer.

## The PMI credit check

To qualify for PMI, the buyer needs to:

- be a natural person, not a corporation, partnership or limited liability company (LLC); and
- take title as the vested owner of the property.

The lender, when qualifying the buyer for a mortgage to be covered by PMI, applies the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;
- debt-to-income ratio (DTI); and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender funds a mortgage undergoes an in-depth *risk analysis* based on the PMI insurer's eligibility requirements.

4 Calif. Code of Civil Procedure §580b

FHA or PMI?

*The* ***mortgage insurance premium (MIP)*** *offered by the Federal Housing Administration (FHA) insures lenders against losses on a default in mortgages originated with homebuyers who make a down payment of less than 20% (typically 3.5%-5%). [See Chapter 36]*

*Private mortgage insurance (PMI) is the only alternative to mortgage insurance issued by the FHA (and other government programs). PMI insurers require higher down payments and have more stringent credit score requirements than the FHA. However, they have lower, less expensive premium rates.*

*Unlike the FHA, PMI insurers do not usually require the routine recurring monthly/annual ownership expenses incurred by the homebuyer to be included in the impound amount before applying the 31% debt-to-income ratio (DTI).*

*Thus, the total amount of mortgage money available for purchasing a home when using PMI is greater than with an FHA-insured mortgage. This exclusion of ownership expenses raises the purchasing power delivered by a maximum mortgage amount since it is set by the limit for payments at 31% of the buyer's gross income. By applying for PMI coverage, the homebuyer directs a higher proportion of their total monthly payment toward principal and interest, allowing them to borrow more money.*

*Further, PMI companies are required by law to cancel PMI payments at 80% LTV, upon the buyer's request. [12 United States Code §4901(2); 12 USC §4902(a)]*

*The FHA's cancellation policy is significantly more stringent, requiring buyers to pay annual MIPs for:*

- *the lesser of 11 years or the entire mortgage term for loan-to-value ratios (LTVs) less than or equal to 90% on origination; and*
- *the lesser of 30 years or the entire mortgage term for LTVs greater than 90% on origination. [HUD Handbook 4000.1 Appendix A]*

## Supporting documentation submitted by the buyer

At a minimum, the buyer is required to submit documents for review by the PMI insurer, including:

- a copy of the mortgage application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the mortgage transaction fulfills the insurer's underwriting requirements, including:

- verification the buyer will occupy the property;
- verification the land value of the property does not exceed 40% of the total value of the property;
- a copy of the signed purchase agreement;
- verification of funds for closing;
- verification of the buyer's salary, including overtime and second jobs; and
- verification of employment.

The buyer's credit rating and disposable income need to clearly support their ability to make the monthly payments on the low down payment mortgage.

## Chapter 37 Summary

Private mortgage insurance (PMI) indemnifies a lender for loss on a loan secured by an interest in real estate, called a mortgage, when a buyer whose down payment is less than 20% defaults.

The lender's recoverable losses include:

- principal on the debt;
- any deficiency in the value of the mortgaged property; and
- foreclosure costs.

A buyer required to qualify for PMI before a lender funds a mortgage undergoes an in-depth risk analysis based on the PMI insurer's eligibility requirements.

## Chapter 37 Key Terms



**Quiz 10 Covering Chapters 36-37 is located on page 630.**

# Chapter 38

# Usury and the non-exempt lender

## Learning Objectives

After reading this chapter, you will be able to:

- appreciate the origins, evolution and remaining purpose of California usury laws;
- determine which lending arrangements are subject to or exempt from usury restrictions on interest rates;
- identify extensions of credit on property sales as excluded from usury restrictions;
- discern when the usury threshold rate applies; and
- explain the penalties imposed on a non-exempt lender that violates usury law.

## Key Terms

**exempt debts**
**excluded debt**
**non-exempt lender**
**restricted real estate mortgages**
**treble damages**
**usury**

## Broker-made or -arranged mortgages avoids usury

When a consumer or business mortgage is made, the lender charges the borrower **interest** for their use of the money during the period lent.

However, the amount of interest a non-exempt lender may charge is regulated by statute and the California Constitution. Collectively, these are referred to as **usury laws**.[1]

**usury**
A limit on the lender's interest rate yield on non-exempt real estate mortgages.

Today, the remaining goal of *usury laws* is the prevention of **loan-sharking** by lenders. *Loan-sharking* involves charging interest at a higher rate than

1 Calif. Constitution, Article XV; Calif. Civil Code §§1916.1-1916.5

the ceiling-rate established by the usury laws (read: a rate that is exorbitant). These non-exempt mortgages are categorized as *usurious* while the same rate charged by an exempt lender is not.[2]

## Usury exemptions spur competitive rates

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for *all lenders* — no exceptions, exemptions or exclusions.

During the *Great Depression*, California legislation exempted certain types of lenders from usury restrictions. The exemptions were implemented with the intent to open up the mortgage market and get more money into circulation.[3]

These exemptions to usury laws remain in place today and more have been added. For example, in 1979, mortgages **made or arranged** in California by real estate *brokers* were exempted from usury restrictions.

Other types of lenders exempted from usury law restrictions include:

- savings and loan associations (S&Ls);
- state and national banks;
- industrial mortgage companies;
- credit unions;
- pawnbrokers;
- agricultural cooperatives;
- corporate insurance companies; and
- personal property brokers.[4]

Exemptions successfully opened the market by increasing the availability of funds. In time, interest rates were soon driven lower due to increased competition.

## Interest paid with goods and services

When a borrower pays interest on a mortgage, they are paying rent to the lender for use of its money for a period of time. The money lent is fully repaid during the period through monthly mortgage amortization or at the end in a final/balloon payment.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid by the borrower providing the lender with personal property, goods or services. The many types of consideration given by the borrower for the lender making a mortgage become part of the lender's yield on the mortgage—*interest*.[5]

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2 CC §1916.3(b)
3 Cal. Const. Art. XV
4 Cal. Const. Art. XV
5 CC §1916.2

Thus, interest includes the *value of all compensation* a lender receives for lending money, whatever its form, excluding reimbursement or payment for mortgage origination costs incurred and services other than mortgage origination efforts rendered by the lender.[6]

## Compensation for services rendered

It is common for **non-exempt lenders** to attempt to evade the usury law restrictions by including bogus charges or charging fees for making the mortgage.

**non-exempt lender**
A lender subject to usury limitations when making a loan.

A lender might charge the borrower a mortgage fee or discount. However, these charges and receipts are recharacterized as interest when they do not compensate the lender for costs and services incurred in the process of originating the mortgage.

Charges unrelated to mortgage origination costs and services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the mortgage may not exceed the *threshold rate* which triggers application of the usury laws — unless the mortgage transaction is exempt.[7]

For the sake of determining usury, as long as the service performed or the expense incurred was necessary to the origination of the mortgage, the charge does not add to the lender's yield and is not considered interest.[8]

Examples of services and expenses not included in the *interest yield* include:

- appraisal, escrow and recording fees;[9]
- arranging and brokerage fees paid to a third party;[10]
- administrative costs, such as foreclosing on a mortgage in default;[11]
- attorney fees for legal services relating to the mortgage;[12] and
- late charges due on a mortgage default or prepayment penalties.[13]

## Setting the interest rate

If the use of mortgage proceeds is earmarked primarily for *personal, family, or household use* by the borrower and is not secured by real estate, the maximum annual interest rate is 10% per annum.[14]

Mortgages made to fund the *improvement, construction, or purchase* of real estate when originated by a non-exempt lender are subject to a different usury threshold rate, which is the greater of:

- 10% per annum; or

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6 CC §1915
7 **Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609
8 **Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770
9 **Ex Parte Fuller** (1940) 15 C2d 425
10 Ex Parte Fuller, *supra*
11 **Penziner** v. **West American Finance Company** (1937) 10 C2d 160
12 **Murphy** v. **Wilson** (1957) 153 CA2d 132
13 **First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592
14 Calif. Const. Art. XV §1(1)

- the applicable discount rate of the *Federal Reserve Bank of San Francisco (FRBSF),* plus 5%.

In addition, federal **ability-to-repay (ATR)** rules may apply to reduce the interest rate on a purchase-assist mortgage for an occupying homebuyer, since it is classified as a consumer mortgage. [See Chapter 2]

## Usury law and real estate loans

Two basic classifications of loan transactions exist relating to interest rates lenders may charge on real estate mortgages:

- **brokered** real estate mortgages; and
- **restricted** or **non-brokered** real estate mortgages.

*Brokered* real estate mortgages are exempt from usury restrictions and fall into one of two categories:

- mortgages *made* by a licensed real estate broker *acting as a principal* for their own account as the lender who funds the loan; or
- mortgages *arranged* with lenders by a licensed real estate broker acting as an agent in the mortgage transaction for compensation.

Further, if the loan is a consumer mortgage, the broker arranging the mortgage is required to be endorsed as a **mortgage loan originator (MLO)**.

**restricted real estate mortgages**
All mortgages made by private party lenders which are neither made nor arranged by a real estate broker.

**Restricted real estate mortgages** are all loans made by lenders which are neither made nor arranged by a broker.

*Editor's note — Lenders include corporations, limited liability companies, partnerships and individuals. These entities are not exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.*

**exempt debts**
Private party transactions exempt from usury laws involving the origination of a loan secured by real estate and made or arranged by a real estate broker. See non-exempt lender.

The most common *restricted loan* involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

## Exceptions for private parties

Private party transactions involving the creation of a *debt* which avoid usury laws break down into two categories:

- **exempt debts**, being *debts* which involve a loan or a forbearance on a loan and are broker-made or arranged; and
- **excluded debts**, being *debts* which do not involve a loan.

**excluded debt**
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions which avoid usury laws.

The most familiar of the excluded "non-loan" type debts is **seller carryback financing**. [See Chapter 23]

Carryback notes executed by the buyer in favor of the seller are not loans of money. They are *credit sales*, also called **installment sales**. A seller may carry back a note at an interest rate in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not the result of a loan. Thus, carryback notes are not subject to usury laws.

Determining the Federal Discount Rate

*The discount rate set periodically by the Federal Reserve Bank of San Francisco (FRBSF) is the rate the FRBSF charges member banks on the advance of funds lent.*

*The discount rate is reviewed no less than once every fourteen days by the Board of Directors of FRBSF. The discount rate may be changed during the review in response to how the directors view the economic health of the region, nation and world.*

*The maximum interest rate allowable beyond the 10% minimum threshold rate for usury limitations is calculated and set for each month. The usury threshold rate set for a particular month applies to only those mortgage transactions entered into any time during that month, a fixed rate attached to that mortgage for the life of the loan.*

*The FRBSF discount rate used to calculate the usury threshold rate for loans agreed to during a particular month is the FRBSF rate for the 25th day of the previous month.*

*A mortgage transaction falls within a particular month based on the date of the earlier of:*

- ***entering into the agreement to make the mortgage; or***
- ***the funding of the mortgage if no prior agreement has been entered into for the non-exempt lender.***

*For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the mortgage in two weeks, closing in the month of May. The lender is not a party to any prior mortgage agreement. The buyer's mortgage application was received by the mortgage loan broker (MLB) in the prior month of March.*

*The FRBSF discount rate applicable to April is 7%, April being the month the loan escrow instructions (or other loan agreement) were signed – entered into – by all participants.*

*The interest rate agreed to is 12% — the maximum yield permitted without triggering the usury threshold rate controlling non-exempt private lenders who make real estate loans entered into in the month of April (7% plus 5%).*

*However, on April 25th, the FRBSF discount rate is 6%, not the 7% it was on the 25th of March. Thus, the FRBSF rate applicable for the month of May is 6%.*

*Prior to closing in May, the buyer claims the interest rate should fall to 11% to reflect the change, because the 12% agreed to in the mortgage is a usurious yield for mortgages funded during the month.*

*However, 7% was the FRBSF discount rate in effect in April, the month during which the lender first committed to fund the mortgage by signing the loan escrow instructions.*

*Since the commitment to make the mortgage occurred earlier than the funding, the rate for the month in which the lender's commitment occurred controls – even though the mortgage was funded in a following month with a different, lower rate.*

*However, contingent interest, such as increased interest received on an adjustable rate mortgage (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws. [**McConnell** v. M**errill Lynch, Pierce, Fenner & Smith, Inc.** (1978) 21 C3d 365]*

## Penalties for usury

The most common penalty imposed on a non-exempt lender in violation of usury law is the forfeiture of all interest on the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. All payments made by the borrower are applied entirely to principal reduction, with nothing applied to interest.[15]

**treble damages**
A usury penalty computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of an action on a non-exempt private lender mortgage.

The lender may also have to pay a usury penalty of **treble damages**.[16]

*Treble damages* are computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of a suit and during the period of litigation until the judgment is awarded.

An award of treble damages is typically reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower.[17]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

## Usurious loans to a broker/ borrower

Consider an owner of real estate who is a licensed real estate broker who negotiates directly with a non-exempt lender to obtain a mortgage secured by their property.

The interest charged for the mortgage exceeds the usury ceiling. The mortgage is negotiated without the services of another real estate broker arranging the loan.

The lender funds the loan and the borrower is handed the mortgage proceeds on closing.

When the first payment becomes due, the owner tenders payment of an amount equal only to the principal advanced by the lender. The owner claims they owe only the principal borrowed and no interest, since the interest rate is usurious.

The lender claims the transaction is exempt from the usury restrictions since the owner as borrower is a licensed real estate broker.

Is this loan controlled by usury laws if the owner who borrowed the money is a licensed real estate broker?

15 **Bayne** v. **Jolley** (1964) 227 CA2d 630
16 CC §1916.3
17 **White** v. **Seitzman** (1964) 230 CA2d 756

Yes! The private lender's rate of return on the loan is limited by usury laws, unless:

- the lender who **made the loan** is a licensed real estate broker; or
- a real estate broker is paid to **arrange the loan** as an agent of at least one of the parties to the loan.[18]

## Usurious loans to a licensed general partner in a partnership

Now, consider a broker who is a **general partner** in a partnership. The partnership wants to borrow money to improve real estate it owns.

The broker/general partner negotiates with a non-exempt lender for a mortgage which is to be secured by real estate owned by the partnership. No fee is paid to the broker.

The partnership's promissory note and trust deed is executed in favor of the lender by the general partner on behalf of the partnership. The interest rate agreed to exceeds the usury threshold rate. The lender funds the mortgage.

The partnership timely repays the mortgage in full and the lender reconveys the trust deed. The partnership then demands the lender return all interest paid on the loan, claiming the loan was usurious.

Is the partnership entitled to a refund of all the interest paid on the mortgage?

Yes! The general partner is not acting in the capacity of a licensed broker when they negotiate a mortgage on behalf of the partnership. The individual is acting as the partnership's general partner, no fee being paid to the individual as a broker.[19]

*Editor's note — Another California appeals court held in a nearly identical factual situation — tenants in common acting as a group — that the broker acting on behalf of a partnership of which they are a member is considered to be acting for others and thus operating in their licensed capacity.*[20]

*However, the court in this second case did not have a firm grasp on brokerage law or the rule that tenants in common constitute a tenancy in partnership. The analysis in the case is further faulty as its conclusion relies on the erroneous assumption a broker's license is required for a general partner to deal with real estate owned by the partnership.*

*No broker fee was received or was to be paid to any real estate broker for the act of negotiating the mortgage for the group. The general partner received only the benefits they would have received as a partner, whether or not the mortgage was originated. Thus, they did not receive a fee or "arrange" the loan as a broker on behalf of the group as required to qualify it for exemption from usury laws.*

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18 **Winnett** v. **Roberts** (1986) 179 CA3d 909

19 **Green** v. **Future Two** (1986) 179 CA3d 738

20 **Stickel** v. **Harris** (1987) 196 CA3d 575

**Attorneys as brokers**

*Although attorneys are authorized to perform brokerage activities for compensation in the normal course of the practice of law, an attorney's activities in arranging a mortgage are not covered by the broker's usury exemption.*

*For example, a borrower retains an attorney, who is also a licensed real estate broker, to arrange a loan from an unlicensed, non-exempt lender to be secured by real estate owned by the borrower.*

*Between the time the attorney/broker is retained by the borrower and the time the mortgage is arranged, the broker's license held by the attorney expires. The transaction closes before the attorney renews their broker's license. The note is payable in monthly installments of interest only, principal being payable as a balloon payment on the due date.*

*After making several interest payments, the borrower defaults and the lender begins foreclosure.*

*The borrower claims the loan is controlled by usury laws and has a usurious rate of interest since the attorney arranging the loan did not have a valid broker's license on the date the lender committed in writing to fund the mortgage. The lender claims the mortgage is exempt from usury laws since the attorney is authorized to conduct, for compensation, all activities requiring a broker's license without first obtaining a broker's license.*

*Can the borrower avoid the payment of interest on the attorney-negotiated loan?*

*Yes! While attorneys may perform acts requiring a broker's license so long as they are rendered in the course of the practice of law, attorneys arranging loans without also being licensed as brokers do not bring the loan under the broker's exemption to usury laws. Thus, the loan is usurious since the attorney's broker license formally expired and was invalid on the date the loan was agreed to, barring the private lender's collection of interest from the borrower. [**Del Mar** v. **Caspe** (1990) 222 CA3d 1316]*

## Agents and usury

Activities of a licensed real estate sales agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For example, consider an owner who wants to refinance a mortgage secured by real estate they own. The owner contacts a broker and they discuss the terms sought. [See **RPI** Form 202]

The broker prepares a *mortgage package* and submits it to different lenders, but is unable to find a lender willing to fund. The broker then informs an affiliate with whom they share office space about the unfunded loan. The affiliate is a licensed real estate agent who is not registered with the DRE as employed by a broker. The agent locates a lender who funds the loan. The interest rate called for in the note exceeds the usury threshold rate for the loan.

The agent receives a fee paid directly by the owner. The agent does not split the fee with the broker, but they do use a portion of their income to pay **joint office expenses**.

The owner makes all payments due on the mortgage and the lender reconveys. The owner then demands a refund of all interest paid, claiming the rate was usurious since the mortgage was arranged by a licensed sales agent, not a broker.

Is the owner entitled to a refund of the interest?

No! The initial terms for the mortgage were established with the owner by the broker on the loan application. The broker's involvement in packaging the mortgage transaction and shopping the mortgage for placement with a lender is sufficient for it to be considered arranged by a broker.

Although the broker did not receive direct compensation from the owner, they did receive indirect compensation for their involvement since the agent who took a fee contributed to *common office expenses*. Thus, the mortgage is exempt from usury limitations.[21]

## Unemployed agents and usury

Now consider a sales agent who arranges mortgages for an unlicensed, non-exempt lender while employed as an agent of a broker. The agent terminates their affiliation with the broker, but does not inform the lender.

Later, a borrower contacts the now **unemployed agent** seeking a mortgage to be secured by real estate owned by the borrower. The sales agent arranges the mortgage which is funded by the lender the unemployed agent had contact with while previously employed with the broker.

The borrower executes a note and trust deed in favor of the lender containing an interest rate which exceeds usury thresholds. The sales agent is paid a fee for arranging the mortgage. After making several interest-only payments, the borrower defaults and the lender initiates foreclosure.

The borrower claims they owe no interest to the lender, and all interest paid is to be credited to principal, since the mortgage was not arranged by a licensed real estate broker and the rate of interest on the mortgage exceeds the usury threshold rate.

Can the borrower avoid paying any interest on the mortgage since no broker was involved and the real estate sales agent was not working with a broker at any time while arranging the mortgage?

Yes! For a mortgage arranged by a salesperson to be exempt from usury laws, the salesperson must be employed under a broker while arranging the mortgage. Since the salesperson was not employed by or affiliated with a broker at any time when they arranged the mortgage, the mortgage is not exempt from usury laws.[22]

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21 **Jones** v. **Kallman** (1988) 199 CA3d 131

22 **Dierenfield** v. **Stabile** (1988) 198 CA3d 126

## Pay to play

If a borrower plans to obtain financing in the form of a brokered mortgage, they need to be prepared to perform on their mortgage commitments.

Courts rarely invalidate contracts or their provisions which are entered into in *good faith* between competent persons. If the lender charges an outrageously excessive interest rate or commits fraud on the borrower, playing off of a borrower's naivety and qualifying as predatory lending, legal remedies are available to protect the borrower.

## Phase out of usury

More often than not, cases involving claims of usury are the result of a borrower who knowingly takes on debt obligations beyond their capacity to perform. These borrowers simply want to escape from enforcement of their agreements and grasp at any legal foothold within reach.

But courts abhor usury. The defense to payment of an agreed rate of interest sets a chaotic precedent, one where mutually agreed to contract provisions can be reneged by one of the parties on a judicially disfavored technicality.

However, the Regulation Z (Reg Z) *ATR rules* imposed on lenders who make more than five (or over $1,000,000 in) consumer mortgages help to protect the borrower from themselves, as well as from lender abuses, rendering usurious conditions less likely to occur.

Already, usury is being phased out of the law, as evidenced by the growing collection of broad usury exemptions already in place. It is likely to continue to fade in influence, following the logical path it is already on. One day, it is likely all mortgages will be exempt from claims of avoidance of the payment of any interest by the law of usury. However, for the time being, if a borrower signs on the dotted line agreeing to a mortgage arranged by a broker for a fee, the borrower cannot exit from the obligation by claims of usurious interest rates.

## Chapter 38 Summary

The amount of interest a non-exempt lender can charge a borrower is regulated by the California Constitution and statutes, collectively called usury laws. Usury laws were put in place with the goal of preventing lenders from charging interest at a rate higher than the threshold set by law.

Brokered real estate mortgages include mortgages made (read: funded) by a licensed California real estate broker acting as the lender and mortgages arranged by a broker acting as a paid agent in the mortgage transaction. As mortgages made or arranged by a California real estate broker, they are exempt from usury restrictions.

Non-exempt private lenders attempt to evade usury law restrictions on interest by including charges or claiming fees or points for making

the mortgage. Charges or other compensation are permissible so long as they cover a mortgage origination expense or service—otherwise, they are considered receipts by the lender of additional interest.

Mortgages made to fund the improvement, construction, or purchase of real estate are subject to an interest restriction of 10% annually or the current discount rate of the Federal Reserve Bank of San Francisco plus 5%, whichever is greater.

Sales transactions involving the extension of credit by a seller are not a loan and thus are not subject to usury laws, such as seller carryback financing.

Penalties for violating usury law include the forfeiture of all interest on a usurious mortgage. Lenders who are found to have taken grossly unfair advantage can also be penalized with treble damages, computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of a suit and the period of litigation until judgment.

Although attorneys are authorized to perform brokerage activities for compensation in the normal course of the practice of law, an attorney's activities in arranging a mortgage are not covered by the broker's usury exemption unless the attorney is also licensed as a real estate broker.

A broker's involvement in packaging the mortgage transaction and shopping the mortgage for placement with a lender in exchange for a fee is sufficient for it to be considered arranged by a broker. For a mortgage arranged by a salesperson to be exempt from usury laws, the salesperson must be employed under a broker while arranging the mortgage.

## Chapter 38 Key Terms



**Quiz 11 Covering Chapters 38-39 is located on page 631.**

*Notes:*

# Chapter 39

# Usury and the carryback note

## Learning Objectives

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.

## Key Terms

| | |
|---|---|
| **assignment** | **unconscionable advantage** |
| **forbearance** | **usury** |

## 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]

**usury**
A limit on the lender's interest rate yield on non-exempt real estate mortgages.

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.

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 by a mortgage holder to temporarily forego exercise of their rights on a default while the property owner takes steps to bring the mortgage payments current.

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

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 **balloon payment**.

When the due date for a *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 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.

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?

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.

**assignment**
A transfer of rights held under a mortgage or other agreement from one person to another.

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.

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.

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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 *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 ratio (LTV)** and rapidly rising mortgage rates.

On the first issue, is the seller correct that the note is not subject to a claim of usury?

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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 39 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 39 Key Terms



**Quiz 11 Covering Chapters 38-39 is located on page 631.**

Chapter 40

# Anti-deficiency: past, present and future

## Learning Objectives

After reading this chapter, you will be able to:

- understand the history and purpose of California anti-deficiency statutes;
- analyze options mortgage holders and carryback sellers have to recover unpaid debts secured by real estate; and
- identify the protections and defenses buyers have against mortgage holders seeking to recover debt not satisfied through foreclosure.

## Key Terms

**anti-deficiency**

**cramdown**

**deficiency**

**discharge-of-indebtedness income**

**exculpatory clause**

**guarantee agreement**

**letter of credit**

**nonrecourse debt**

**purchase-assist funding**

**put option**

**recourse debt**

**redeem**

**subordination agreement**

## The trade-off: real estate as security

A buyer of real estate encumbers the property with a **mortgage** to secure a debt.

The *mortgage*, in favor of either a lender or a carryback seller, is an agreement to pay the dollar amount owed.

Securing the debt by a mortgage lien on real estate does not abolish the buyer's **personal obligation** under their promise to pay. However, the inclusion of real estate as security places the enforcement of the debt under *mortgage law*, with dramatically different results from commercial law for all involved. If the debt had been unsecured, the buyer's promise to pay is enforced under *commercial law*.

**put option**
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

In accepting a mortgage on real estate as security for the repayment of a debt, a mortgage holder or carryback seller alters their ability to force the borrower to pay on that promise. When held as security, the real estate, not the borrower, becomes the primary source of the mortgage holder's **recovery** in the event the borrower defaults. Under mortgage law, a trade-off occurs for accepting real estate as security for a debt.

To satisfy an unpaid mortgage debt on a default, the mortgage holder is forced to **foreclose**. Thus, the mortgage holder first sells the real estate before attempting any other method of collection, called **exhausting the security**.

A default is the borrower's act of exercising the **put option** contained in the provisions of all mortgages. On default, the mortgage holder is forced to sell the secured property through a foreclosure sale to satisfy the amounts owed.[1]

## Limits to recovery

Mortgage holders are limited in their ability to recover losses incurred when a foreclosed property's value is insufficient to satisfy the mortgage debt. This protected class of mortgage debt is known as a **nonrecourse debt**, also called **antideficiency debt**, which includes:

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

- the *purchase-assist funding* by a mortgage holder of a one-to-four unit residential property to be occupied by the buyer;
- *carryback mortgages* evidencing the installment sale of any type of property; and
- *refinanced* purchase-money mortgages, to the extent the funding is applied to obligations under the replaced purchase money mortgage (including fees and costs associated with the refinance transaction).[2]

*Editor's note — Purchase-money debt does not include purchase-assist loans which fund the purchase of property other than buyer-occupied one-to-four residential units.*

**purchase-assist funding**
The use by a buyer of proceeds from a mortgage to fund a portion of the price paid to acquire real estate.

Occasionally, the **fair market value (FMV)** of the secured real estate is insufficient to satisfy the debt at the time of a foreclosure sale. Yet the buyer, as the borrower on the mortgage, is still *personally responsible* for the deficiency remaining.

However, getting a court judgment to collect money losses from a deficiency in the secured property's value to fully satisfy the debt requires the debt to be **recourse** in nature and the foreclosure to be processed judicially. [See Chapter 43]

Thus, the mortgage holder needs to have structured the transaction and the foreclosure sale to deprive the buyer of an anti-deficiency defense.

1 Calif. Code of Civil Procedure §726
2 CCP 580b

Until the 1930s, the signer of a mortgage evidencing any type of debt secured by any type of real estate remained *personally liable* for any deficiency in value remaining after any type foreclosure sale. Thus, the signer was subject to an award of a *money judgment* after either a judicial or nonjudicial (trustee's) foreclosure sale on the property.

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

For example, consider a lender in 1929 who holds a mortgage evidencing a loan secured by a mortgage lien on the owner's principal residence.

The owner defaults on the mortgage. The mortgage holder forecloses through a trustee's sale and recovers the property at a price below its FMV by bidding less than the dollar amount of the secured debt, called an **underbid**.

Prior to the mid-1930s, the mortgage holder was able to obtain an award of money losses for the difference between the amount of the *underbid* and the amount due on the mortgage, regardless of the value of the property the mortgage holder held as security.

After the payment of the money judgment, the owner was not entitled to recover the property. Foreclosure by a trustee's sale barred any later *redemption* or *recovery* of the real estate by the wiped-out owner and was not a defense in court to avoid a money judgment.

Thus, in addition to losing the secured real estate, the owner also remained burdened with the responsibility of paying off the balance of a debt they incurred to buy property they no longer owned.

This disconnect came to an end in California in the late-1930s.

## Recovery of deficiencies eliminated as against public policy

In the 1920s, the economy was booming. Real estate values were high and rising, and real estate prices and public confidence in the future were even higher. It was like the giddy **Millennium Boom** era of the mid-2000s, but with the added post-WWI fervor.

However, the 1930s ushered in an economic depression which, due in part to the abrasive foreclosure practices of mortgage holders and carryback sellers (as well as a penurious Federal Reserve), decimated values in the real estate market.

Outsized real estate values plunged along with the solvency of banks and the health of the general economy. Foreclosure sales were rampant and the loss of homeownership escalated out of control.

With the additional burden of personal liability of owners for their property's deficient value, the chances of financial recovery for most owners who lost property through a trustee's foreclosure were slim. The easiest way to escape a **deficiency judgment** was to move to another state.

The drastic increase in foreclosures and the resulting money judgments and displacement of owners was a further drag on the region's economy.

**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.

To curb those negative impacts, the California legislature enacted **anti-deficiency laws** which:

- limited the amount recoverable in a money judgment for mortgage debts to the difference between the amount due on the mortgage and a court-established FMV of the secured property at the time of a judicial foreclosure sale;[3]
- prohibited deficiency judgments on either type of foreclosure by limiting recovery to the value of the secured property when:
    - the mortgage funded the purchase and was secured by a one-to-four unit residential property occupied by the buyer, including refinanced purchase-money mortgages to the extent the funding is applied to payoff obligations under the purchase money mortgage; or
    - the mortgage evidenced the installment sale of any type of real estate and the property sold was the sole security for the debt;[4] and
- barred a deficiency judgment for any mortgage holder on completion of a **trustee's sale**.[5]

## The risk of drop in market value

Anti-deficiency laws shift the **risk of loss** on a mortgage signed by the owner in favor of a *purchase-money* lender or carryback seller. The *risk of loss* shifts from the owner to the mortgage holder when the value of the secured real estate becomes inadequate to fully satisfy the debt, a condition called **negative equity**.

The value of the real estate securing a *purchase-money debt* may become deficient to cover the mortgage debt when real estate values fall due to a local or general economic downturn.

Here, anti-deficiency laws ensure an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales. Thus, as a matter of public policy to avoid exacerbating a recession and stalling a recovery, buyers of any type of real estate on an installment sale are not held personally liable for those debts in the event of default.[6]

Consider a homebuyer who obtains a 30-year purchase-assist mortgage to fund their purchase of a one-to-four unit residential property to be occupied as their **principal residence**.

Later, changes in the local economy cause the property's FMV to drop below the mortgage balance. The buyer defaults and the mortgage holder acquires title to the *negative equity* property at a foreclosure sale.

Is the mortgage holder who funded the purchase-assist mortgage secured by the buyer-occupied one-to-four unit residential property able to enforce collection of the remaining unpaid mortgage balance?

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3 CCP §580a
4 CCP §580b
5 CCP §580d
6 **Roseleaf Corporation** v. **Chierighino** (1963) 59 C2d 35

No! The mortgage holder is barred from obtaining a deficiency judgment in any amount regardless of the type of foreclosure. The purchase-assist mortgage is classified as *nonrecourse* since it funded the purchase of the property and was secured by a one-to-four unit residence occupied by the buyer.[7]

## Overinflated prices for profit, and a carryback risk

Consider a seller of real estate who locates a buyer willing to pay an inflated price for the property. To help finance the buyer's purchase, the seller carries back a portion of the sales price in an *installment sale* as a mortgage secured solely by the property sold.

Realizing the property is **over-encumbered,** the buyer later defaults on the carryback mortgage. The seller forecloses and the property is sold at a foreclosure sale for less than the amount owed on the mortgage. The seller seeks to recover their loss on the mortgage due to the property's deficient value.

Here, *anti-deficiency laws* bar the carryback seller from enforcing collection of any deficiency at the time of the foreclosure sale, regardless of the foreclosure method employed. The property sold was the sole security for the mortgage, evidenced by an installment sale.[8]

Thus, the carryback seller whose property's sales price is inflated, or whose property declines in value after it is sold, will not benefit beyond the price received at the foreclosure sale.

## Deficiency and other security

Now consider a seller who carries back two separate mortgage amounts on the sale of a single parcel of real estate after the buyer makes a 5% down payment, sometimes called **piggyback financing**. Two notes evidence separate amounts due the seller, totaling 95% of the property's total sales price.

One note is in an amount equal to an 80% **loan-to-value (LTV)** ratio and is secured by the property sold. The other note for 15% of the sales price is secured by other property owned by the buyer. A default on one note does not constitute a default on the other. [See **RPI** Form 154 §4]

The buyer defaults on both notes.

The seller completes a trustee's foreclosure sale under the carryback mortgage for the debt encumbering the property sold to the buyer. A judicial foreclosure is later initiated against the buyer's other property under the separate mortgage in an effort to recover what will be a deficiency in the other property's value to fully satisfy the debt at the time of the judicial foreclose sale.

7 CCP §580b

8 CCP §580b

Shift in risk of loss

*When a buyer uses anti-deficiency rules to defend against liability for the unpaid balance on a purchase-money mortgage, the risk of loss shifts from the buyer to the lender or carryback seller holding that mortgage.*

*In the event the value of real estate securing a purchase-money mortgage falls, the mortgage holder's potential for loss increases. On a default, mortgage holders often minimize their loss through pre-foreclosure workouts. Mortgage holders often accept the net proceeds from the owner's sale of the secured property in exchange for cancelling the unpaid mortgage balance, called a* ***short payoff*** *or* ***short sale****.*

*By accepting a short payoff, the lender or carryback seller avoids the costs of both:*

- *foreclosure; and*
- *its REO acquisition of the property by foreclosure.*

*Anti-deficiency laws protect buyers and prompt mortgage holders to minimize their potential losses, balancing the risk of losses during times of economic reversal.*

*Taxwise, a buyer who participates in a short payoff on a nonrecourse mortgage incurs no reportable* ***discharge-of-indebtedness income*** *when the original purchase price of the secured property is greater than the principal remaining on the debt prior to the payoff. [****Commissioner of Internal Revenue*** *v.* ***Tufts*** *(1983) 461 US 300]*

**discharge-of-indebtedness income**
Reportable income resulting from a mortgage holder's discount on a payoff of a mortgage debt. Called a short pay.

The buyer claims the judicial foreclosure on the other property violates anti-deficiency law since the second foreclosure is an attempt to recover a deficiency on the price the buyer paid for the first property the seller recovered through a trustee's sale.

Is the seller able to foreclose on the buyer's other property under the separate mortgage and obtain a money judgment for any deficiency?

Yes! The foreclosure on the other property does not violate anti-deficiency law. A carryback debt secured by property other than the property sold is not subject to anti-deficiency law.[9]

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

In this example, the buyer, when negotiating to secure the carryback mortgage with a lien on other property in addition to the property purchased, needs to be advised by their agent to negotiate the inclusion of an **exculpatory clause** in the mortgage note. An *exculpatory clause* converts **recourse debt** into nonrecourse debt by eliminating personal liability for any deficiency in the value of the secured property. [See Chapter 5; see Form 418-5 §2.2 accompanying this chapter]

## Anti-deficiency waiver barred

Consider a seller of unencumbered property who carries back two mortgages evidencing separate portions of the sales price remaining to be paid. The mortgages are separately secured by first and second trust deeds on the real estate sold, an 80-10-10 piggyback financing arrangement.

9 **Hodges** v. **Mark** (1996) 49 CA4th 651

Later, the buyer arranges for a lender to refinance the balance due on the carryback seller's first mortgage.

However, as a condition for recording the refinancing, the seller is required to **subordinate** their second mortgage to the lender's new mortgage. Thus, the refinancing will have priority as a first mortgage lien on the property.

The carryback seller agrees to reconvey the first mortgage and subordinate the second mortgage to the refinancing, if the buyer:

- **personally guarantees** the seller's second mortgage; and
- signs a **written waiver** of any anti-deficiency protection against payment of the second mortgage.

The buyer agrees and enters into a **guarantee agreement** and a modification of the second mortgage. The seller enters into a **subordination agreement** allowing their original second mortgage to remain junior in priority to the new mortgage. The lender's trust deed and the subordination agreement are recorded on closing the mortgage escrow.

The buyer defaults. The first mortgage holder forecloses on the property, wiping out the carryback seller's second mortgage. The carryback seller seeks to recover the balance due on the second mortgage, since the foreclosure on the first mortgage exhausted their security interest in the property.

Continuing our previous example, the carryback seller claims they are entitled to a deficiency judgment from the buyer since the buyer personally guaranteed the debt and waived their anti-deficiency protection in consideration for the seller subordinating their interest to new financing.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are *unenforceable* attempts by the seller to circumvent anti-deficiency law on the carryback debt.

Is the carryback seller able to enforce collection on the mortgage or the personal guarantee for the balance due on the mortgage?

No! The buyer is not liable on the mortgage or their guarantee. The seller's carryback debt remained secured by a mortgage on the property sold, with no additional property involved as security, and thus subject to the buyer's anti-deficiency defenses. Any agreement which purports to waive the buyer's anti-deficiency protection without a substitution of property as security is unenforceable as against **public policy**.[10]

As for the *guarantee agreement*, only a third party (not the person who signs the mortgage) can become personally liable for amounts due on another's debt. [See Form 439 in Chapter 12]

**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]

**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]

**Only a third party guarantor is personally liable**

**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]

10 **Palm** v. **Schilling** (1988) 199 CA3d 63

Now consider a seller who carries back a second mortgage on property they sell. Later, during a real estate recession, the buyer of the property defaults and is unable to sell the property or borrow funds to pay off the mortgage. The seller commences foreclosure by recording a **notice of default (NOD)**.

Prior to the trustee's sale, the buyer and seller modify the terms of the mortgage. A provision is included stating the buyer waives their anti-deficiency protection in exchange for cancellation of the *NOD*.

The first mortgage holder forecloses, wiping out the seller's second mortgage. The carryback seller seeks to recover the amount owed on their mortgage since the first mortgage lienholder's foreclosure exhausted their security interest under the second mortgage lien.

The buyer claims the carryback seller is barred from any recovery on the mortgage since enforcement of debt created in an installment sale of real estate is subject to anti-deficiency protection, which, as a matter of public policy, cannot be waived.

The seller claims the buyer waived their anti-deficiency protection in a written agreement which modified the mortgage in exchange for the seller's cancellation of the NOD.

Is the seller able to recover on the carryback mortgage based on the modification and waiver agreement?

No! Recovery on the modified mortgage, which evidences a carryback debt secured at all times only by the property sold, is barred by anti-deficiency rules. Even though the buyer waived their anti-deficiency protection, any waiver of that protection while the carryback debt remains secured solely by the property sold is unenforceable as against public policy.[11]

## Deficiency judgment and one year redemption

The public policy objective behind anti-deficiency legislation is to protect property owners and dissipate the "debtor's prison" effect on these owners.[12]

A mortgage holder holding a *recourse mortgage* is able to foreclose judicially and obtain a deficiency judgment if the FMV of the secured property at the time of the judicial foreclosure sale has fallen below the amount of the debt.

However, when a deficiency judgment is awarded to the mortgage holder, the property owner has the **right to redeem** the property within one year after the judicial foreclosure sale by paying the amount of the successful bid (plus interest).

**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.

If the money judgment remains unsatisfied, it is a separate debt. The judgment is unconnected to the *right to redeem* the property for the price bid at the foreclosure sale, even when the mortgage holder is both the successful bidder and judgment creditor.[13] [See Chapter 43]

11 **DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659; CCP §580d
12 Palm, *supra*
13 CCP §729.030

Form 418-5

Note Enforcement Provisions

**NOTE ENFORCEMENT 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 a guarantee, exculpatory or governing law provision 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,

1.4 and 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 **Guarantee provision**

☐ The Note is guaranteed by ____________________________________, under a Guarantee Agreement dated _____________, 20_____, at ________________________________, California. [See **RPI** 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.

| | |
|---|---|
| Payor's name: ______________________________ | Payor's name: ______________________________ |
| Signature: ______________________________ | Signature: ______________________________ |
| Payor's name: ______________________________ | Payor's name: ______________________________ |
| Signature: ______________________________ | Signature: ______________________________ |

**FORM 418-5** 03-11 

As in most litigation, a **judicial foreclosure** is costly to the mortgage holder both in time and money. Also, the mortgage holder who acquires the property at the foreclosure sale faces the risk of a further decline in the property's value during the one-year redemption period after the foreclosure sale, as well as the risk of being unable to recover a money award.

In contrast, a mortgage holder of either a recourse or nonrecourse mortgage is able to foreclose quickly and inexpensively through the trustee's sale procedure. On completion of the trustee's sale, the owner's right of redemption is terminated. [See Chapter 44]

To counterbalance the recourse mortgage holder's right to a swift foreclosure through a trustee's sale, the recourse mortgage holder is barred from obtaining a deficiency judgment after foreclosing non-judicially by a trustee's sale. A buyer has no right to redeem the property after a trustee's sale, but is protected from a money judgment in favor of the mortgage holder for any deficient value.[14]

14 CCP §580d

## The reemergence of anti-deficiency law

When faced with an economic downturn, mortgaged property owners need the protection of anti-deficiency laws to shield them from mortgage holders if they are to continue live in California and contribute to the state's economy. This was the exact economic scenario during the **2008 Great Recession**, the echo of which we are still coping presently.

**cramdown**
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

But signs of erosion are seen in the long-standing public policy behind the anti-deficiency defense. The California legislature passed laws to the benefit of mortgage holders in 1994, and **cramdown** authority on single family residences (SFRs) was removed by federal bankruptcy reform in 2005.[15]

Lenders are very good at lending too much money when profits remain **privatized** and then later lobbying governments to cover their errors in judgment by **socializing** their losses.

**letter of credit**
A commitment made by a bank to a mortgage holder assuring payment of a stated amount on presentation to the bank, used by mortgage holders as a supplemental security device to avoid anti-deficiency laws.

As a result, mortgage holders are able to circumvent California's anti-deficiency protections by requiring buyers to provide a **letter of credit** as a condition for financing (with the exception of purchase-money financing for buyer-occupied one-to-four unit residential property). The buyer is ultimately liable for repayment of any amounts the mortgage holder or carryback sellers draws on the *letter of credit*.[16]

Following the 1994 legislation, mortgage holders are no longer barred from drawing on letters of credit either before or after completing a trustee's sale to recover any deficiency in property value to fully pay off the mortgage balance. This procedure is quicker than the alternative of judicial foreclosure, appraisals, money judgment awards and redemption periods in pursuit of collection.

## The letter of credit is not a guarantee

Additionally, the letter of credit has been legislatively re-classified. It is no longer legally considered a **guarantee** or additional security, although enforcing a letter of credit has the same economic function as the enforcement of a guarantee or pursuit of the additional security.

The issuer of a letter of credit (usually a lender) does not receive the same protection as a guarantor signing a guarantee. A guarantor is entitled to a **notice of foreclosure** and an opportunity to purchase the guaranteed mortgage before the completion of a foreclosure on the property, unless the guarantor waives this right to a notice in writing or fail to record a request for notice of NOD. [See Form 439 in Chapter 12]

Further, unlike additional security, a mortgage holder is able to draw on a letter of credit before completing a judicial foreclosure. This does not then bar the foreclosure for having enforced collection without first foreclosing on the secured property, which is known as the **one-action rule**.

Currently protected from the letter of credit device are:

- homebuyers;

15 CCP §580b; Calif. Commercial Code §5114; Pub.L. 109-8 (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005)
16 CCP §§580.5; 580.7

- owner-occupants of one-to-four unit residential properties; and
- buyers who refuse to provide a letter of credit on which the mortgage holder is able to draw at any time.

A letter of credit is now legally considered a **source of payment**, not a form of security. It may be used by a mortgage holder at any time.

Thus, a buyer defaulting on any debt secured by real estate and accompanied by a letter of credit (excluding an owner-occupied, one-to- four unit residence) has lost the much-needed protection that anti-deficiency law provides against reckless lending, boom-time mentality and dramatic declines in the real estate economy.

## Chapter 40 Summary

Securing a debt by a mortgage on real estate places the enforcement of the debt under mortgage law. When held as security, the real estate, not the borrower, becomes the primary source of the mortgage holder's recovery in the event the borrower defaults.

Thus, to satisfy an unpaid debt on a default, the holder of a mortgage secured by real estate is forced to first foreclose, selling the real estate before attempting any other method of collection.

Mortgage holders are further limited in their ability to recover losses incurred when a foreclosed property's value is insufficient to satisfy the underlying debt. This protected class of debt is called purchase-money debt and includes carryback mortgages on any type of property sold, the purchase-assist funding of a one-to-four unit residential property occupied by the buyer and the refinance of a purchase-money debt for the purchase of an owner-occupied, one-to-four unit residential property.

The value of the real estate securing a purchase-money mortgage may become deficient as real estate values fall due to a local or general economic downturn. Anti-deficiency laws ensure an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales.

A carryback debt secured by a property other than the property sold is not subject to anti-deficiency law. When negotiating to secure the carryback mortgage with a note on other property in addition to the property purchased, a buyer is advised to arrange for the inclusion of an exculpatory clause in the mortgage to eliminate personal liability for any deficiency.

Any guarantee or agreement under which the buyer purports to waive anti-deficiency protection without a substitution of property as security is unenforceable as against public policy.

Mortgage holders are able to circumvent California's anti-deficiency protections by (other than on buyer-occupied one-to-four residential units) requiring buyers to provide a letter of credit as a condition for financing in which the buyer is personally liable for repayment of any amounts the lender or carryback sellers draws on the letter of credit. A letter of credit is not a guarantee or additional security, although enforcing a letter of credit has the same economic function.

## Chapter 40 Key Terms



**Quiz 12 Covering Chapters 40-42 is located on page 632.**


# Chapter 41

# 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 debt**
**reconveyance**
**recourse debt**
**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 lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

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 28]

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 debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

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]

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 debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

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 accompanying this chapter]

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]

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]

**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.

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 Form 472 in Chapter 12]

## 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

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]<br>Date: _____________________, 20______ | ☐ See attached Signature Page Addendum. [**RPI** Form 251]<br>Date: _____________________, 20______ |
| Buyer/Trustor: ________________________________ | Seller/Beneficiary: ________________________________ |
| Buyer/Trustor: ________________________________ | Seller/Beneficiary: ________________________________ |

**FORM 281** 03-11 

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]

10 **Freedland** v. **Greco** (1955) 45 C2d 462

## 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]

11 CCP §580b
12 CCP §726(a)

## Chapter 41 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 41 Key Terms



**Quiz 12 Covering Chapters 40-42 is located on page 632.**

*Notes:*


Chapter 42

# Reinstatement and redemption periods during foreclosure

## Learning Objectives

After reading this chapter, you will be able to:

- identify the boilerplate acceleration and power-of-sale provisions in trust deeds;
- understand how a property owner or junior lienholder terminates foreclosure proceedings by reinstating or redeeming a mortgage;
- distinguish the timeframes an owner has to cure a default and reinstate a mortgage from periods for trustee's notices, postings and advertising periods;
- advise a client on their financial options when faced with a mortgage foreclosure; and
- recognize defaults curable only by redemption.

## Key Terms

| | |
|---|---|
| **acceleration** | **recourse debt** |
| **future advances clause** | **redemption** |
| **nonrecourse debt** | **reinstatement** |
| **power-of-sale provision** | |

## Nullifying the call

Trust deeds contain a boilerplate provision authorizing mortgage holders to call all amounts remaining unpaid due and payable on a material default of the mortgage, called an **acceleration clause**. In tandem, the trust deed **power-of-sale provision** authorizes the trustee to initiate a non-judicial foreclosure sale of the property on the mortgage holder's declaration of default and instructions to foreclose.

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

**power-of-sale provision**
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

To exercise the *power-of-sale provision* and initiate the trustee's foreclosure procedures, the trustee records a *notice of default* (NOD) when so instructed by the mortgage holder. As triggered by the *acceleration clause* when an NOD is recorded, all sums remaining to be paid on the mortgage debt become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights to cure the default.

Consider a homeowner who defaults on a mortgage encumbering their property, which includes any default on the note or trust deed. To enforce collection of all sums owed, the mortgage holder hands instructions to the trustee authorizing the trustee to record an NOD to commence foreclosure proceedings.

An equity purchase (EP) investor's agent, aware of the NOD, submits an EP agreement offer to the homeowner. The homeowner accepts. The terms include the transfer of ownership to the EP investor, taking title subject to the existing mortgage debt now in foreclosure. The homeowner is to pay all delinquencies and foreclosure charges through escrow on closing using funds received on the price paid by the EP investor.

Escrow is opened after the five-day right to cancel the EP transaction has ended. Escrow sends a request for a *beneficiary statement* to the holder of the mortgage, called the **beneficiary**. The mortgage holder responds to escrow's request for a beneficiary statement by sending a **payoff demand**, not a beneficiary statement. The mortgage holder claims they are enforcing the acceleration clause in the trust deed and will only accept payment in full now that the trustee has recorded an NOD.

## Itemization of delinquencies and charges

The NOD itemizes the amount of all delinquencies and related charges separately from the balance due. Thus, escrow is able to determine the amount due to cure the default. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are established.

On escrow's call for funds, the EP investor deposits closing funds with escrow. Escrow is closed, title is conveyed to the EP investor and the delinquencies and foreclosure costs sufficient to reinstate the mortgage debt are forwarded to the trustee, payable to the mortgage holder from funds accruing to the homeowner on closing.

**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.

The mortgage holder rejects the sales proceeds, claiming the entire amount of their note is due as agreed in the trust deed provisions. Further, the mortgage holder now claims the **due-on clause** in the trust deed has been triggered by the buyer's failure to obtain the mortgage holder's consent to the sales transaction. Thus, the mortgage holder now further justifies a full payoff of the note based on a violation of the due-on clause.

Does escrow, on tendering only the amount of the delinquencies and foreclosure costs necessary to cure the default noted in the NOD, cause the mortgage debt to be reinstated as though a default had never occurred?

Yes! After an NOD is recorded and prior to five business days before the trustee's sale, the owner is able to terminate the foreclosure proceedings by paying:

- the *delinquent amounts* due on the mortgage debt as described in the NOD and foreclosure charges incurred by the trustee, called **reinstatement**;[1] or
- the *entire amount* due on the mortgage debt, plus foreclosure charges, called **redemption**.[2]

**redemption**
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

In this instance, the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the EP investor took place after the recording of the NOD. The default in payment due on the call under the due-on clause is not stated as a default in the NOD. Thus, the due-on call cannot be enforced under this NOD. Here, the mortgage holder needs to call the mortgage due when they do not intend to accept further monthly payments from the new owner, and if not paid in full, proceed anew to foreclose under a later recorded NOD.

## Monetary defaults and reinstatement

A mortgage on which the trustee has recorded an NOD initiating foreclosure is *reinstated* when the mortgage holder receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes and insurance (collectively known as PITI), assessments and advances;
- installments that become due and remain unpaid after the recording of the NOD;
- any future advances made by the mortgage holder after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums and to eliminate any other impairment of the security; and
- costs and expenses incurred by the mortgage holder to enforce the trust deed, including statutorily limited trustees fee's (or attorney fees).[3]

## After the NOD is recorded

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the **reinstatement period**. When the sale is postponed, the *reinstatement period* is extended, ending the day before the fifth business day prior to the postponed sale date.[4] [See Figure 1]

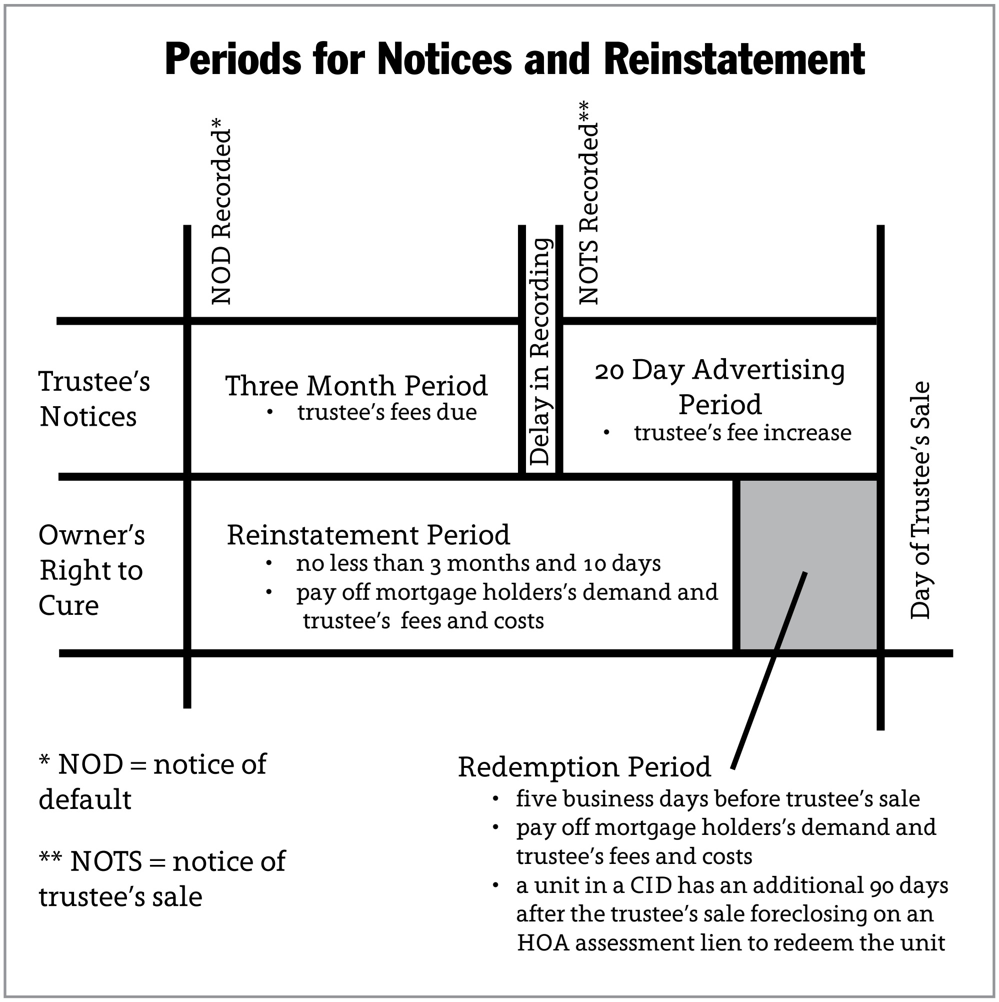
Until the trustee records an NOD, the mortgage holder is compelled to accept the tender of all delinquent amounts.

After recording the NOD, the trustee allows three months to pass before advertising and posting notice of the date of the trustee's sale.[5] [See Figure 1]

1 Calif. Civil Code §2924c
2 CC §2903
3 CC §2924c(a)(1)
4 CC §2924c(e)
5 CC §2924

Figure 1

Periods for Notice and Reinstatement




The trustee needs to begin advertising and post a **notice of trustee's sale (NOTS)** at least 20 days before the date of the sale. The trustee may sell the property no sooner than the twenty-first day after advertising begins and the posting of notice occurs.[6] [See Figure 1]

Additionally, when the billing address for the owner is different than the address of the *residential property* in foreclosure, a notice to the occupants needs to accompany the NOTS regarding their tenant rights during and after foreclosure.[7] [See **RPI** Form 573]

The owner in foreclosure is no longer allowed to delay the trustee's sale by requesting a postponement.[8]

Thus, the owner or junior lienholder has approximately 103 to 105 days after recording the NOD to cure the default and reinstate the mortgage debt. Doing so avoids a full payoff or foreclosure of the property.

6 CC §2924f(b)
7 CC §2924.8
8 CC §2924g

## Reinstatement of the mortgage debt

To determine the last day for reinstatement of the mortgage debt, consider a trustee's sale scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (when no holidays exist).

Thus, the very last day to reinstate the mortgage is on Thursday, the day before the five business days and, in this example, eight calendar days before the trustee's sale.

The mortgage holder's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the mortgage holder may enforce payment of any omitted defaults by recording another, separate NOD.[9]

On reinstatement of the mortgage debt, the trustee rescinds the NOD, removing the recorded default from title to the property.[10]

Any call due to a default is eliminated when the mortgage debt is reinstated. Upon reinstatement, the owner continues their ownership of the property as though the mortgage had never been in default.

## Redemption

An owner's failure to cure a default before the reinstatement period expires allows the mortgage holder to require the owner — who intends to retain ownership of the property — to *redeem* the property prior to completion of the trustee's sale by:

- paying all sums due on the mortgage debt; and
- reimbursing the costs of foreclosure.

The owner's right of redemption runs until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property (such as a tenant with a leasehold estate) may satisfy the debt and redeem the property prior to the completion of the trustee's sale.[11]

To redeem the property, the owner or junior lienholder is required to pay:

- the principal and all interest charges accrued on the principal;
- permissible penalties;
- foreclosure costs; and
- any future advances made by the foreclosing mortgage holder to protect its security interest in the property.

Unless all unpaid amounts due on the mortgage debt are paid in full during the redemption period, the owner loses ownership of the property at the trustee's foreclosure sale.

9 CC §2924
10 CC §2924c(a)(2)
11 CC §2903

## The owner's alternatives

*Aside from reinstatement and redemption, an owner of property has several other options when faced with losing their property through foreclosure. These options include:*

1. ***Refinance*** *— The owner obtains a new mortgage to pay off the one in default.*
2. ***Foreclosure consultant*** *— The owner seeks the services of a financial advisor or investment counselor, called a foreclosure consultant. For a fee, a foreclosure consultant will:*
   - *prevent a mortgage holder from enforcing or accelerating the note;*
   - *help the owner reinstate the mortgage or receive an extension of the reinstatement period; or*
   - *arrange a mortgage or an advance of funds for the owner. [Calif. Civil Code §2945.1(a)]*

   *However, a property owner grappling with foreclosure may obtain similar services at no cost from a mortgage counselor subsidized by the federal government.*
3. ***Deed-in-lieu*** *— The owner deeds the property directly to the mortgage holder in exchange for cancelling the secured debt.*
4. ***Litigate*** *— The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.*
5. ***Bankruptcy*** *— The owner files a petition in bankruptcy for protection. The petition automatically stays the foreclosure until the court orders a release of the stay on request from the mortgage holder. [11 United States Code §362(a)]*

   *Unless the owner can make up the default or have the mortgage amount "crammed down" as part of any reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]*
6. ***Sale*** *— The owner sells the property to a buyer before the trustee's sale. A recorded NOD states the owner has the right to sell their property while in foreclosure. [CC §2924c(b)]*

   *In an effort to protect homeowners from being unlawfully deprived of the equity in their residence, special requirements exist for purchase agreements between owners and* ***equity purchase investors*** *on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq.]*

   *However, selling property in foreclosure is difficult for an owner. Time constraints imposed by reinstatement and redemption periods and the difficulty of locating a buyer-occupant or investor able to meet the financing needs to assume or pay off existing mortgages, cure defaults and correct the deferred maintenance on the property exacerbate any sales effort.*
7. ***Walk away*** *— The owner on a default decides to vacate the property when the mortgage holder completes foreclosure, known as a strategic default.*

   *A strategic default is an economically viable alternative for an owner with little or no equity remaining in the property. The strategy is particularly useful when payments saved during continued occupancy (nine months on average from default) exceed the value of the equity in the property, and specifically when the mortgage balance exceeds the property's value.*

## Mortgage holder remedies on a default

An owner's default on a mortgage encumbering their property may arise under a provision in either the note or trust deed.

A default on the note triggers a default on the trust deed, permitting foreclosure on the secured property. For example, when the owner fails to pay installments as they become due under the terms of the note, the owner is in default on the note. In turn, a default exists on the trust deed.

The owner's default prompts the mortgage holder to instruct the trustee to record an NOD. The recording of the NOD acts as an automatic call of all amounts due under the *acceleration clause* in the trust deed.

Additionally, when the owner fails to meet their obligations regarding the care, use and maintenance of the secured real estate, the owner is in default under the **waste provision** in the trust deed. The default on the trust deed exists even though the owner may be current on all payments called for in the note.

Other activities are considered a default on the trust deed, such as the owner's failure to pay:

- property taxes;
- hazard insurance premiums;
- assessments with priority; and
- amounts due on senior mortgages.

A mortgage holder may advance funds to cure a default on the trust deed or preserve the value of the property. The amount of the advance is added to the mortgage debt owed by authority of the trust deed's **future advances** provision. The mortgage holder may then demand the immediate repayment of the advance from the owner.

**future advances clause**
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste. [See **RPI** Form 450 §2.5]

## Anti-deficiency protections in California

All mortgage debt is categorized as either:

- *nonrecourse*; or
- *recourse*.

**Nonrecourse debt** is one of two types of mortgage debt:

- *purchase-money debt* of any priority (first, second or even third mortgages), which funds the purchase or construction of a homebuyer's one-to-four unit owner-occupied residence; or
- *seller-financed debt,* also called *installment* or *carryback paper,* on the sale of any type of real estate when the debt is secured solely by the property sold.[12]

**nonrecourse debt**
A debt recoverable on default solely through the value of the security interest in the secured property.

A mortgage holder of a *nonrecourse debt* may not pursue the homeowner personally to collect for a deficiency in the value of the secured property to fully pay off the nonrecourse debt following any type of foreclosure, judicial or nonjudicial.

12 Calif. Code of Civil Procedure §580b

However, the mortgage holder who underbids at the trustee's sale may pursue an owner for nonrecourse mortgage debt losses caused by the owner's **bad-faith waste** of the property, defined as reckless or malicious injury to the property, reducing its value.[13]

Additionally, while the mortgage holder may not pursue a homeowner for a deficiency in the value of the property to satisfy purchase-money paper, the *Federal Housing Administration (FHA)* or *U.S. Department of Veterans Affairs (VA)* have recourse against the homebuyer who signed an FHA or VA guarantee agreement. Practically speaking, the FHA and the VA rarely pursue collection on their indemnity rights; however they have the legal right to do so.[14]

## Recourse mortgage debt collection

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

**Recourse debt** is any mortgage debt not classified as nonrecourse debt. A mortgage holder may pursue an owner for a loss due to a deficiency in the value of the secured property on a recourse debt only through judicial foreclosure, and only if:

- the court-appraised value of the property at the time of the *judicial foreclosure sale* is less than the debt; and
- the bid is for less than the debt owed.[15]

Any mortgage securing a loan on other than a one-to-four unit buyer-occupied residential property is recourse debt. Thus, lender-funded mortgages secured by second homes, apartments (five or more units) or commercial properties are recourse debt.

*Editor's note — A seller carryback mortgage debt is not included in any definition of a loan, as it is a credit sale. Carryback paper is nonrecourse debt regardless of the type of property securing the note when the debt is secured solely by the property sold.*[16]

## The appraisal and a consumer mortgage

A homeowner with a recourse mortgage is not necessarily destined to be hounded by the mortgage holder's debt collectors forever. One last, significant protection lies in the mortgage holder's choice of mortgage debt recovery.

In response to any owner's default, a mortgage holder must *first foreclose* on the property to satisfy the debt before attempting any other kind of collection effort, its bargain under the power of sale and put option in the trust deed.[17]

The mortgage holder's ability to seek a deficiency after foreclosure on a recourse debt depends upon their choice of foreclosure remedies:

- *judicial foreclosure*; or
- *nonjudicial foreclosure*.

13 **Cornelison** v. **Kornbluth** (1975) 15 CA3d 590
14 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611
15 CCP §580a
16 CCP §580b
17 CCP §726(a); **Walker** v. **Community Bank** (1974) 10 C3d 729

A mortgage holder may only obtain a money judgment for a deficiency (and associated attorney and filing costs) when it completes a judicial foreclosure, and only if:

- the mortgage is recourse paper; and
- the property value is less than the amount of the mortgage at the time of the judicial foreclosure sale.[18]

Judicial foreclosures are lengthy and expensive procedures for mortgage holders. They also risk further decline in a property's value during the period of litigation plus the one-year redemption period after the foreclosure sale. Further, they may be unable to recover on a separate money award for the deficiency against the owner.

When a mortgage holder chooses instead to foreclose nonjudicially via a trustee's sale (and in California, most do so, suing only on any guarantee of the note they may hold), it loses its right to pursue any loss on the note. Mortgage holders trade the right to complete a judicial foreclosure for a cheaper, faster trustee's sale. Additionally, an owner's right to redeem their property by payment of the debt in full is terminated on completion of the trustee's sale.[19]

## Mortgage defaults and reinstatement

A property owner's ability to **reinstate** a mortgage by curing a default depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a mortgage fails to pay property taxes. The mortgage holder records an NOD, specifying the delinquent property taxes as the owner's default under the trust deed.

Is the property owner able to reinstate the mortgage and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the mortgage by simply paying the delinquent property taxes, and the trustee's fees and charges incurred in the foreclosure proceeding. Monthly payments on the note, payment of insurance premiums and payments on senior encumbrances are also curable defaults allowing reinstatement of the mortgage debt.

## Defaults cured only by redemption

Some mortgage defaults do not allow the debt to be reinstated. Reinstatement of the mortgage on those defaults is only available when agreed to by the mortgage holder. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt without the ability to reinstate the mortgage include:

- a breach of a due-on clause;
- a breach of a waste provision; or
- a violation of law provision in the use of the property.

18 CCP §580c, 580a

19 CCP §580d

Consider real estate encumbered by a trust deed with a waste provision requiring the owner to maintain their property in good condition and repair. The owner fails to maintain the property, and the roof needs replacement.

The mortgage holder becomes concerned as the owner's activities have decreased the value of the mortgage holder's security, called **impairment**. Due to the owner's failure to maintain the property in good condition, the mortgage holder calls the mortgage. On the owner's failure to fully pay the remaining debt, a trustee on instructions from the mortgage holder records an NOD against the property.

In this instance, the owner may not cure the default in the trust deed (waste provision) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the mortgage. As a result, the entire foreclosure period becomes the redemption period.

To retain ownership of the property, the owner needs to *redeem* the property by tendering full payment of all sums due, including foreclosure costs, prior to completion of the trustee's sale.

Alternatively, the trust deed gives the mortgage holder the authority to cure the waste and add the costs incurred to the principal balance of the note under the future advances clause.

However, when waste by the owner is committed in *bad faith*, the foreclosing mortgage holder needs to consider an underbid at the trustee's sale. The underbid will be in an amount equal to the property's reduced fair market value attributable to the waste. With an underbid, the mortgage holder may sue the owner to recover the deficiency in the property's value below the amount due on the debt when the bad faith waste caused the deficiency.[20]

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20 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590

## Chapter 42 Summary

Trust deeds contain a boilerplate provision authorizing mortgage holders to call all amounts remaining unpaid due and payable on a material default of the mortgage, called an acceleration clause. In tandem, the trust deed power-of-sale provision authorizes the trustee to initiate a non-judicial foreclosure sale of the property on the mortgage holder's declaration of default and instructions to foreclose.

To exercise the power-of-sale provision and initiate the trustee's foreclosure procedures, the trustee records a notice of default (NOD) when so instructed by the mortgage holder. As triggered by the acceleration clause when an NOD is recorded, all sums remaining to be paid on the mortgage debt become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights to cure the default.

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the reinstatement period. When the sale is postponed, the reinstatement period is extended, ending the day before the fifth business day prior to the postponed sale date.

Some mortgage defaults do not allow the debt to be reinstated. Reinstatement of the mortgage on those defaults is only available when agreed to by the mortgage holder. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt without the ability to reinstate the mortgage include:

- a breach of a due-on clause;
- a breach of a waste provision; or
- a violation of law provision in the use of the property.

## Chapter 42 Key Terms



**Quiz 12 Covering Chapters 40-42 is located on page 632.**

*Notes:*

Chapter
43

# Judicial foreclosure

## Learning Objectives

After you read this chapter, you will be able to :

- distinguish foreclosure proceedings as either judicial or nonjudicial;
- discuss the judicial foreclosure process;
- advise an owner of their right to reinstate a mortgage in default or redeem a property following a judicial foreclosure sale; and
- calculate any deficiency in value an owner may owe the holder of a recourse mortgage after the secured property is sold at a judicial foreclosure sale.

## Key Terms

**certificate of sale**

**fair value hearing**

**foreclosure decree**

**judicial foreclosure**

**lis pendens**

**litigation guarantee**

**money judgment (on foreclosure)**

**nonjudicial foreclosure**

**probate referee (on foreclosure)**

**recourse debt**

## Deficient property value and recourse debt

When a loan is in default, the mortgage holder's *collection efforts* are limited to judicial or nonjudicial activities, both of which are very structured. If the note evidences a **recourse debt**, the mortgage holder may recover against both the property and the owner as the named borrower, but only if a judicial foreclosure sale takes place.

**recourse debt**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

To initiate a collection effort, the mortgage holder needs to first *exhaust the security* by foreclosing on the security, i.e., the real estate. The mortgage holder's security interest in a property is exhausted when the mortgage holder completes a foreclosure sale on the property. Alternatively, the mortgage holder's security interest may have been wiped out — exhausted — by a senior trust deed holder's foreclosure sale. Thus, the note is now unsecured and the noteholder unable foreclose.

**money judgment (on foreclosure)**
An award for any unpaid balance remaining after a judicial foreclosure sale due to the secured property's insufficient fair market value (FMV) on the date of the sale to satisfy the debt owed, also called a deficiency.

Only when the note evidences a *recourse debt* may the mortgage holder pursue a **money judgment** against the property owner for any deficiency in the property's value to fully satisfy the debt. To obtain a *money judgment*, the holder of a recourse mortgage is limited to using the judicial foreclosure process, or if their security interest has otherwise been exhausted suing directly on the now unsecured recourse note.[1]

A mortgage holder may foreclose on a property and sell it to exhaust their security interest in one of two ways:

- **judicial foreclosure**, under mortgage law, also called a **sheriff's sale;**[2] or
- **nonjudicial foreclosure**, under the power-of-sale provision in the trust deed or other security device, also called a **trustee's sale**.[3]

## Judicial foreclosure versus nonjudicial foreclosure

*Judicial foreclosure* is the court-ordered sale by public auction of the secured property. It can take eight months to multiple years to complete a judicial foreclosure.

Alternatively, when a mortgage holder *nonjudicially forecloses* by a trustee's sale, the property is sold as authorized by the trust deed provisions at a public auction, called a **trustee's sale**. *Trustee's sales* can be completed on property other than a one-to-four unit residential property within four months after a property owner defaults. On average, it takes approximately nine months to nonjudicially foreclose on a one-to-four unit residential property. [See Chapter 44]

**nonjudicial foreclosure**
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

Unlike a judicial foreclosure sale, the completion of a trustee's sale bars the foreclosing mortgage holder from obtaining a money judgment for any unpaid balance remaining after the foreclosure sale due to *insufficient value* in the secured property.[4]

**judicial foreclosure**
The court-ordered sale by public auction of the mortgaged property. Also known as a sheriff's sale.

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. Alternatively, a judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

1 Calif. Code of Civil Procedure §726(b)
2 CCP §725a
3 Calif. Civil Code §2924
4 CCP §580d

However, when the value of a mortgaged property drops below the balance owed on a *recourse debt*, the mortgage holder may elect to foreclose by judicial action. A judicial foreclosure sale allows the holder of a recourse mortgage to obtain a money judgment against the property owner for any deficiency in the value of the mortgaged property at the time of the sale to fully satisfy the recourse debt.[5]

## Suing to foreclose

The first step in the judicial foreclosure process is to file a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint names as defendants the original borrowers named in the mortgage as the trustors. The complaint also names anyone else holding a recorded interest in the secured property junior to the foreclosing mortgage holder's security interest in the property.

The trustee named in the mortgage is not involved in the lawsuit and is not named. A trustee under a mortgage has no interest in the property.

The mortgage holder foreclosing judicially needs to obtain a **litigation guarantee** of title insurance. The *litigation guarantee* lists all parties with a recorded interest in the property and their addresses of record. The guarantee further ensures that persons with a recorded junior interest to the foreclosing mortgage holder in the property are named and served. Thus, when noticed, their junior interest is also eliminated from title by the judicial foreclosure sale.

**litigation guarantee**
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

If a person holding an interest in the property junior to the mortgage holder's trust deed is not named as a defendant, their lien or ownership interest:

- is not affected by the outcome of the foreclosure proceedings; and
- remains of record.[6]

Additionally, when the foreclosing mortgage holder intends to seek a deficiency judgment, the original borrowers need to be named as defendants, whether or not they still hold an interest in the property.[7]

At the time the lawsuit is filed, the foreclosing mortgage holder records a **notice of pending action** against title to the mortgaged property, also called a **lis pendens**.

**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.

The *lis pendens* places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests to the results of the litigation.

## The foreclosure decree ends reinstatement

Until the court enters a judgment ordering the sale of the secured property, called a **foreclosure decree**, the property owner has the right to bring the delinquencies current, called **reinstatement**. A *foreclosure decree* ends the *reinstatement period*. [See Chapter 42]

5 CCP §580d
6 CCP §726(c)
7 **Hutchison** v. **Barr** (1920) 183 C 182

**foreclosure decree** Decree by a court ordering the sale of mortgaged property and the payment of the debt owing to the lender out of the proceeds.

A foreclosure decree orders the sale of the real estate to satisfy:

- the outstanding debt; and
- cover foreclosure-related expenses incurred by the mortgage holder.[8]

The foreclosure decree also states whether the property owner will be held personally liable for any deficiency in the property's **fair market value (FMV)** to satisfy the debt owed.[9] Importantly, FMV is never determined by the amount of the high bid at the judicial foreclosure sale.

## Notice of Levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a **levying officer**.

After the court decree authorizing the judicial foreclosure sale, the foreclosing mortgage holder is issued a **writ of sale** by the court clerk. In turn, the *writ of sale* authorizes the receiver or sheriff to record a **notice of levy**. Both describe the property to be sold and state the levy is against the security interest the mortgage holder holds in title to the property under its mortgage lien.[10]

The levying officer **records** the writ of sale and the notice of levy in the county where the property is located. They also mail the writ of sale and the notice of levy to the owner and any occupant of the property.[11]

## The notice of judicial sale

Similar to the notice of trustee's sale (NOTS) recorded in a nonjudicial foreclosure, the receiver's or sheriff's **notice of judicial sale** states the necessary details of the auction, such as the:

- date;
- time; and
- location of the sale.[12]

When a deficiency judgment is sought by the foreclosing mortgage holder, the notice of judicial sale also states:

- the property is being sold subject to the property owner's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure-related costs.[13]

If a money judgment for any deficiency is barred, as occurs with a *nonrecourse debt*, the receiver or sheriff waits at least 120 days after service of the notice of levy before proceeding to notice the judicial sale.[14]

8 CCP § 726(a), (b)
9 CCP §726(b)
10 CCP §712.010
11 CCP §700.010
12 CCP §701.540(a)
13 CCP §729.010(b)(1)
14 CCP §701.545

**The junior mortgage holder**

*Before entry of a judicial foreclosure decree, a junior trust deed holder or other mortgage holder also have the right to* ***reinstate*** *the note by paying the trust deed delinquencies and foreclosure costs, bringing the trust deed note current.*

*After entry of a foreclosure decree ordering the property to be sold, the junior mortgage holder has until the time the property is sold to the highest bidder at the foreclosure sale to redeem the property by paying all amounts owed on the debt and foreclosure costs. [Calif. Civil Code §2903 et seq.]*

*Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing mortgage holder's trust deed are wiped out and eliminated from the title. [Calif. Code of Civil Procedure §§701.630; 729.080(e)]*

*If the junior mortgage holder does not reinstate the note or purchase the property at the judicial foreclosure sale, and the owner later* ***redeems the property****, the junior mortgage holder will then be able to recover the amount of their lien, plus interest. [CCP §729.060(b)(5)]*

*A creditor holding an unrecorded lien not actually known to the foreclosing lender does not need to be named or notified of the judicial foreclosure action to have the unrecorded lien extinguished on completion of a recorded mortgage holder's judicial foreclosure sale. [CCP §726(c)]*

*If the junior mortgage holder of record is unnamed or unserved in a judicial foreclosure action by the senior trust deed holder, the junior trust deed holder still has an enforceable trust deed after completion of a senior trust deed lender's judicial foreclosure sale.*

*If the senior mortgage holder is time barred from filing another judicial foreclosure action, a junior trust deed holder of record who was not given notice of the judicial foreclosure action may initiate their own judicial or trustee's foreclosure proceedings to enforce their trust deed. The junior trust deed holder's interest is now senior to the interest of the high bidder at the first mortgage holder's judicial foreclosure sale. [****Little**** v. ****Community Bank**** (1991) 234 CA3d 355]*

*Consider a wiped-out junior trust deed holder whose note evidences a* ***recourse debt****. The junior mortgage holder whose security interest in the property has been exhausted by a foreclosure sale on a prior mortgage sues to collect the debt from the owner who executed the note. Accordingly, the junior mortgage holder obtains a money judgment on the note since their trust deed has been eliminated and they hold no security in the property to foreclose.*

*With a money judgment replacing the now unsecured note, the junior mortgage holder records an* ***abstract of judgment****. The recorded abstract of the money judgment:*

- *creates an involuntary lien on all properties vested in the name of the owner; and*
- *replaces the trust deed note but evidences a different debt (the money judgment) with different rights than the prior mortgage debt.*

*If the owner redeems the property after the judicial foreclosure sale, the junior trust deed holder has a lien on the property which they can foreclose if not paid. The junior mortgage holder can also proceed with a sheriff's sale to collect on the money judgment by a foreclosure on all properties attached by the recorded abstract. [****O'Neil**** v. ****General Security Corporation**** (1992) 4 CA4th 587]*

However, if the mortgage holder seeks a deficiency judgment on a *recourse debt*, no waiting period applies before noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the clerk of the court issues the writ of sale.[15]

15 CCP §729.010(b)(2), (3)

At least 20 days before the sale, the notice of judicial sale is:

- served on the property owner personally or by mail;[16]
- mailed to any person who has recorded a request for a notice of judicial sale;[17]
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published once a week for three successive weeks in a local newspaper of general circulation.[18]

## Loss mitigation efforts on a consumer mortgage

When a **consumer mortgage** is being foreclosed, the mortgage holder is required to comply with federal mortgage rules under any type of foreclosure proceeding. A property owner subject to foreclosure under a consumer mortgage has the right to submit a complete **loss mitigation application** to the mortgage holder prior to 37 days before a scheduled judicial or nonjudicial foreclosure sale. On receipt of the application, the mortgage holder can't move forward with the foreclosure sale until the following criteria are met:

- the loan servicer sends the property owner a notice informing them they are not eligible for loss mitigation; and
- the property owner either is not eligible to appeal, has not requested to appeal within the time period allowed, or their appeal has been denied; or
- the property owner rejects all loss mitigation possibilities the servicers offers; or
- the property owner did not perform under an agreement on a previously agreed to loss mitigation option.[19]

## Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an *auction*. The property is sold to the highest bidder.[20]

The foreclosing mortgage holder is entitled to make a credit bid up to the full amount of the debt owed to acquire the property at the foreclosure sale. Payment by a successful bidder other than the mortgage holder is made at the time of the public sale:

- in cash;
- by certified check; or
- by a credit transaction as long as the amount is over $5,000, in which case the greater of $5,000 or 10% of the amount bid is due at the time of sale, with the remaining balance plus applicable costs and interest due within ten days after the sale.[21]

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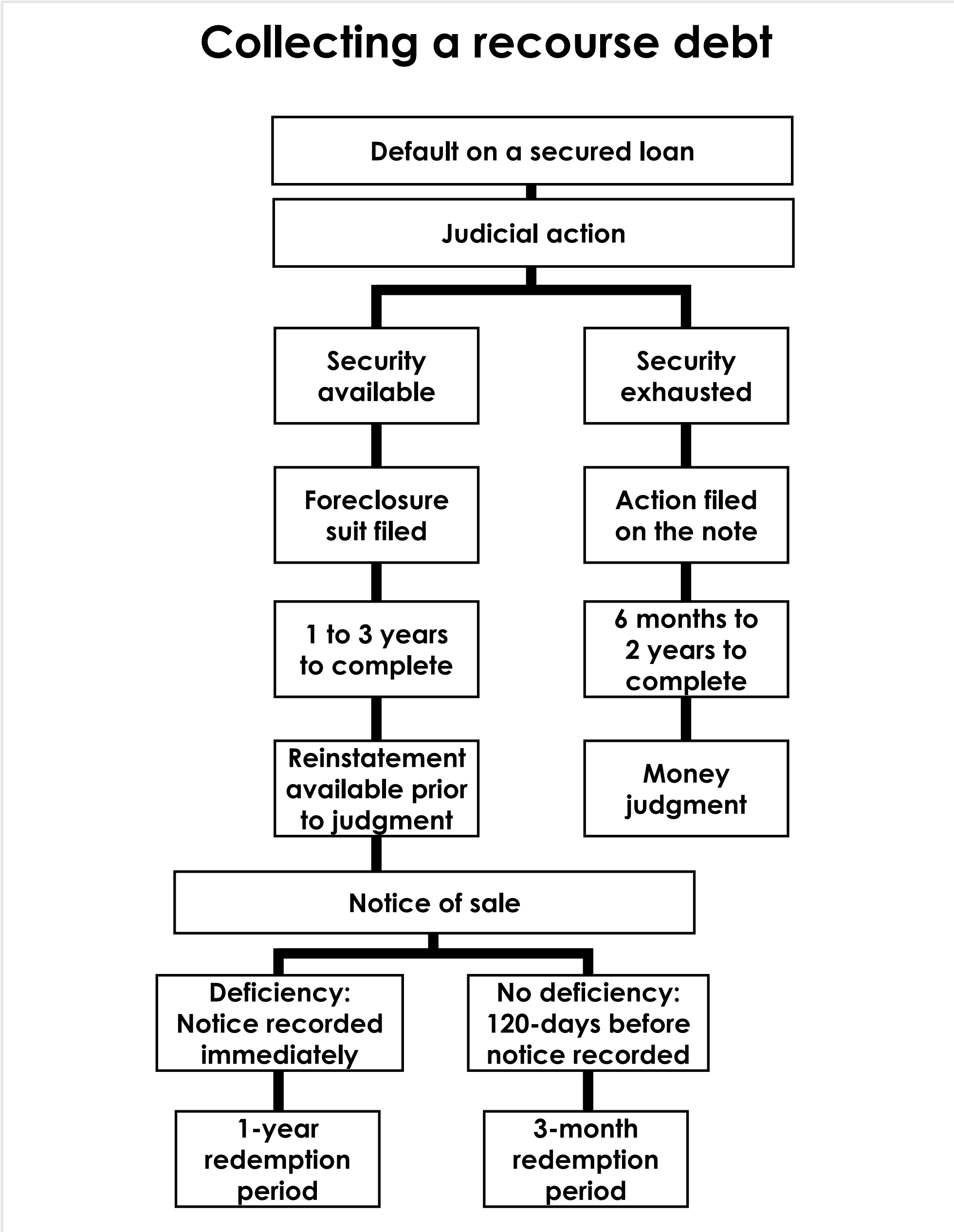
16 CCP §701.540(c)
17 CCP §701.550(a)
18 CCP §701.540(g)
19 12 Code of Federal Regulations 1024.41(g)
20 CCP §701.570(b)
21 CCP §701.590(a), (c)




**Collecting a recourse debt**

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for their failure to pay their bid.[22]

The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a deficiency judgment, the mortgage holder needs to **bid no less** than an amount it believes the court will set as the *FMV* of the property. Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage holder. The loss from a **below market bid** is the spread between the high bid when the owner redeems and the greater FMV.[23]

22 CCP §701.600

23 **Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652

## Judicial sale completed

A **certificate of sale** is issued to the successful bidder on the completion of a judicial foreclosure sale.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable **redemption period** expires.[24] [See Chapter 42]

The *certificate of sale* reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder.[25]

## The owner's redemption follows foreclosure

**certificate of sale**
A certificate issued to the successful bidder on the completion of a judicial foreclosure sale.

On a judicial foreclosure of a purchase-assist mortgage secured by a buyer-occupied one-to-four unit residential property, or a seller carryback note secured solely by the property sold no matter its use, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt;[26] and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs.[27]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property.[28]

The property can only be redeemed by the owner or the owner's **successor-in-interest** since all junior mortgage holders are wiped out, leaving no remaining rights in the property.

*Successors-in-interest* to the owner include any person who acquires the owner's interest in the property by deed prior to the judicial foreclosure sale.[29]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bidder at the judicial foreclosure sale (even if the amount is less than the property's FMV on that date);
- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and
- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full.[30]

On redemption, the owner (or successor) is entitled to:

- an offset for any net rents collected by the mortgage holder under an *assignment of rents provision* in the mortgage; and

24 CCP §729.090
25 CCP §729.020
26 CCP §580b
27 CCP §729.030(a)
28 CCP §729.030(b)
29 CCP §729.020
30 CCP §729.060

- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale.[31]

If the owner or successor does not redeem the property within the redemption period, the sale is final and the high bidder is entitled to possession.[32]

## Obtaining a deficiency judgment

The remaining balance owed on a mortgage may be greater than the *fair price* of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the *deficiency* in the value of the property to cover the debt.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by **anti-deficiency** statutes as a nonrecourse debt. The mortgage holder holding a recourse mortgage will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At a **fair value hearing**, noticed within three months after the foreclosure sale, the amount of the deficiency is set by the court.[33]

**fair value hearing**
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

The amount awarded as a deficiency judgment is based on the debt owed on the date of the judicial foreclosure sale, and the *greater* of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the mortgage being foreclosed, the result setting the *fair price* of the mortgage holder's security interest in the property; or
- the amount bid for the property at the judicial foreclosure sale.[34]

The mortgage holder is awarded a money judgment for the portion of the debt not covered by the fair price of the mortgage holder's secured position on title, or the price bid at the sale if it is higher.

**probate referee (on foreclosure)**
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

The mortgage holder and property owner present evidence at the fair value hearing to establish the property's FMV on the date of the foreclosure sale. The court may appoint an appraiser, called a **probate referee**, to advise the court on the property's FMV.[35]

31 CCP §§729.060, 729.090
32 CCP §729.080
33 CCP §§580a, 726(b)
34 CCP §580a
35 CCP §§580a, 726(b)

## Chapter 43 Summary

When a loan is in default, the mortgage holder's collection efforts are limited to judicial or non-judicial activities, both of which are very structured. If the note evidences a recourse debt, the mortgage holder may recover against both the property and the owner as the named borrower, but only if a judicial foreclosure sale takes place.

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. Alternatively, a judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

Similar to the notice of trustee's sale (NOTS) recorded in a nonjudicial foreclosure, the receiver's or sheriff's notice of judicial sale states the necessary details of the auction, such as the:

- date;
- time; and
- location of the sale.

When a consumer mortgage is being foreclosed, the mortgage holder is required to comply with federal mortgage rules under any type of foreclosure proceeding.

The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a deficiency judgment, the mortgage holder needs to bid no less than an amount it believes the court will set as the fair market value (FMV) of the property. Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage holder.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable redemption period expires.

The remaining balance owed on a mortgage may be greater than the fair price of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the deficiency in the value of the property to cover the debt. A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes as a nonrecourse debt.

## Chapter 43 Key Terms

**Quiz 13 Covering Chapters 43-45 is located on page 633.**

*Notes:*

Chapter 44


# The nonjudicial foreclosure process

## Learning Objectives

After you read this chapter, you will be able to :

- identify a mortgage or other lien on real estate by its power-of-sale authority to nonjudicially foreclose on the secured property if the owner defaults;
- determine the pre-foreclosure workout process mandated for a first lien, one-to-four unit residential property;
- understand an owner's rights during the different periods in the trustee's foreclosure process;
- determine whether the trustee has abided by recording and posting procedures governing the foreclosure process and rights of residential tenants;
- advise buyers and owners on the procedures for a trustee's sale, including advertising, postponing and accepting bids; and
- distinguish the priority for disbursements of excess proceeds from a trustee's sale.

## Key Terms

**bona fide purchaser (BFP)**
**declaration of default and demand for sale**
**full credit bid**
**lis pendens**
**nonjudicial foreclosure**
**notice of default (NOD)**
**notice of trustee's sale (NOTS)**
**power-of-sale provision**
**pre-foreclosure workout**
**surplus funds**
**trustee (on a mortgage)**
**trustee's sale guarantee**

## Power-of-sale provision

**nonjudicial foreclosure**
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

**power-of-sale provision**
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

A mortgage holder or carryback seller holding a note secured by a trust deed in default has two foreclosure methods available to enforce collection of the mortgage debt. These two foreclosure methods are:

- a **judicial foreclosure** sale, also called a *sheriff's sale* [See Chapter 43];[1] or
- a **nonjudicial foreclosure** sale, also called a *trustee's sale*.[2]

The key to the mortgage holder's ability to *nonjudicially foreclose* by a trustee's sale on the mortgaged real estate is the *power-of-sale provision* contained in the mortgage, also called a trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a land sale contract [See **RPI** Form 165];[3]
- a lease-option sale [See **RPI** Form 163 §19];
- a homeowners' association (HOA)'s conditions, covenants and restrictions (CC&Rs) regarding assessment liens;
- bonded improvement assessments; or
- a UCC-1 financing statement. [See **RPI** Form 436-1][4]

The grant of the power-of-sale by the owner of a property provides a private contract remedy for the **recovery of money** by a creditor, typically a mortgage holder. The power-of-sale is voluntarily agreed to by the owner of the mortgaged property, authorizing the mortgage holder on a default to hold a nonjudicial foreclosure sale of the property by public auction.[5]

If the note evidences a **recourse debt** with a remaining balance exceeding the *fair price* of the mortgage holder's security position in real estate, the mortgage holder may want to choose a *judicial foreclosure*. A judicial foreclosure action allows the mortgage holder to seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 40]

However, by foreclosing under the power-of-sale provision, the mortgage holder avoids a costly (and potentially time-consuming) court action for judicial foreclosure.

*Editor's note — When a mortgage holder completes a nonjudicial foreclosure, it cannot later obtain a deficiency judgment against the owner of the mortgaged real estate. Alternatively, the owner cannot redeem the property after the mortgage holder's trustee's sale as they can after a judicial foreclosure sale. [See Chapter 43]*

## Who conducts the sale

A trust deed is a **security device** which imposes a mortgage lien on real estate. The mortgage wording purports to create a *fictional trust* which is said to "hold title" to the mortgaged real estate for the benefit of the mortgage

1 Calif. Code of Civil Procedure §726
2 Calif. Civil Code §2924
3 **Petersen** v. **Hartell** (1985) 40 C3d 102
4 **Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25
5 CC §2924

**Figure 1**

**Excerpt from Form 450**

**Trust Deed and Assignment of Rents**

| | |
|---|---|
| 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. |

holder. As you will observe, the trustee holds no interest in the property and has no duty owed to anyone, until they voluntarily undertake to reconvey or foreclose on a declaration by the mortgage holder.

Thus, a mortgage has three parties:

- at least one **trustor** (the owner(s) of the mortgaged real estate);
- a **trustee** who need not be named; and
- at least one **beneficiary** (a lender, carryback seller, HOA, bonded assessment or other lienholder with a trustee's sale provision).

**trustee (on a mortgage)**
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.

The trustee's sale is conducted by the *trustee* who is either:

- named in the mortgage; or
- appointed by the *beneficiary* of the mortgage at the time the beneficiary initiates the foreclosure process.

A broker, attorney, mortgage servicer, subsidiary of the mortgage holder, or the mortgage holder itself may be appointed at any time as the trustee.

The trustee begins the nonjudicial foreclosure process by recording a **notice of default (NOD)**. The trustee ends the process on delivery of the trustee's deed and disbursement of any sales proceeds.[6] [See Figure 2]

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

Generally, trust deed forms are prepared and distributed by title or escrow companies naming their corporation as the trustee. However, a trust deed or other security device does not need to name the trustee at all. The mortgage holder later simply appoints a trustee to handle the *NOD* or reconveyance. [See **RPI** Form 450]

Also, the mortgage holder may appoint a substitute trustee to replace the trustee named in the trust deed.

## Pre-foreclosure workout prior to NOD

Before recording an NOD on a first lien mortgage securing a purchase-assist loan on a *principal residence*, a mortgage holder needs to conduct a **pre-foreclosure workout** with the homeowner.

6 **Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194

**Figure 2**

**Form 471**

**Notice of Default**

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

**NOTICE OF DEFAULT**
With Substitution of Trustee
(California Civil Code §2924c)

**NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED**
注：本文件包含一个信息摘要
참고사항: 본 첨부 문서에 정보 요약서가 있습니다
**NOTA: SE ADJUNTA UN RESUMEN DE LA INFORMACIÓN DE ESTE DOCUMENTO**
**TALA: MAYROONG BUOD NG IMPORMASYON SA DOKUMENTONG ITO NA NAKALAKIP**
**LƯU Ý: KÈM THEO ĐÂY LÀ BẢN TRÌNH BÀY TÓM LƯỢC VỀ THÔNG TIN TRONG TÀI LIỆU NÀY**

**IMPORTANT NOTICE**

**IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).**

**This amount is $____________________ as of ______________, 20_______, and will increase until your account becomes current.**

**While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.**

**Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).**

**Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.**

---------- PAGE 1 OF 3 — FORM 471 ----------

---------- PAGE 2 OF 3 — FORM 471 ----------

**To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:**

______________________________
*(Name of Beneficiary or Mortgagee)*

______________________________
*(Mailing address)*

______________________________
*(Telephone)*

**Pursuant to California Civil Code §2923.5, Beneficiary:**

- ☐ **has contacted Owner and discussed avenues for refinance.**
- ☐ **is unable to contact Owner after a due diligence effort.**
- ☐ **is not required to contact Owner since Beneficiary's record does not show the trust deed is secured by an owner-occupied, one-to-four unit primary residence.**

**If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.**

**Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.**

**Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.**

**NOTICE IS HEREBY GIVEN:**
**A Deed of Trust dated ______________________________ executed by ______________________________, as the Trustor, in favor of ______________________________, as the Beneficiary, recorded on ____________________, as Instrument No. ______________, of Official Records in the office of the County Recorder of ______________ County, California, secures, among other obligations, _______ note(s) in the original amount of $______________.**

**The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints ______________________________ as Trustee under the Deed of Trust.**

**A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:**

______________________________

______________________________

______________________________

______________________________

______________________________

______________________________

______________________________

---------- PAGE 2 OF 3 — FORM 471 ----------

---------- PAGE 3 OF 3 — FORM 471 ----------

**Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.**

______________________________
*(Signature of Beneficiary)*

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.

*(This area for official notarial seal)*

Signature: ______________________________
*(Signature of notary public)*

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**pre-foreclosure workout**
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

At least 30 days prior to recording an NOD, the mortgage holder needs to contact the homeowner to:

- assess the homeowner's financial situation;
- explore options for the homeowner to avoid foreclosure;
- advise the homeowner of their right to an additional meeting within 14 days to discuss their financial options; and
- provide homeowners with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency.[7]

Further, after attempting the initial contact, the servicer must send a written statement to the owner informing the owner of their right to:

- additional protections and services if they are a servicemember or a dependent of a servicemember; and
- request the note, trust deed, assignment and payment history.[8]

7 CC §2923.5(a)

8 CC §2923.55

If the mortgage holder is unable to make contact with the homeowner, the mortgage holder:

- sends the homeowner a first-class letter containing a toll-free number for a housing counselor certified by the *HUD*; and
- calls the homeowner by the primary telephone number on file at least three times at different hours on different days.[9]

The mortgage holder may record an NOD on a mortgage without complying with any of these 30-day pre-foreclosure requirements when the homeowner has:

- surrendered the property to the mortgage holder either by a letter confirming the surrender or by delivery of the keys to the mortgage holder;
- contracted with a person who facilitates a homeowner's decision to leave their home by extending the foreclosure process and avoiding the mortgage holder's enforcement of the loan; or
- filed a bankruptcy petition which is pending.[10]

## The nonjudicial stages of foreclosure

To successfully complete a trustee's foreclosure sale under a *power-of-sale provision*, the trustee and mortgage holder need to adhere to the procedures detailed in the California foreclosure statutes for handling a trustee's sale.[11]

The nonjudicial foreclosure process has three stages:

1. the **NOD** is recorded and mailed;
2. the **notice of trustee's sale (NOTS)** is recorded, posted and mailed; and
3. the **trustee's sale** of the real estate by auction occurs, followed by the execution of the trustee's deed and distribution of sales proceeds.

**notice of trustee's sale (NOTS)**
The notice recorded, posted and mailed to evidence an impending trustee's sale to the property owner and potential bidders.

*Editor's note — Mortgage servicers are required to wait until a mortgage is at least 120 days delinquent before commencing foreclosure on a first lien mortgage secured by an owner's principal residence.*[12]

While the trustee is concerned about the three stages for processing the foreclosure, the owner of the real estate and the mortgage holder are concerned primarily with two different periods of time which control payment of the debt:

- the **reinstatement period**, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and
- the **redemption period,** which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 42]

The owner of a unit in a **common interest development (CID)** has 90 days after the trustee's foreclosure sale on an HOA assessment lien to redeem

9 CC §2923.5(e)
10 CC §2920.5(c)(2)
11 **Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268
12 12 Code of Federal Regulations §1024.41(f)(1)

How does California's Homeowner Bill of Rights affect the foreclosure process?

*Protections for homeowners going through the nonjudicial foreclosure process were afforded under The California Homeowner Bill of Rights until January 1, 2018. A new bill, SB 818, has reinstated many of the provisions of the original bills, including:*

- *Dual track foreclosures are restricted. This prohibits a mortgage holder from continuing the foreclosure process if the homeowner has applied for a loan modification. The foreclosure process may only resume if the loan modification application is formally denied in writing. [Calif. Civil Code §2923.5(B)]*
- *Single points of contact are to be provided by mortgage holders to homeowners pursuing foreclosure alternatives. [CC §2923.7(a)]*
- *Verification of foreclosure documents is required. A mortgage holder who records and files "multiple" unverified foreclosure documents may be fined up to $7,500 per violation. These documents include an NOD, a Notice of Trustee's Sale (NOTS), assignment of the trust deed or a substitution of the trust deed. Each of these documents needs to be verified for substantial evidence of the mortgage holder's right to foreclose. [CC §2924.17(c)]*
- *Tenants of foreclosed homes are also protected by the Homeowner Bill of Rights. Upon completion of the trustee's sale, the new owner needs to honor an existing lease if it has a fixed-term. If the home is to be occupied as a principal residence, the new owner may serve the tenant with a 90-day eviction notice. [See **RPI** Form 573; CC §2924.8(a)(1)]*

*These protections also provide relief if a foreclosure sale has already taken place.*

*Violations of foreclosure law by mortgage holders result in the homeowner receiving money sufficient to cover their economic losses, including attorney fees and court costs. [CC §2924.12]*

the unit. This is distinct from the standard redemption period applicable to non-HOA units which expires five business days before the trustee's sale. This HOA-specific legislation was adopted to stymie the efforts of an HOA attempting to initiate foreclosure to collect overdue HOA assessments of minimal value.[13]

## Trustee's sale guarantee

**declaration of default and demand for sale**
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

When a mortgage is in default and the mortgage holder has chosen to foreclose, the mortgage holder hands a **declaration of default and demand for sale** to the trustee.

The declaration contains instructions directing the trustee to initiate foreclosure on the mortgaged property as authorized under the power-of-sale provision contained in the mortgage. [See Figure 2]

Even though the trustee may have received the mortgage holder's declaration of default, the trustee's foreclosure process and the periods imposing rights and obligations do not begin until the trustee or mortgage holder records an NOD.[14]

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13 CCP §2924.1

14 **System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137

Once the NOD is recorded, the trustee is required to strictly comply with statutory notice requirements. To be assured the required notices are served on all the proper persons, the trustee orders a **trustee's sale guarantee** from a title company before or at the time the NOD is recorded. [See Chapter 42]

**trustee's sale guarantee**
A policy issued by a title insurance company to a trustee before or at the time the notice of default (NOD) is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

The *trustee's sale guarantee* provides coverage to the trustee for failure to serve notices on any party due to an omission of that person's identity in the guarantee.

The trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;
- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

## The notice of default and election to sell

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located.[15]

The NOD contains statutorily mandated statements which set forth the *monetary default* on the note or other obligation secured by the mortgage.[16]

The monetary default statement informs the owner:

- they need to continue to pay other obligations required of them by the mortgage, such as hazard insurance premiums and property taxes; and
- if they do not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan. [See Figure 2]

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD needs to state the nature of the *present defaults* on the mortgage.[17]

For one-to-four unit residential property, a summary of key information contained in the NOD needs to be attached to the NOD. The summaries do not have to be published or recorded.[18] [See **RPI** Form 471-1]

15 CC §2924(a)(1)
16 CC §2924c(b)(1); CC § 2924(a)(1)
17 CC §2924c(a)(1)(B); CC §2924c(a)(1)(C)
18 CC §2923.3(c)

**No address for trustor**

*The trustee must send a copy of the notice of default (NOD) to:*

- *the trustor's address as noted in the trust deed; and*
- *the address given by the trustor in a recorded request for NOD. [Calif. Civil Code §2924b(b)(3)]*

*If the trust deed does not contain a request for NOD, or contains a request for NOD but no address for the trustor, the trustee can do one of the following within 10 business days after recording the NOD:*

- *publish the NOD in a newspaper of general circulation in the county in which the property is located (the trustee's sale guarantee issued by the title company advises which newspaper to use), and continue publishing once a week for at least four weeks;*
- *personally serve the NOD on the trustor; or*
- *post the NOD in a conspicuous place on the secured property and mail the notice to the last known address of the trustor. [CC §2924b(d)]*

*A trustee is not required to discover a trustor's address if the current address is not actually known to the trustee. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]*

*Unless the trustee has actual knowledge of the trustor's last known physical address, which does not include the use of an email address, the trustee is not liable if the trustor does not receive a copy of the NOD. [CC §2924b(b)(3)]*

Further, if the mortgage was originally negotiated in one of five languages other than English, the summary is to be provided in that language. These languages are:

- Chinese;
- Korean;
- Spanish;
- Tagalog; or
- Vietnamese.[19] [See **RPI** Form 474-1 through 474-6]

To determine the amount needed to cure the default, the NOD directs the owner seeking to *reinstate* the mortgage or *redeem* the property to contact the trustee. Thus, the trustee insulates the mortgage holder from all direct contact with the owner or junior mortgage holder after the date the NOD is recorded until cancelled or a trustee's sale occurs.

If the NOD does not list a default known to the mortgage holder at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated.[20]

19 CC §2923.3(a)

20 **In re Peters** (9th Cir. BAP 1995) 184 BR 799

However, the mortgage holder may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default.[21]

## Delivering the NOD

Within **ten business days** after recording a NOD, two copies of the NOD are mailed to:

- the owner of the property;
- the administrator of a deceased owner's estate; and
- each person who has recorded a request to receive a copy of the NOD.[22]

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail.[23]

Within **one month** after recording the NOD, the trustee sends a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the mortgaged property, including:

- the owner's successor-in-interest;
- any junior mortgage holder;
- the assignee of a junior mortgage;
- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a *Notice of Lien for Postponed Property Taxes* is recorded against the property.[24]

Any other person interested in obtaining a copy of the NOD records a **request for NOD.** The request for NOD assures the interested person they will be notified of the default. [See **RPI** Form 412]

A trustee or person depositing the NOD into the mail to give notice to others prepares a *proof of service* and includes a copy of the form with the NOD in each mailing.[25]

## The notice of trustee's sale

A trustee or mortgage holder may begin noticing the date set for the sale of a property on the day following **three months after** the NOD is recorded.[26]

The date of the sale may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m.[27]

In general practice, a **date down** of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or on the day the title company records the NOTS.

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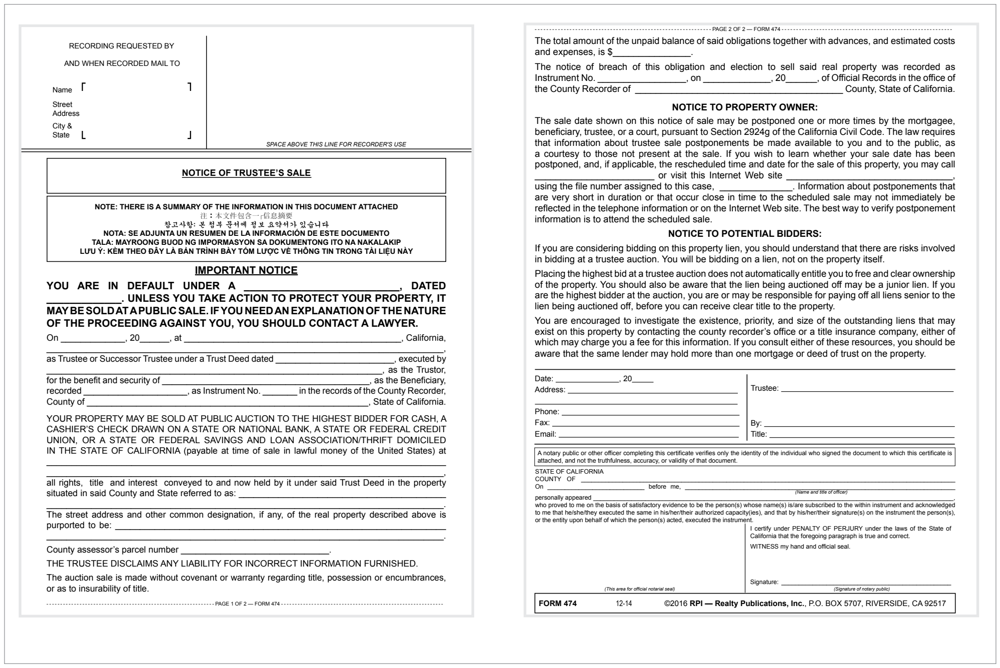
21 CC §2924(e)
22 **Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)
23 CC §2924b(b)(1), (e)
24 CC §2924b(c)
25 CC §2924b(e)
26 CC §2924(a)(3)
27 CC §2924g(a)

**Figure 3**

**Form 474**

**Notice of Trustee's Sale**



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

**NOTICE OF TRUSTEE'S SALE**

**NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED**
注：本文件包含一个信息摘要
참고사항: 본 첨부 문서에 정보 요약서가 있습니다
**NOTA: SE ADJUNTA UN RESUMEN DE LA INFORMACIÓN DE ESTE DOCUMENTO**
**TALA: MAYROONG BUOD NG IMPORMASYON SA DOKUMENTONG ITO NA NAKALAKIP**
**LƯU Ý: KÈM THEO ĐÂY LÀ BẢN TRÌNH BÀY TÓM LƯỢC VỀ THÔNG TIN TRONG TÀI LIỆU NÀY**

**IMPORTANT NOTICE**

**YOU ARE IN DEFAULT UNDER A ____________, DATED ____________. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.**

On ____________, 20______, at ____________, California, ____________, as Trustee or Successor Trustee under a Trust Deed dated ____________, executed by ____________, as the Trustor, for the benefit and security of ____________, as the Beneficiary, recorded ____________, as Instrument No. _______ in the records of the County Recorder, County of ____________, State of California.

YOUR PROPERTY MAY BE SOLD AT PUBLIC AUCTION TO THE HIGHEST BIDDER FOR CASH, A CASHIER'S CHECK DRAWN ON A STATE OR NATIONAL BANK, A STATE OR FEDERAL CREDIT UNION, OR A STATE OR FEDERAL SAVINGS AND LOAN ASSOCIATION/THRIFT DOMICILED IN THE STATE OF CALIFORNIA (payable at time of sale in lawful money of the United States) at ____________, all rights, title and interest conveyed to and now held by it under said Trust Deed in the property situated in said County and State referred to as: ____________.

The street address and other common designation, if any, of the real property described above is purported to be: ____________.

County assessor's parcel number ____________.

THE TRUSTEE DISCLAIMS ANY LIABILITY FOR INCORRECT INFORMATION FURNISHED.

The auction sale is made without covenant or warranty regarding title, possession or encumbrances, or as to insurability of title.

PAGE 1 OF 2 — FORM 474

PAGE 2 OF 2 — FORM 474

The total amount of the unpaid balance of said obligations together with advances, and estimated costs and expenses, is $____________.

The notice of breach of this obligation and election to sell said real property was recorded as Instrument No. ____________, on ____________, 20______, of Official Records in the office of the County Recorder of ____________ County, State of California.

**NOTICE TO PROPERTY OWNER:**

The sale date shown on this notice of sale may be postponed one or more times by the mortgagee, beneficiary, trustee, or a court, pursuant to Section 2924g of the California Civil Code. The law requires that information about trustee sale postponements be made available to you and to the public, as a courtesy to those not present at the sale. If you wish to learn whether your sale date has been postponed, and, if applicable, the rescheduled time and date for the sale of this property, you may call ____________ or visit this Internet Web site ____________, using the file number assigned to this case, ____________. Information about postponements that are very short in duration or that occur close in time to the scheduled sale may not immediately be reflected in the telephone information or on the Internet Web site. The best way to verify postponement information is to attend the scheduled sale.

**NOTICE TO POTENTIAL BIDDERS:**

If you are considering bidding on this property lien, you should understand that there are risks involved in bidding at a trustee auction. You will be bidding on a lien, not on the property itself.

Placing the highest bid at a trustee auction does not automatically entitle you to free and clear ownership of the property. You should also be aware that the lien being auctioned off may be a junior lien. If you are the highest bidder at the auction, you are or may be responsible for paying off all liens senior to the lien being auctioned off, before you can receive clear title to the property.

You are encouraged to investigate the existence, priority, and size of the outstanding liens that may exist on this property by contacting the county recorder's office or a title insurance company, either of which may charge you a fee for this information. If you consult either of these resources, you should be aware that the same lender may hold more than one mortgage or deed of trust on the property.

Date: ____________, 20_____
Address: ____________
Phone: ____________
Fax: ____________
Email: ____________

Trustee: ____________
By: ____________
Title: ____________

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.

*(This area for official notarial seal)*

Signature: ____________ *(Signature of notary public)*

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The *date down* notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded.[28]

The trustee prepares an NOTS which contains:

- the trustee's name or their agent's name, street address and telephone number (or toll-free number if located out of state);
- the street address or common designation of the mortgaged property;
- the county assessor's parcel number of the mortgaged property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner they are in default.[29] [See Figure 3]

If the billing address of the defaulting owner is different from the mortgaged property's address, an additional notice needs to be posted on the property concurrent with the NOTS. The notice states in English and five other mandated languages that any tenant has the right to a 90-day notice to vacate the property. A copy of the tenant's rights is also to be mailed at the time of posting to the "Resident of property subject to foreclosure sale."[30] [See **RPI** Form 474-1]

28 CC §2924b(c)(1)
29 CC §2924f
30 CC §2924.8(a)

Like the NOD, the NOTS needs to contain a summary of key information in the language the mortgage was originally negotiated in.[31] [See **RPI** Form 474-2]

## The NOD and NOTS in Spanish

If the mortgage was negotiated in Spanish, the mortgage may contain a request for a Spanish-language NOD. The trustee is then obligated to serve the owner an NOD in Spanish.[32]

## Delivering the NOTS

At least **20 calendar days** before the trustee's sale, the trustee sends two copies of the NOTS to each party who previously received the NOD.[33]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail.[34]

To ensure the sale at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee performs all of the following at least 20 calendar days prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;
- **post a copy** of the NOTS in a conspicuous place on the property to be sold; and
- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located.[35]

## The location of the sale

A trustee's sale is held in the county where the mortgaged real estate is located.[36]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties.

For example, consider a trustee who is to conduct a foreclosure sale of two properties which secure the same debt by the same mortgage and are located in different counties. The trustee can sell both properties at one sale, in either county the trustee chooses.

31 CC §2923.3
32 CC §2924c(b)(1)
33 CC §2924b(c)(3)
34 CC §2924b(b)(2), (e)
35 CC §2924f(b)(1)
36 CC §2924g(a)

## Postponing the sale

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the mortgage holder or by the trustee at their discretion.[37]

To postpone or reschedule a trustee's sale, the trustee gives a **notice of postponement** at the time and place stated in the NOTS for the sale by a public declaration of:

- the reason for the postponement; and
- the new date and time of the foreclosure sale. [See **RPI** Form 474-8]

The postponed trustee's sale is held at the same place originally stated in the recorded NOTS.[38]

When a trustee's sale is postponed for ten or more business days, the mortgage holder or trustee is to provide written notice to the owner within five business days following the postponement. This notice is to include the new sale date and time.[39]

## Sold to the highest bidder

A trustee's sale is a **public auction** by private agreement where the property is sold to the highest bidder.[40]

Before the auction begins, the trustee may:

- demand all prospective bidders show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid.[41]

A bidder at auction can tender their bid amount in U.S. dollars in the form of:

- cash;
- a cashier's check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings bank or credit union; or
- a cash equivalent designated by the trustee in the NOTS, such as a money order.[42]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid.[43]

The trustee's sale is considered final on the trustee's *acceptance* of the last and highest bid.[44]

---

37 CC §2924g(c)(1)
38 CC §2924g(d)
39 CC §2924(a)(5)
40 CC §2924h
41 CC §2924h(b)(1)
42 CC §2924h(b)(1)
43 CC §2924h(a)
44 CC §2924h(c)

Once the highest bid has been accepted by the trustee, the trustee may require the successful bidder to immediately deposit the full amount of the final bid with the trustee.[45]

If the successful bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available.[46]

## Failure to deliver payment of a bid

If a successful bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the successful bidder a *notice of rescission* for failure of consideration.[47]

To hold a new trustee's sale auction, the trustee sets a new trustee's sale date and records, serves and publishes a new NOTS. The new NOTS follows all the same statutory requirements as the original NOTS.

The successful bidder who fails to tender payment when demanded is liable to the trustee for all resulting damages, including:

- court costs;
- reasonable attorney fees; and
- the costs for recording and serving the new NOTS.[48]

## Bids by the mortgage holder, a credit

The mortgage holder is frequently the only bidder at the trustee's sale. Thus, the mortgage holder automatically becomes the successful bidder.

The mortgage holder may bid without tendering funds up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses. This amount is called a **full credit bid**.[49]

**full credit bid**
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

If the mortgage holder is the successful bidder under a *full credit bid*, the trustee retains possession of the mortgage holder's note (or other evidence of the mortgaged debt) in exchange for the trustee's deed to the property.

The mortgage holder is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The mortgage holder can bid an amount below the full amount of the debt, called an **underbid**.

On the completion of a trustee's sale, the trustee uses a **trustee's deed** to transfer title to the property on to the successful bidder at the auction.

45 CC §2924h(b)(2)
46 CC §2924h(c)
47 CC §2924h(c)
48 CC §2924h(d)
49 CC §2924h(b)(2)

## Conveyance by a trustee's deed

When a buyer other than the mortgage holder purchases the property for value and without notice of title or trustee's sale defects, the buyer is considered a **bona fide purchaser (BFP).**

**bona fide purchaser (BFP)**
A buyer who purchases a property for valuable consideration in good faith without notice or knowledge of pre-existing encumbrances or conditions affecting their right to full ownership.

The *BFP's* interest in the property sold is *perfected* as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within **15 calendar days** after the date of the trustee's sale; or
- the **next business day** following the 15th day after the sale if the county recorder is closed on the 15th day.[50]

The title received by the third-party BFP is clear of any interest claimed by the owner, mortgage holders or tenants whose interests are junior to the foreclosed mortgage.[51]

However, upon completion of the trustee's sale, the new owner needs to honor an existing residential lease if it has a fixed-term. If the home is to be occupied as a principal residence, the new owner may serve the tenant with a *90-day eviction notice*.[52] [See **RPI** Form 573]

More importantly, title is taken clear of any *unrecorded prior interests* or **claims** in the property held by others not in possession of the real estate. However, to take clear title free of claims, the BFP needs to have no *constructive notice* or actual knowledge of any existing priority claims when acquiring title to the property at the trustee's sale.[53]

**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 **lis pendens** recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. If the claim has priority to the foreclosed mortgage, the *lis pendens* destroys the BFP status of the successful bidder.

## Surplus funds

Occasionally, the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due under the foreclosed mortgage. The excess amounts are called **surplus funds**. [See **RPI** Form 479]

**surplus funds**
Funds remaining when the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due the foreclosing mortgage holder.

The trustee has a duty to distribute the *surplus funds* to the junior mortgage holders and the owner(s).

The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;
- to pay the indebtedness secured by the property in default, including advances made by the mortgage holder;
- to satisfy the outstanding balance of junior mortgage holders of the property, distributed in the order of their priority; and

50 CC §2924h(c)
51 **Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605
52 CC §2924.8(a)(1)
53 CC §§1107, 1214

- to the owner, the owner's successor-in-interest or the vested owner of record at the time of the trustee's sale.[54]

54 CC §2924k(a)

## Chapter 44 Summary

A mortgage holder or carryback seller holding a note secured by a trust deed in default has two foreclosure methods available to enforce collection of the mortgage debt. These two foreclosure methods are a judicial foreclosure sale, also called a sheriff's sale, and a nonjudicial foreclosure sale, also called a trustee's sale. A trustee's sale is a public auction by private agreement where the property is sold to the highest bidder.

A mortgage has three parties:

- at least one trustor (the owner(s) of the mortgaged real estate);
- a trustee who need not be named; and
- at least one beneficiary (a lender, carryback seller, homeowners' association (HOA), bonded assessment or other mortgage holder).

The trustee holds no interest in the property and has no duty owed to anyone, until they voluntarily undertake to reconvey or foreclose on a declaration by the mortgage holder.

Before recording an Notice of Default (NOD) on a first lien mortgage securing a purchase-assist loan on a principal residence, a mortgage holder needs to conduct a pre-foreclosure workout with the homeowner.

To successfully complete a trustee's foreclosure sale under a power-of-sale provision, the trustee and mortgage holder need to adhere to the procedures detailed in the California foreclosure statutes for handling a trustee's sale.

When a mortgage is in default and the mortgage holder has chosen to foreclose, the mortgage holder hands a declaration of default and demand for sale to the trustee.

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located.

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the mortgage holder or by the trustee at their discretion.

The mortgage holder is frequently the only bidder at the trustee's sale. Thus, the mortgage holder automatically becomes the successful bidder.

On the completion of a trustee's sale, the trustee uses a trustee's deed to transfer title to the property on to the successful bidder at the auction.

Occasionally, the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due under the foreclosed mortgage. The trustee has a duty to distribute the surplus funds to the junior mortgage holders and the owner(s).

## Chapter 44 Key Terms



**Quiz 13 Covering Chapters 43-45 is located on page 633.**

# Chapter 45

# Requests for notices of delinquency and default

## Learning Objectives

After reading this chapter, you will be able to:

- explain when requests for notices of delinquency and default 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 both notices; 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** — notice will be sent to the person requesting the Notice of Delinquency (NODq) 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** — notice is sent to the person requesting the Notice of Default (NOD) 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, it 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]

1 California 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.

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.

*(This area for official notarial seal)*

Signature: __________ *(Signature of notary public)*

FORM 412 03-15 

## The NOD request

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

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]

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]

**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.

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 13]

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.

**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.

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**
The holder of a note secured by a trust deed and entitled to the performance of the provisions in the trust deed.

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 Sale (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]

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]

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 **RPI** Form 421, 442, and 443; see Form 450 in Chapter 13]

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 under a lease with the owner. Here, the owner implicitly agrees to do nothing

13 CC §2924e(b)

14 CC §2924e(c)

15 CC §2924e(d)

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 45 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 and Request for Notice of Default.

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

By recording the request for a Notice of Delinquency (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.

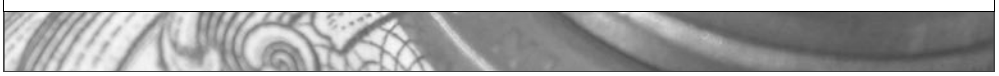
## Chapter 45 Key Terms



**Quiz 13 Covering Chapters 43-45 is located on page 633.**

# Chapter 46

# Accepting partial payments after a default



## Learning Objectives

After reading this chapter, you will be able to:

- understand whether a mortgage holder's receipt of partial payment affects the foreclosure process;
- discuss a mortgage holder's options when accepting regular installment payments from an owner after they commit a default which cannot be cured by reinstatement; and
- identify the mortgage holder's options to accept or reject partial payments which are conditionalized by the owner.

## Key Terms

**assumption agreement** **reinstatement**

## The mortgage holder may continue to foreclose

Consider an owner of real estate that is encumbered by a mortgage who loses their primary source of income. As a result, the owner is unable to make mortgage installment payments. Negotiations with the mortgage holder to restructure the payment schedule in a *pre-foreclosure workout* are futile. The owner does not cure the default and the mortgage holder records a **Notice of Default (NOD)**.

On receipt of the *NOD*, the owner tenders some of the delinquent payments referenced in the notice. However, the owner does not tender all delinquent installments and foreclosure charges required to **reinstate** the mortgage and rescind the NOD. [See Chapter 42]

The mortgage holder accepts the owner's **partial payments**. Immediately after receipt, the mortgage holder sends the owner a letter notifying them:

- the mortgage is still in default;
- the amount needed to cure the default and bring the mortgage current; and
- the property remains in foreclosure, since the owner's partial payments were insufficient to *reinstate* the loan.

## Does acceptance waiver foreclosure rights?

Continuing form our previous example, the owner is also informed the foreclosure will continue until the mortgage is brought current or the property is sold at a trustee's sale. Ultimately, a trustee's sale is set by recording and posting a **Notice of Trustee's Sale (NOTS)**.

The owner challenges the validity of the NOTS, claiming the mortgage holder *waived its right* to complete the foreclosure by accepting the partial payment on the mortgage after recording the NOD.

The mortgage holder claims the foreclosure may proceed to the trustee's sale since the owner paid only part of the amount noticed as delinquent in the NOD, and thus the mortgage remained in default at all times after the NOD was recorded.

Can the mortgage holder proceed with the foreclosure sale after accepting partial payments of the delinquent amount noticed in the NOD?

Yes! By accepting *partial payments* after recording an NOD and then promptly making a written demand on the owner for the additional amounts required to reinstate the mortgage, the mortgage holder **does not waive** its right to complete the foreclosure process by its conduct. Only the owner's (or a junior mortgage holder's) **payment in full** of the delinquent amounts and foreclosure charges owed will reinstate the mortgage and rescind the NOD.[1]

## Non-waiver clause provides authorization

A *non-waiver clause* in the mortgage authorizes the mortgage holder to accept partial payments without waiving its right to foreclose since the note and trust deed have not been brought current and a delinquency remains.[2] [See Form 450 §3.2 in Chapter 13]

Thus, when a mortgage holder accepts a partial payment while the property is in foreclosure, to clarify its right to continue with foreclosure it needs to immediately notify the owner:

- the payment received does not reinstate the mortgage, the owner still remains in default and the property is subject to foreclosure;
- the dollar amount necessary to reinstate the mortgage and rescind the NOD; and

1 **Sellman** v. **Crosby** (1937) 20 CA2d 562

2 **M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002

- confirmation the mortgage holder retains the right to complete foreclosure on the property if the amount remaining to be paid to cure the default is not tendered prior to the expiration of the **reinstatement period**.[3]

**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.

If the conduct of the mortgage holder leads the owner to believe the default has been cured, which might occur if the mortgage holder fails to notify the owner the amount tendered is insufficient to bring the mortgage current, the mortgage holder is barred from continuing with the foreclosure.[4]

Additionally, when the trust deed contains an assignment of rents provision and the trust deed is in default, the mortgage holder is entitled to collect rents from the property owner or the tenants. Rents collected by the mortgage holder are then applied toward the amounts called for in the NOD to cure the default. The mortgage holder may continue with foreclosure on the real estate until the default is paid in full. [See Chapter 8]

## Partial payment on an incurable default

A mortgage holder accepting regular installment payments from an owner after declaring a default which cannot be cured by a reinstatement of the mortgage—a call for *full payoff*—waives its right to foreclose based on that default.

For example, consider a buyer who acquires property which is subject to a mortgage containing a **due-on-sale clause**. The buyer tenders the regularly scheduled mortgage payments directly to the mortgage holder but does not obtain the mortgage holder's waiver of the *due-on clause* by formally assuming the mortgage.

The mortgage holder, on later learning of the change in ownership, proposes a mortgage **assumption agreement** to modify the terms of the mortgage in exchange for waiving its right to call the mortgage. The buyer rejects the mortgage holder's offer. Further, the buyer continues to make the regularly scheduled payments to the mortgage holder as called for in the note. The mortgage holder accepts the buyer's payments without qualification.

**assumption agreement**
A promise given by a buyer to the seller or an existing mortgage holder to perform all the terms of the mortgage taken over by the buyer on the sale. [See **RPI** Form 431 and 432]

A year later, the mortgage holder sends the buyer a letter *calling the mortgage* and stating their further acceptance of mortgage payments will not constitute a waiver of the call. The buyer fails to pay the mortgage in full following the call, thus prompting the mortgage holder to initiate foreclosure on the buyer's property.

Here, the mortgage holder failed to *promptly enforce* its rights under the due-on-sale clause when it first learned of the transfer of ownership. The mortgage holder did not call the mortgage for a long period after it had knowledge of the change in ownership. Throughout the period during which it had knowledge of the transfer, it accepted regular mortgage payments from the buyer without first entering into a non-waiver agreement, also known as a **reservation of rights agreement**.

3 **Hunt** v. **Smyth** (1972) 25 CA3d 807
4 **Altman** v. **McCollum** (1951) 107 CA2d Supp. 847

Thus, the mortgage holder, by its conduct with the buyer, waived its right to enforce its due-on-sale clause on that transfer to the buyer by calling the mortgage.[5]

The mortgage holder's remedy for a violation of the due-on clause in a trust deed is limited to *calling the mortgage*. After making the call, the mortgage holder may attempt to negotiate a restructuring of the mortgage with the buyer if it so chooses.

However, the mortgage holder may not accept payments after the call has been made (without first entering into a *reservation of rights agreement*). A mortgage which has been called under a due-on clause cannot be reinstated after the call unless the mortgage holder permits it, since the call leaves but one payment due in the form of a balloon payment.

## Take the money and credit the mortgage

Some mortgage holders return partial payments tendered by an owner in default. However, mortgage holders are entitled to take the money and credit it to the amounts due. Still, some mortgage holders are under the mistaken belief that acceptance of the payment will bar them from completing their foreclosure on the property.

Mortgage holders may always accept payments tendered by the owner when the owner has the **right to reinstate** the mortgage, unless the owner imposes a condition upon the tender with an endorsement on the checks regarding a *disputed amount*.

In an attempt to evade the mortgage holder's foreclosure rights, property owners occasionally place conditions on the check they tender, stating the amount of the check is intended to fully cure the default or constitutes a rescission of the NOD. When this occurs, the mortgage holder is not required to accept the owner's **conditional tender**.[6]

The mortgage holder can return the *conditional tender* and inform the buyer that only a full payment of the amount due will cure the default and terminate the mortgage holder's right to proceed with the foreclosure on the real estate.

## Conflicting endorsement

Consider an owner of real estate who enters into a service contract employing a broker to obtain a lower property assessment on their property for the current and prior tax year.

The owner agrees to pay the broker a percentage of the tax savings received as payment for the services rendered. However, the owner believes they will only owe a percentage on one tax year's savings.

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5 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

6 Calif. Civil Code §1494

The broker obtains reduced assessments for the current and prior year. The owner pays for the broker's services based on the tax savings for only one year and writes an **endorsement** on the back of the check which states, "payment in full for all services."

The broker cashes the check without deleting the owner's *endorsement*. The broker promptly sends a letter to the owner stating the dollar amount of the check does not fully pay for all services performed and makes a claim on the owner for the remaining unpaid amount.

The owner claims the broker is barred from collecting any further amounts for their services since the check was deposited with "payment in full" printed on it.

The broker claims the acceptance of the check promptly followed by their notice to the owner that the amount was insufficient does not constitute payment in full.

Here, the broker's claim for the full payment of services is allowed since the broker promptly communicated with the owner that acceptance of the check did not constitute payment in full.[7]

A mortgage holder might be improperly motivated to refuse to accept any partial payment from an owner until the mortgage is brought current, in an effort to trigger additional monthly *late charges*—a source of low-cost revenue. Further, a mortgage holder can only collect one late fee per late payment, and can't charge late fees on late fees.[8]

Additionally, if a borrower makes partial payments that add up to the amount of a full monthly payment, the mortgage holder needs to accept the combined payments as a monthly payment.[9]

7 **In re Van Buren Plaza, LLC.** (1996) 200 BR 384
8 12 CFR §1026.36(c)(B)(iii)(2)
9 12 CFR §1026.36(c)(1)(ii)

## Chapter 46 Summary

A mortgage holder does not waive its right to complete the foreclosure process after recording a notice of default (NOD) when accepting partial payments as long as they promptly make a written demand on the owner for the additional amounts required to reinstate the mortgage. Only the owner's (or a junior mortgage holder's) payment in full of the delinquent amounts and foreclosure charges owed the mortgage holder will reinstate the mortgage.

A mortgage holder accepting regular installment payments from an owner when the default cannot be cured by a reinstatement of the mortgage waives its right to foreclose based on that default.

Some mortgage holders are under the mistaken belief that acceptance of the payment will bar them from completing their foreclosure on the property. However, mortgage holders are entitled to take the money and credit it to the amounts due.

Property owners occasionally place conditions on the partial payment check they tender, stating the amount of the check is intended to fully cure the default. Here, the mortgage holder is not required to accept the owner's conditional tender and may return it and inform the buyer only a full payment of the amount due will cure the default and terminate the mortgage holder's right to foreclose on the real estate.

## Chapter 46 Key Terms

**assumption agreement** ........ **pg. 527**
**reinstatement** ........ **pg. 527**

**Quiz 14 Covering Chapters 46-49 is located on page 635.**

Chapter 47

# A deed-in-lieu of foreclosure

## Learning Objectives

After reading this chapter, you will be able to:

- explain the advantages for a distressed owner unable or unwilling to make mortgage payments to negotiate a deed-in-lieu of foreclosure with the mortgage holder;
- identify when a deed-in-lieu functions as a deed absolute and a mortgage-in-fact;
- understand when a deed-in-lieu is void;
- discuss the mortgage holder's need for title insurance when accepting a deed-in-lieu; and
- identify when a deed-in-lieu triggers the due-on provision in a senior mortgage.

## Key Terms

**deed-in-lieu of foreclosure** **title insurance**

**mortgage-in-fact**

## Reducing the risk of loss

During vicious economic cycles of declining property values, a foreclosure sale of mortgaged property by a junior mortgage holder, such as a carryback seller or an equity lender, often leaves the lienholder unable to recover all the monies due on the debt. The same holds true for a first lienholder with a loan-to-value ratio (LTV) exceeding 94%, a condition called **negative equity**. [See Chapter 28]

When a property owner with *negative equity* defaults, a prudent mortgage holder first attempts to arrange for a **deed-in-lieu of foreclosure** before initiating a trustee's foreclosure. If arranged and agreed to by the owner, the mortgage holder will save the considerable time and money otherwise lost through foreclosure.

*Editor's note — The following deed-in-lieu rules also apply to a seller's recovery of a property by termination of the buyer's rights of redemption under* ***lease-options sales*** *and* ***land sales contracts***. [See Chapter 31]

## The deed-in-lieu is an exchange

A **deed-in-lieu** is prepared on the same grant deed form used for the conveyance of fee title. [See Form 406 accompanying this chapter]

**deed-in-lieu of foreclosure**
A grant deed conveying the mortgaged real estate to a mortgage holder which is accepted from the property owner in exchange for cancelling the mortgage debt to avoid foreclosure. [See **RPI** Form 406]

An owner of property who signs and delivers a deed-in-lieu essentially conveys their property to the mortgage holder *in exchange* for the mortgage holder cancelling the debt.

To complete the exchange, both the deed-in-lieu and a reconveyance of the trust deed are recorded. Thus, the lender-borrower relationship between the mortgage holder and the owner of the property is extinguished.

Before completing the exchange, the mortgage holder arranging a deed-in-lieu of foreclosure needs to consider:

- title insurance;
- purchase options;
- due-on clauses contained in the trust deed;
- potential reassessment of the property for property tax purposes; and
- the tax aspects of the transfer of title in exchange for cancellation of the debt.

## Deed absolute vs. a mortgage

For a deed-in-lieu to function as a **deed absolute**, the transaction needs to qualify as a **fair exchange** of values — a conveyance by the owner retaining no future interest in a property for a mortgage holder's complete cancellation of a debt. Thus, the owner agrees to a deed-in-lieu of foreclosure when they have little or no measurable net equity in their property in excess of the security interest under the mortgage.

Conversely, a deed-in-lieu does not function as a *deed absolute* but as a **mortgage-in-fact** when the property owner retains their rights to:

**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.

- cure their default and have the property reconveyed to them at a later date;
- receive a payment of surplus net proceeds if the mortgage holder later resells the property; or
- continue in possession of the property under a lease and purchase option. [See Chapter 17]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

**DEED-IN-LIEU OF FORECLOSURE**

**NOTE:** This form is used by a mortgage holder when the owner of a mortgaged property defaults and faces loss of the property by foreclosure, to transfer ownership of the property to the lender in exchange for the lender cancelling the trust deed note.

**DATE:** ______________, 20______, at ________________________________________, California.

**1.** I/We, ____________________________________________________________,
hereby quitclaim to ____________________________________________________________

1.1 all of my rights, title and interest in the real property situated in ________________________County, California, referred to as ____________________________________________________________
____________________________________________________________

**2.** This deed is an absolute conveyance in consideration for ________________________________________
____________________________________________________________ and

2.1 the cancellation and release of all rights and obligations arising from the document

2.2 entitled ________________________________________, dated __________________,

2.3 entered into by ________________________________, as the __________________, and

2.4 ________________________________________, as the __________________.

**3.** Grantor declares that this conveyance was freely and fairly made upon the consideration listed above, and no agreements exist, oral or written, except as contained in this deed, with respect to the described property.

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

Date: ______________, 20______ ________________________________________
*(Print name)* *(Signature)*

Date: ______________, 20______ ________________________________________
*(Print name)* *(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)*

**FORM 406** 03-15 

Form 406

Deed-in-Lieu of Foreclosure

## A voidable deed-in-lieu

A deed-in-lieu (or **quit claim deed**) handed to a mortgage holder before a default has actually occurred is voidable. Thus, it is unenforceable against the owner of the property who signed and delivered the deed when no default existed.

The premature delivery of the deed-in-lieu to the mortgage holder is usually performed for the purpose of eliminating the owner's reinstatement and redemption rights under a mortgage on the property. Here, the deed-in-lieu can be *set aside* as **void**.[1]

1 **Hamud** v. **Hawthorne** (1959) 52 C2d 78

For example, when a mortgage is originated or later modified, a deed-in-lieu is sometimes entered into by the owner, notarized and delivered unrecorded to the mortgage holder. The deed-in-lieu will be recorded by the mortgage holder on a default by the owner.

However, if the deed-in-lieu is recorded, it merely functions as a replacement mortgage for the existing trust deed mortgage to secure the debt it was intended to cancel. The premature deed-in-lieu is not a conveyance of ownership much in the same way a trust deed is not a conveyance of title. When recorded, the premature deed-in-lieu extinguishes and replaces the existing trust deed mortgage. Thus, the deed-in-lieu becomes a *mortgage-in-fact*. It also becomes the security device for the purpose of attaching the debt owed to the property.

The trust deed is no longer the security device attaching the debt as a lien on the property. The mortgage holder now holds title as security for repayment of the debt by the owner who now does not hold title but still owns the property. Here, a transfer of ownership did not occur since the deed-in-lieu is *void*.

The delivery of a deed-in-lieu in advance of a default is an *invalid waiver* of the **redemption rights** an owner holds under any debt secured by their real estate. Thus, if a default occurs after a mortgage holder has received a deed-in-lieu and the deed-in-lieu is recorded, the mortgage holder is forced to complete a **judicial foreclosure** to clear title in their name. [See Chapter 43]

Recording an ineffective deed-in-lieu creates a mortgage without the benefit of a trustee's foreclosure provision.[2]

## The need for title insurance

**title insurance**
A form of indemnity insurance by which a title insurance company holds harmless a person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that is not listed in the policy and the insured was unaware of when the policy was issued.

On recording a deed-in-lieu, a **title insurance** policy needs to be issued or endorsed to assure the mortgage holder that the title conveyed to them is still vested in the owner and is clear of liens or other types of junior encumbrances (easements) which may have been recorded after the mortgage holder's trust deed was recorded.

When any encumbrance exists on a property which is **junior in time** to the foreclosing seller's or equity lender's trust deed, a deed-in-lieu conveys title subject to that encumbrance on record.

Thus, it is imprudent for a mortgage holder to accept a deed-in-lieu and reconvey their trust deed if **junior liens** or conveyances which affect title to the property have been recorded after their mortgage was recorded. If the title has been further encumbered or conveyed, the mortgage holder needs to foreclose to eliminate these encumbrances and clear title to the property in their name (or the name of the highest bidder at the trustee's sale).

Title insurance companies view a deed-in-lieu with suspicion since the deed may be voidable as an invalid waiver of the owner's redemption right. Thus,

2 Calif. Civil Code §2889

special wording is required to signify the deed is a true conveyance, not a **disguised mortgage** with a lease and option allowing the owner to recover title and continue possession in the future.

To be insurable, the deed-in-lieu will state the transfer was freely and fairly entered into by the owner for **adequate consideration**. The deed also state whether the conveyance fully or partially satisfies the debt. [See Form 406]

Additionally, the title insurance company may require an **estoppel affidavit** from the owner, containing similar assurances that the deed-in-lieu is a *deed absolute*, not a mortgage-in-fact.

## Junior liens, a deed-in-lieu and merger

Consider an owner who contracts for renovations on property encumbered by a mortgage. The contractor is not paid on completion of the work. The contractor records a **mechanic's lien** on the property for the sums due for labor and materials.

The owner defaults on the mortgage and the mortgage holder records a notice of default (NOD). In a pre-foreclosure workout, the owner conveys the property to the mortgage holder by a deed-in-lieu of foreclosure in exchange for cancellation of the mortgage debt.

The mortgage holder, who is now the owner of the property, discovers the existence of the junior mechanic's lien and records an NOD under their trust deed. The mortgage holder acquires ownership of the property at the trustee's sale. The contractor holding the mechanic's lien now seeks to foreclose on their lien and clear title of the mortgage holder's interests in the property.

The contractor claims the mortgage holder's right to foreclose under their trust deed was eliminated and the trustee's sale is void since the security interest under the trust deed and title merged on recording the deed-in-lieu eliminating the trust deed.

Is the mechanic's lien eliminated by the trustee's foreclosure sale?

Yes! The contractor has no interest in the property to foreclose. Here, a merger of title did not occur on recording the deed-in-lieu due to the intervening mechanic's lien. Thus, the trust deed holder was not barred from foreclosing under their trust deed and eliminating the mechanic's lien by the trustee's sale — after becoming the owner under the deed-in-lieu of foreclosure.[3]

As a long established rule, when a mortgage holder accepts a deed-in-lieu of foreclosure from an owner in default, the trust deed and title do not merge to eliminate the trust deed when a junior lien exists on title. Thus, the mortgage holder retains the right to foreclose and eliminate any junior liens encumbering the property, even though they became the owner of the property before foreclosing.

3 **Decon Group Inc** v. **Prudential Mortgage Capital Company, LLC** (June 30, 2014) 227 CA4th 665

## Incentive to stay or convey

An owner who defaults on a mortgage is more inclined to agree to deliver a deed-in-lieu of foreclosure when their gross equity in the property is less than 10% of the property's current fair market value (FMV). Additionally, the mortgage holder will take a loss on the foreclosure and resale of the property if the owner's equity is less than 10%, possibly even 15%, of the property's current FMV.

However, when the owner has little or no equity to lose, the mortgage holder may need to offer some greater incentive beyond cancellation of the mortgage note in exchange for title to the property. One incentive the mortgage holder may offer for a deed-in-lieu is a relatively small amount of "move-out" cash — **key money** — which is acceptable to the owner, in addition to the mortgage holder erasing the debt.

The incentive to enter into a deed-in-lieu may also include non-cash considerations, such as an agreement which permits the owner to continue occupying the property after the conveyance solely as a holdover tenant. [See **RPI** Form 272]

*Editor's note — An option to repurchase accompanying the right to retain possession of the property under a lease may not be granted to the buyer. Doing so converts the deed-in-lieu into a mortgage-in-fact.*[4] *[See Chapter 17 and 18]*

The prudent mortgage holder weighs their money expenditures and lost interest involved in completing a foreclosure against the amount of cash or other forms of consideration they might offer the owner in order to obtain a deed-in-lieu and possession of the property. It is the price paid to avoid a delay in foreclosing on the property. [See Form 406]

## Due-on-sale triggered

For a junior lienholder, taking title to real estate by a deed-in-lieu has some of the same effects as receiving a trustee's deed on foreclosure. Both trigger any **due-on clause** in the senior trust deed.

Whether repossessing property by foreclosure or a deed-in-lieu, the junior lienholder needs to consider negotiating with the senior mortgage holder for a waiver of its due-on enforcement rights before they reinstate the senior lender's mortgage. [See Chapter 26]

## Profit reporting consequences

Unlike lenders, carryback sellers who take back the property they sold, either by way of a trustee's sale or deed-in-lieu, cannot report a profit or loss on the exchange of the cancelled carryback note for title to the property. The current value of the property is of no concern to the government for tax reporting purposes.

However, the tax consequence of the original sale in which the carryback paper was created is reanalyzed. Taxwise, any portion of the down payment and principal paid in the installments which were not previously taxed are now **taxed on repossession** of the property.[5]

4 Calif. Code of Civil Procedure §744

5 Internal Revenue Code §1038

## Reassessment by the county assessor

Whether a seller obtains title through foreclosure or a deed-in-lieu, a **change of ownership** occurs. This event calls for a *reassessment* of the property for determining local property taxes.

The property will be reassessed by the county assessor at its current market value on receipt of a deed-in-lieu or a trustee's deed.

## Chapter 47 Summary

When a property owner with a negative equity defaults, a prudent mortgage holder first attempts to arrange for a deed-in-lieu of foreclosure before initiating a trustee's foreclosure. If arranged, the mortgage holder will save the considerable costs and time lost by foreclosing.

A deed-in-lieu handed to a mortgage holder before a default has actually occurred is voidable. Thus, it is unenforceable against the owner of the property who signed and delivered the deed when no default existed.

Title insurance companies view a deed-in-lieu with suspicion since the deed may be voidable as an invalid waiver of the owner's redemption right. Thus, special wording is required to signify the deed is a true conveyance, not a disguised mortgage with a lease and option allowing the owner to recover title.

When a mortgage holder accepts a deed-in-lieu of foreclosure from an owner in default, the trust deed and title do not merge to eliminate the trust deed when a junior lien exists on title.

The prudent mortgage holder weighs their money expenditures and lost interest involved in completing a foreclosure against the amount of cash or other forms of consideration they might offer the owner in order to obtain a deed-in-lieu and possession of the property.

For a junior mortgage holder, taking title to real estate by a deed-in-lieu has some of the same effects as receiving a trustee's deed on foreclosure.

Carryback sellers who take back the property they sold, either by way of a trustee's sale or deed-in-lieu, cannot report a profit or loss on the exchange of the canceled carryback note for title to the property.

## Chapter 47 Key Terms



**Quiz 14 Covering Chapters 46-49 is located on page 635.**

*Notes:*

Chapter 48

# Trustee's or attorney fees, not both

## Learning Objectives

After reading this chapter, you will be able to:

- identify the maximum amount of trustee's or attorney fees collectible on a judicial or nonjudicial foreclosure of a mortgage lien; and
- identify the different stages of the judicial and nonjudicial foreclosure process.

## Key Terms

**foreclosure decree**

**specific performance action**

## The three-stage foreclosure period

Consider a lender who originates a second mortgage for an owner of real estate secured by the property they own. The amount of the mortgage equals 10% of the property's value. Together with the amount of the first mortgage, the property is encumbered with a total *loan-to-value ratio (LTV)* of 85%.

The lender, as mortgage holder, is willing to accept the risk of a high LTV ratio on the property in order to receive a higher-than-market interest rate.

The mortgage holder perceives the present real estate market to be dynamic enough to support a continuing rise in resale prices beyond the due date of the mortgage. Additionally, the owner has a significant liquid net worth independent of their equity in the property.

The owner later defaults on the second mortgage.

The mortgage holder pursues recovery of the mortgage amount from the sale of the secured property by concurrently:

- recording a *Notice of Default* (NOD) using a trustee to initiate a nonjudicial foreclosure and sale; and
- filing a court action to initiate a judicial foreclosure and sale.

**specific performance action**
An action to compel performance of an agreement, such as a purchase agreement or assignment of rents.

No **specific performance action** is filed to appoint a receiver to enforce the collection of rents under the *assignment of rents* provision in the trust deed. [See Chapter 15]

Prior to the sale of the property by either a judicial or nonjudicial foreclosure, the mortgage holder orders an appraisal of the property to determine its present **fair market value (FMV).** The mortgage holder reasons if the property's FMV is sufficiently high to cover the amount remaining due on the first and second mortgages and the costs of the property's resale, the trustee's sale will be completed and the judicial foreclosure action dismissed.

However, the appraisal may indicate the property's FMV is insufficient for the mortgage holder to recover their entire mortgage balance plus accrued interest and foreclosure/resale costs from the value of the property. If insufficient value exists, the mortgage holder will pursue a **money judgment** against the owner under the judicial foreclosure action for the deficiency in the property's FMV on the date of the judicial sale to cover the recourse debt.

On the sale of the property under the judicial foreclosure action, the mortgage holder will abandon the trustee's foreclosure by rescinding the NOD.

## Reinstatement of the mortgage

Prior to entering a **foreclosure decree** in the judicial foreclosure action, or the expiration of the reinstatement period in the trustee's foreclosure, the owner locates investors who join the owner as co-owners of the property, contributing capital to fund a reinstatement of the mortgage. [See Chapter 43]

With the investors' additional capital, the owner tenders the amount owed to reinstate the mortgage, consisting of:

**foreclosure decree**
Decree by a court ordering the sale of mortgaged property and the payment of the debt owing to the lender out of the proceeds.

- the delinquent payments of principal and interest;
- the late charges properly noticed and accounted for;
- any advance made by the mortgage holder;
- any delinquent property taxes; and
- trustee's fees authorized by foreclosure statutes.[1]

The mortgage holder refuses tender of the money, claiming the tender of no more than the *statutory trustees' fees* is insufficient to reimburse the mortgage holder for handling the NOD and notice of trustee's sale (NOTS) and attorney fees incurred to litigate the judicial foreclosure action. Together, these fees collectively exceed the statutory ceiling on foreclosure fees chargeable by trustees or attorneys.

1 Calif. Civil Code §2924c

The mortgage holder claims the reinstatement statute is unreasonable and cannot be applied to attorney fees in a judicial foreclosure action, since reasonable fees far exceed the statutory limits set for attorney fees collectible in foreclosure actions.

Is the mortgage holder limited to accepting the amount of the statutory ceiling for the total of both the trustee's fees and attorney fees, despite the fact that reasonable attorney fees in the foreclosure action run far in excess of the statutory limit?

Yes! The owner tendered the correct amount to bring the mortgage current before entry of a foreclosure decree in the judicial action or commencement of the five business day redemption period prior to a trustee's sale.

## Uncollectable double set of fees

A collection of attorney fees incurred to *litigate the judicial foreclosure*, in addition to the trustee's fees, is prohibited. They are prohibited since attorney fees are controlled by the statutory limit on both trustee's fees and attorney fees.[2]

While a double set of fees was reasonably incurred by the mortgage holder in its pursuit to recover the mortgage amount from the sale of the secured property, the mortgage holder is unable to collect both the trustee's fees and the attorney fees from the owner. One or the other is permissible, but not both, and the option is controlled by the property owner.

## Time periods during foreclosure

The maximum amount of trustee's fees and attorney fees a foreclosing mortgage holder may recover in a judicial or trustee's foreclosure is dependent on the stage of the foreclosure proceeding. [See Chapter 42]

The mortgage holder may foreclose on secured property by filing a judicial action or by instructing the trustee to record an NOD. Alternatively, the mortgage holder may initiate both remedies concurrently, as previously demonstrated.

If a *mortgage holder completes* one of the foreclosure procedures, the mortgage holder's other foreclosure procedure is then eliminated. However, commencement of one foreclosure remedy without completion by a foreclosure sale does not preclude the commencement and completion of the other.[3]

Strategically, mortgage holders may commence foreclosure by both recording a trustee's NOD and filing a judicial foreclosure action. However, *costs recoverable* on the double foreclosure, as distinguished from trustee's fees and attorney fees, are limited to only one set of costs.

2 **Bruntz** v. **Alfaro** (1989) 212 CA3d 411

3 **Vlahovich** v. **Cruz** (1989) 213 CA3d 317

Mortgage holders initiating a foreclosure on a *recourse mortgage* need to consider promptly beginning a trustee's sale by recording an NOD on the borrower's default. Immediate recording expedites the sale of the property, as any delay is disadvantageous to the mortgage holder.

Then, an appraisal of the property's FMV is obtained by the mortgage holder before completing the foreclosure to determine whether the property's value is sufficient to recover the mortgage amount and related costs. [See Form 303 in Chapter 30]

If the property's value is insufficient to satisfy the recourse debt and related costs, the mortgage holder then considers delaying the setting of the trustee's sale and filing a judicial foreclosure action to *obtain a decree* ordering the property to be sold by a sheriff.

By resorting to a judicial foreclosure sale and abandoning the trustee's foreclosure, the mortgage holder holding a recourse mortgage is able to pursue a *money judgment* for any deficiency in the property's FMV at the time the property is sold at the judicially ordered sheriff's sale.

If the value of the property increases prior to the judicial foreclosure sale, or the mortgage holder wishes to expedite foreclosure of the property, the trustee's sale may be held and the judicial action dismissed.

However, mortgage holders who foreclose by initiating concurrent trustee's and judicial foreclosure proceedings cannot collect the fees incurred to prosecute both foreclosure proceedings when the property owner reinstates the mortgage or redeems the property by payment in full.

## Limits on attorney fees

Attorney fees are only collectible in an action for *judicial foreclosure* at two times:

- on the owner's reinstatement of the note and trust deed prior to the foreclosure decree, in the amount allowed by statute for trustee's fees or attorney fees; or
- on completion of the judicial foreclosure, in an amount deemed reasonable by the court.[4]

However, on reinstatement of the mortgage, the trustee in the concurrent trustee's foreclosure will rescind the recorded NOD and demand payment of trustee's fees from the mortgage holder. In the process of reinstatement, the mortgage holder will be reimbursed for the trustee's fees, but not for the attorney fees.

Only the statutory fees are permitted to be recovered by the mortgage holder from the property owner as reimbursement.

If the owner fails to reinstate the note and the mortgage holder sells the property in a trustee's foreclosure sale, the mortgage holder only recovers fees expended for foreclosing nonjudicially. A mortgage holder is not allowed

4 CC §2924c(d); Calif. Code of Civil Procedure §726(a)

to recover attorney fees incurred in a concurrent judicial foreclosure action. If the mortgage holder was allowed to do so, the mortgage holder would receive an improper double recovery of foreclosure fees.

## Statutory limits on fees

When a mortgage is in default and the mortgage is reinstated during the foreclosure process, the mortgage holder is limited by statutory fee schedules to reimbursement of a maximum amount for trustee's or attorney fees.

The owner or junior lienholder may *reinstate* a defaulted trust deed lien prior to the earlier of:

- entry of a foreclosure decree in a judicial foreclosure action; or
- five business days before the date set for the trustee's sale.[5] [See Chapter 42]

The *foreclosure fee schedule* for trustee's fees (or attorney fees) recoverable by a mortgage holder during the stage of a trustee's foreclosure following the recording of an NOD and before recording an NOTS, is limited to:

- $350 for the first $50,000 of the mortgage balance; or
- $350 for mortgages exceeding $50,000 of the mortgage balance; plus
- 0.5% of the unpaid principal between $50,000 and $150,000; plus
- 0.25% of the unpaid principal between $150,000 and $500,000; plus
- 0.125% of the unpaid principal balance exceeding $500,000.[6]

## Limits during the NOTS stage

However, after an NOTS in a trustee's foreclosure has been deposited in the mail, the trustee's fee schedule for the maximum trustee's fee changes. The mortgage holder during the *NOTS stage*, which ends with the completion of the trustee's sale of the property, can recover fees limited to:

- $475 if the mortgage balance is $50,000 or less;
- $475 if the mortgage balance is between $50,000 plus 1% of the unpaid principal balance between $50,000 and $150,000;
- $410 if the mortgage balance is greater than $150,000; plus
- 1% of the unpaid principal balance between $50,000 and $150,000; plus
- 0.5% of the unpaid principal balance between $150,000 and $500,000; plus
- 0.25% of the unpaid principal balance exceeding $500,000.[7]

When the property is sold at a *trustee's sale*, the maximum increase in statutory trustee's fees or attorney fees is limited to the greater of:

- $475; or
- 1% of the principal balance on the date of the NOD.[8]

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5 CC §2924c(e)
6 CC §2924c(d)
7 CC §2924d(a)
8 CC §2924d(b)

For *judicial foreclosures*, attorney fees are fixed at the NOD fee schedule for reinstatement until entry of the **foreclosure decree**. As part of the *foreclosure decree*, attorney fees may be awarded for legal services rendered in excess of the statutory limits, so long as a court deems them reasonable. Unless a deficiency is awarded, the extra fee incurred to litigate the judicial sheriff's sale is not to be awarded since a trustees sale accomplishes the same end result in less time (and for less money).[9]

## Attorney fees unrelated to foreclosure

Often, a mortgage holder is required to file a lawsuit to defend its security interest as a lien on title or to maintain the value of the property. Here, the litigation is separate from any judicial or trustee's sale foreclosure procedures which may or may not be concurrently in process. The attorney fees expended in a separate action are unrelated to the trustee's fees or attorney fees incurred to foreclose.

Defending the mortgage holder's security interest is not a foreclosure action. For example, consider an owner who defaults on a mortgage containing an **attorney fees** provision. The mortgage holder initiates a trustee's foreclosure. In response, the owner files a lawsuit to stop the foreclosure.

The owner claims the foreclosure was commenced solely to satisfy the mortgage holder's desire to acquire the real estate for investment purposes during a real estate recession. It would be impossible for the owner to realize the property's full value by selling it during this recessionary period.

The mortgage holder prevails and is allowed to continue with the trustee's foreclosure. In the process, out-of-pocket costs and attorney fees have been incurred by the mortgage holder to defend its right to foreclose on the property.

The attorney fees awarded in the judicial action are added to the property owner's mortgage balance by the mortgage holder as a **future advance** authorized by the trust deed. On a reinstatement demand requested by the owner, the mortgage holder requires the attorney fees be paid before the owner may bring the mortgage current by reinstating the loan.

The owner claims the attorney fees are limited under reinstatement law since the mortgage holder's attorney fees were incurred during the reinstatement period.

Can the mortgage holder collect the full amount of its award for attorney fees incurred in the non-foreclosure action?

Yes! The attorney fees were incurred in litigation initiated to protect the mortgage holder's rights, not to initiate and litigate a judicial foreclosure. Accordingly, and in addition to trustee's fees, the mortgage holder can collect the award for attorney fees under the attorney fees provision in the trust deed. The attorney fees are limited to a reasonable and necessary amount.[10]

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9 CCP §580c

10 **Buck** v. **Barb** (1983) 147 CA3d 920

Attorney fees paid by the mortgage holder are considered *future advances* when the fees are incurred to protect the mortgage holder's security interest in the property and the fees are secured by the property under the terms of the mortgage.[11] [See Form 450 §§1.3d, 2.3 and 2.5; see Chapter 13]

11 **Bisno** v. **Sax** (1959) 175 CA2d 714

## Chapter 48 Summary

The mortgage holder's collection of attorney fees incurred to litigate a judicial foreclosure, in addition to the trustee's fees, is prohibited under statutory limits on both trustee's fees and attorney fees.

The maximum amount of trustee's fees and attorney fees a foreclosing mortgage holder may recover in a judicial or trustee's foreclosure proceeding is set depending on the stage of the foreclosure proceeding during which they are incurred.

If the owner fails to reinstate the mortgage and the mortgage holder sells the property at a trustee's foreclosure sale, the mortgage holder will only recover fees expended for foreclosing nonjudicially. A mortgage holder will not be allowed to recover the attorney fees incurred in a concurrent judicial foreclosure action.

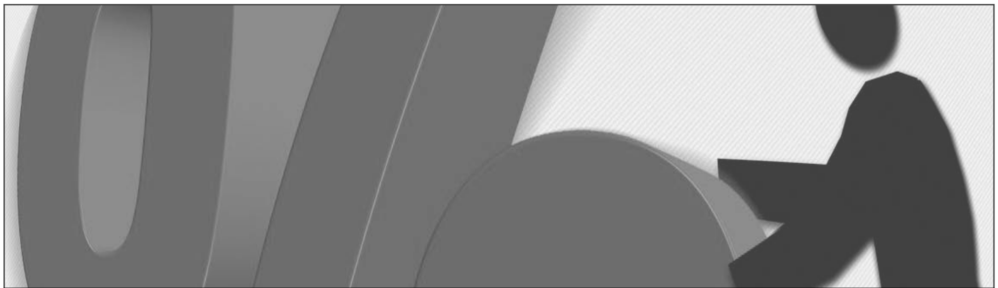
For judicial foreclosures, attorney fees are fixed at the notice of default (NOD) fee schedule for reinstatement until entry of the foreclosure decree. As part of the foreclosure decree, attorney fees may be awarded for legal services rendered in excess of the statutory limits, so long as a court deems them reasonable.

## Chapter 48 Key Terms



**Quiz 14 Covering Chapters 46-49 is located on page 635.**

*Notes:*



Chapter 49

# Deduction of mortgage points

## Learning Objectives

After reading this chapter, you will be able to:

- explain how interest on home mortgages is treated differently from interest on business, rental or portfolio mortgages for income tax purposes;
- describe how points are capitalized or deducted from income taxes;
- identify the differences between seller- and lender-paid points; and
- explain how refinancing affects income-tax reporting for points paid on permanent financing.

## Key Terms

**nominal interest rate** **personal use loan**

## Homeowner's prepaid interest accrual exception

Interest on a mortgage debt *accrues daily* over the life of the mortgage. In contrast, a mortgage holder's *penalty charge* accrues in its entirety on the occurrence or failure of an event to occur, such as a prepayment penalty or late charge.

Taxwise, **interest**, no matter the form it may take, which has accrued and been paid on a mortgage can be written off when determining income tax liability if the interest qualifies as either an *expense* or *deduction* from income.

For example, accrued interest paid on a mortgage, the proceeds of which funded a person's **trade or business activities**, is written off as an *operating expense* of the person's business.

Conversely, accrued interest paid on a mortgage that funded the purchase, improvement or carrying costs of a **rental property** is not an **operating expense** incurred by the property. Thus, mortgage debt on a rental property is not considered when establishing the property's *net operating income (NOI).* However, this interest is written off as a **deduction** from the NOI produced by the specific rental property (much like the deduction for depreciation allowance) called **tracking**. [See **RPI** Form 352]

## Accrued interest on portfolio property

Somewhat different from accounting for interest on a business or rental property, accrued interest paid on a mortgage that funded the purchase, improvement or carrying costs of **portfolio property** held for long-term profit is written off as a **deduction** against any income and profit from all sources within the portfolio income category. This is the case for:

- ground leases;
- management-free, net leases; or
- land held for profit on resale.

Then, the income or loss within each of the three different income categories is calculated independent of each other category. As a result, the reportable income or loss within one category is not commingled with income from any other category, at least not at the category stage of accounting.

## Personal use loans

**personal use loan**
A mortgage origination which funds a personal use, such as a loan that funds the purchase or improvement of an owner's principal residence or second home.

In contrast, home mortgages are treated differently from mortgages for business, rental or portfolio purposes. A mortgage that funds the purchase or improvement of an owner's **principal residence** or **second home** is classified as a **personal use loan**. Accrued interest paid on personal use debts, generally a mortgage for the purchase or improvement of an owner's principal residence or second home, is not tax deductible, with some exceptions.

One exception to the non-deductibility rule is interest paid on mortgages **made in connection with** the principal and second residence beyond providing security for payment of the mortgage.

Under the **non-deductibility exception**, interest accrued and paid on a mortgage for a first and second home is written off as a deduction from the owner's adjusted gross income (AGI) once the AGI has been set. Thus, the home mortgage interest becomes part of the schedule A *itemized deductions* from AGI. This treatment directly reduces the homeowner's taxable income, not their adjusted gross income. Thus, the amount on which they will pay taxes is reduced by the deductions.

## The federal objective

The government *subsidizes* homeownership through interest deductions on home mortgages by reducing the income taxes a homeowner pays. The amount of tax reduction ranges from 10% and 15% for low-income homeowners, to over 39% for high-income homeowners depending on the amount of interest they pay.

Thus, benefits of the interest deduction are not felt uniformly. The wealthier one is, to a point, the greater the subsidy for homeownership.

Limitations on wealthier homeowners are imposed by the itemized deductions phase out and the **alternative minimum tax (AMT)** restrictions on allowable personal deductions.

Wealthier homeowners who are subject to the *AMT* and have encumbered their first or second home with a home equity line of credit (HELOC) or refinanced it and used the net proceeds for purposes other than the improvement of, or in connection with, the first or second home are not allowed to deduct the interest paid on these mortgage amounts which are not connected to the purchase or improvement of the first and second home.[1]

*Editor's note — 26 United States Code (26 USC) is the Internal Revenue Code (IRC).*

The sole basis for allowing the personal interest deduction for a mortgage on a first and second residence is the **federal policy** of encouraging homeownership over tenancy.

The social policy is propagandized by the use of the slogan "The American Dream" and implemented through tax incentives and mortgage guarantees and thus lower interest rates for mortgages held by federally sponsored mortgage holders such as Freddie Mac or Ginnie Mae.

The rationale of the federal policy is that homeowners generally require less government assistance in their elder years and make more responsible local citizens.

## The points of interest as further subsidies

Points paid to a lender to originate a mortgage are considered **prepaid interest**. Points are interest, but the interest has not yet accrued as required for expensing or deduction, unless an exception exits.Points essentially buy down the mortgage's *par rate* for the life of the mortgage to the interest rate denominated in the note.

No points on origination of a mortgage mean the **nominal interest rate** stated in the note is the market rate.

> **nominal interest rate**
> The interest rate agreed to between the homebuyer and the lender as stated on the promissory note.

As *prepaid interest*, only the fraction of the points paid which accrues each month over the life of the mortgage, called the *life-of-loan accrual*, may be

1 26 United States Code §56(e)(1)

**Homeownership through tax incentives**

*Income tax law is often used as a tool by the federal government for social engineering.*

*The social purpose for allowing immediate deduction of points is to encourage tenants to purchase homes.*

*However, a tenant compares the amount of their rent payment with the amount of their potential house payment when deciding to take on the status of homeowner. Since the house payment for new homeowners is typically greater than the rental payment for a comparable property in California, the encouragement has little effect.*

*While the deduction of loan origination points is financial aid during the new homeowner's first year of increased living costs, the homeowner's tax relief in the following years is limited only to the interest included in the monthly payments and property taxes paid.*

*However, the deduction of points in the year of closing is more effective in inducing sustainable long-term homeownership than other tax incentives. The deduction of points is not a direct subsidy designed to bailout builders and REO lenders, such as a tax credit for buying a newly constructed home.*

*Tax credits often encourage financially unprepared buyers to purchase homes, shifting the risk of ownership from overextended lenders and builders to homeowners.*

deducted against that year's income, with exceptions. When the mortgage amount is fully prepaid, any remaining un-accrued prepaid interest can then be deducted.

As an exception to the **life-of-loan** accrued reporting, the entire amount of the points paid on mortgages that assist in the purchase or improvement of an individual's **principal residence** (not a second home or vacation residence) is allowed as a *personal deduction* in the year the mortgage was originated.

The immediate deduction for all points paid in connection with a mortgage that finances the purchase or improvement of the taxpayer's primary home is another government subsidy to encourage homeownership in lieu of renting.[2]

Further, the deductibility of the mortgage points in the year paid, instead of over the life of the mortgage, depends on *who paid the points*— the buyer, the seller or the lender.

## Who pays?

Consider a homebuyer who applies for a mortgage to fund the purchase of property they will occupy as their principal residence. The lender will be paid points (prepaid interest) for making a purchase-assist mortgage at

2 26 USC §461(g)(2)

an interest rate below the **par rate** for the mortgage. The lender will not withhold the points from the mortgage proceeds (as a discount) or add them to the mortgage balance.

Instead, the points will be paid by either the homebuyer from their separate funds, or by the seller, under the terms negotiated by the buyer and their (well-informed) agent in the purchase agreement.

In this situation, the homebuyer can write off the points paid to the lender as a **current deduction** from their adjusted gross income (AGI), since:

- the mortgage proceeds are used to *purchase or improve* the borrower's principal residence;
- the mortgage is *secured* by the principal residence, with or without any additional security;
- the Uniform Settlement Statement (HUD-1) accounts for the points paid as "points," "mortgage origination fees," "mortgage discount" or "discount points," and computes them as a percentage of the mortgage;
- the points were paid by the seller or from the buyer's separate funds, not as a discount or add-on by the lender;
- the payment of points is an established business practice of lenders in the area; and
- the points paid do not exceed the amount of points generally charged in the surrounding area.[3]

## Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement mortgage needs to be *secured by* a buyer's or homeowner's principal residence.

When the mortgage is secured solely by property other than the residence purchased or improved with the mortgage funds, such as business or rental property owned by the homeowner or others, the points are then deducted over the life of the mortgage.

Likewise, points paid by a buyer to finance the purchase or improvement for a *second residence* need to be deducted as they accrue over the life of the mortgage. For example, points paid on a purchase-assist mortgage for a vacation home, payable monthly with a 30-year amortization schedule, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

## Deduction of lender itemized charges

Now consider a homeowner who obtains a home improvement mortgage secured by their **principal residence**.

The homeowner pays 2½ points on the mortgage from their separate funds. One of the points is called a *mortgage origination fee* and is a competitive amount.

3 Revenue Procedure 92-12

Here, the points, even when they are called mortgage origination fees, are considered prepaid interest. An origination fee is fully deductible if the fee is **based on a percentage** of the homeowner's mortgage amount.

The owner also pays mortgage charges itemized by the lender to include:

- administrative fees;
- processing fees;
- appraisal fees; and
- title expenses.

Can the owner deduct these itemized lender charges in the year they are paid?

No! These itemized charges reimburse the lender for **costs incurred** to originate the mortgage. Lender costs reimbursed by the borrower are not considered prepaid interest and are not deductible either at the time they are paid or over the life of the mortgage.[4]

## Capitalized costs

*Mortgage costs* incurred by the lender and paid by the owner on any type of real estate to originate a purchase or improvement mortgage are *capitalized* by the owner. Thus, mortgage costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted or expensed as interest. Mortgage charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which can be expensed or deducted as it accrues and is paid or was prepaid.[5]

**Capitalized costs** for originating a mortgage on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

## Seller-paid points

Consider a homebuyer who lacks sufficient funds or incentive to pay the points required to obtain a home mortgage. The buyer negotiates for the seller to pay the points so the property can be sold, documented by a provision in their offer to purchase the property.

In this instance, the homebuyer is allowed to deduct the points paid by the seller to assist the buyer in originating a purchase-assist mortgage. When the *seller pays the points*, the homebuyer is considered to have received **cash back** from the seller in the amount of the points. The cash is then used to pay the points as though the cash had come from the buyer's *separate funds*.[6]

However, when the seller pays the points and the buyer deducts the amount as prepaid interest, the buyer's *cost basis* in the residence is adjusted to reflect a **reduction in the price paid** by the dollar amount of the seller-paid points. The seller who paid the points expenses the amount as part of their costs of the sale, not as interest paid by the buyer's use of the cash.

4 26 USC §163; Rev. Proc. 94-27

5 **Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179

6 Rev. Proc. 94-27

This tax treatment for the seller makes a financial difference. Here, if the seller's principal residence is sold at a loss they can deduct them since points are interest. If it is costs of a sale, they cannot take a loss.

## Lender-paid points

Consider a homebuyer who lacks sufficient funds to pay the points demanded by a lender for the interest rate sought on a 30-year purchase-assist mortgage. Additionally, the seller refuses to pay any of the points without renegotiating the purchase price of the property.

The lender agrees to increase the mortgage amount and withhold the points from the mortgage proceeds as a **discount**.

Can the homebuyer deduct the points paid from the mortgage proceeds in the year the points are paid from mortgage funds?

No! The homebuyer did not pay the points from separate funds, either their own or funds they received from the seller. The points were paid as a *discount*, or an add-on, to the mortgage. The points, being prepaid interest withheld by the lender, need to be deducted annually as they accrue over the 360-month life of the 30-year mortgage.

## Deduction of points on refinancing

Consider a homeowner who refinances the existing purchase-assist or improvement mortgage on their principal residence. Mortgage points for the refinancing are paid from their separate funds.

Here, the **refinancing** did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement mortgage. Thus, the points on a refinance are annually written off as they accrue monthly over the life of the mortgage.

However, if a homeowner uses the **excess mortgage proceeds** from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the mortgage funds which paid for improvements) can be deducted in the year the homeowner refinanced their personal residence.[7]

When the homeowner sells their residence or refinances again, the unaccrued points remaining on the existing mortgage are reported (with itemized deductions) as interest paid in the year of the sale, whether the mortgage is paid off or assumed by a buyer.

## Permitted deductions on a refinance

Consider a different homeowner who refinances their principal residence to reduce their monthly payment by $500. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms.

7 Revenue Ruling 87-22

The homeowner deducts all the points they paid for refinancing in the year they refinanced as an itemized deduction on their federal income tax return. The homeowner claims the refinancing freed up money for the improvements and was thus a property improvement mortgage.

The Internal Revenue Service (IRS) disallows the deduction, claiming the refinancing merely funded the payoff of an existing mortgage on the property with no net mortgage proceeds for any improvements.

In this scenario, the deduction of all the points paid to refinance the existing mortgage is permitted. The refinancing was a loan the homeowner incurred **in connection with the improvement** of their property. The reduction in payments caused the homeowner to have funds to pay for the improvements they then made on the property.[8]

## Refinancing short-term financing

Consider a homebuyer who executes a short-term note with a three-year balloon payment to help finance the purchase of their principal residence. The short-term note, which is secured by the residence, is a type of *swing loan* or *bridge loan* which needs to be refinanced if the buyer is to continue their ownership of the residence as intended.

When the short-term note becomes due, the homebuyer obtains permanent long-term financing. The short-term note is paid off with the proceeds of the permanent financing.

The homebuyer deducts the entire amount of the points paid on the long-term refinancing in the year paid. The buyer claims the permanent financing was part of their original scheme to finance the long-term ownership of their principal residence, and was not a simple refinance.

The Internal Revenue Service (IRS) claims the homebuyer cannot deduct the points paid on the permanent financing since, to be entitled to an immediate deduction as a mortgage made in *connection with the acquisition* of the principal residence, the points need to be paid on a mortgage made to directly fund the actual purchase or improvement of the owner's principal residence.

Here, the points paid on the long-term refinancing of a short-term balloon payment note are deductible in their entirety in the year the points are paid.

The existence of a **short-term due date** in the note originated as a purchase-assist mortgage was evidence that the homebuyer contemplated refinancing the short-term note to retain the residence for long-term ownership.[9]

The long-term mortgage, while it did not directly fund the purchase of the residence, was obtained in connection with the purchase of the residence. The refinancing occurred within the original term of the short-term balloon payment note, which by its nature compelled the refinancing.[10]

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8 Tax Court Summary Opinion 2005-125 (non-precedent)

9 **Huntsman** v. **Commissioner of Internal Revenue** (8th Cir. 1990) 905 F2d 1182

10 26 USC §461(g)(2)

## Chapter 49 Summary

Taxwise, interest, no matter the form it takes, which has accrued and been paid on a mortgage can be written off when determining income tax liability if the interest qualifies as either an expense or deduction from income.

The government subsidizes homeownership through interest deductions on home mortgages. Deductions reduce the total taxes the homeowner is required to pay. The amount of tax savings range from 10% and 15% for low-income homeowners, to 35% for high-income homeowners on the amount of interest they pay. Thus, the wealthier one is, to a point, the greater the subsidy for homeownership.

Points essentially buy down the mortgage's par rate for the life of the mortgage to the interest rate denominated in the note. No points means a higher nominal interest rate will be stated in the note.

When the mortgage is secured solely by property other than the residence purchased or improved with the mortgage funds, such as business or rental property owned by the homeowner or others, the points need to be deducted over the life of the mortgage.

When the seller pays the points, the homebuyer is considered to have received cash back from the seller in the amount of the points. The cash is then used to pay the points as though the cash had come from the buyer's separate funds.

If a homeowner uses the excess mortgage proceeds from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the mortgage funds which paid for improvements) can be deducted in the year the homeowner refinanced their personal residence.

## Chapter 49 Key Terms



**Quiz 14 Covering Chapters 46-49 is located on page 635.**

*Notes:*

# Chapter 50

# Home mortgage interest deductions

## Learning Objectives

After reading this chapter, you will be able to:

- understand the intent of government policies encouraging tenants to become homeowners through the mortgage interest tax deduction (MID);
- distinguish when interest paid on a home equity mortgage secured by a principal or second residence is tax deductible;
- advise buyers on the ceiling thresholds for MIDs; and
- determine a buyer's income tax reduction due to interest paid on mortgages encumbering a principal residence or second home by use of a tax analysis form.

## Key Terms

**fair market value (FMV)**
**home equity mortgage**
**itemized deductions**
**mortgage interest deduction (MID)**
**qualified interest**

## Two residences, two deductions

The federal government has a long-standing policy of encouraging residential tenants to become homeowners. The incentives provided by the government to individual homeowners come in the form of a reduction in the *income taxes* they pay. To qualify, they need to take out a mortgage to **finance the purchase** or further encumbrance of a residence, a vacation home or both. [See Chapter 32]

For a residential tenant considering their income taxes, the monthly payment on a purchase-assist home mortgage is not just a substitute for their monthly rent payment — it also reduces their combined state and federal income taxes.

A buyer's agent representing prospective buyers in their purchase of a single family residence (SFR) needs to be able to intelligently discuss and document this tax reduction incentive.

## Persuasive marketing

With knowledge about allowable ownership deductions and tax bracket rates, agents are better able to market to tenants, persuading them to buy a home based on the full range of financial benefits of homeownership.

*Editor's note — To best understand this chapter's presentation of the tax treatment of mortgage interest and property tax deductions, see* ***RPI*** *Form 351.*

*In particular, attention is to be paid to:*

- *Section 1.10, adjustable gross income;*
- *Sections 2, 2.1 and 2.2, home mortgage interest deductions;*
- *Section 4, taxable income; and*
- *Section 6, income tax due.*

*These sections are to be addressed when demonstrating for a homebuyer the effect mortgage interest deductions have on the amount they owe in income taxes. [See Form 351 accompanying this chapter]*

## The MID deduction rule

**home equity mortgage**
A junior mortgage encumbering the value in a home remaining after deducting the principal on the senior mortgage from the market value of the home.

**Two categories** of mortgages exist to control the deduction of interest paid on any mortgages secured by the principal residence or second home:

- interest on the balances of *purchase or improvement mortgages* up to a combined principal amount of $1,000,000; and
- interest on all other mortgage amounts up to an additional $100,000 in principal, called **home equity mortgages**.

A tax loophole for personal use expenditures has been created allowing for home **mortgage interest deductions (MIDs)** for income tax reporting. The *MID* rules allow mortgaged homeowners to deduct from their adjusted gross income (AGI) the interest accrued and paid on first and second homes. The MID reduces their taxable income and, in turn, the income taxes they pay.

The mortgage interest accrued and paid by homeowners is reported as an **itemized deduction**, when:

- the mortgages funded the **purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home;
- net proceeds of *home equity mortgages* were used for personal or business/investment purposes; and

**Form 351**

**Individual Tax Analysis**

**INDIVIDUAL TAX ANALYSIS (INTAX)**

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

**NOTE:** This form is used by an agent when negotiating a sale or partial §1031 transaction for a client, to prepare an estimate for review and provide advice on any income tax liability generated by the proposed transaction.

Date: ______________, 20____
Client: ______________________________
Prepared by: ______________________________

| Items | Standard Income Tax (SIT) | Alternative Minimum Tax (AMT) |
|---|---|---|
| **1. ADJUSTED GROSS INCOME (AGI):** | | |
| 1.1 Salary/professional fees/wages . . . . . . . . . . . . . . | (+) $__________ | (+) $__________ |
| 1.2 Trade or business income/loss . . . . . . . . . . . . . . | (+/-) $__________ | (+/-) $__________ |
| 1.3 Sale of business property profit/loss . . . . . . . . . . | (+/-) $__________ | (+/-) $__________ |
| 1.4 Rental operating income and profit . . . . . . . . . . . . | (+) $__________ | (+) $__________ |
| 1.5 Business related rental operating loss . . . . . . . . . . | (-) $__________ | (-) $__________ |
| 1.6 Loss spillover of rental sales . . . . . . . . . . . . . . . . . | (-) $__________ | (-) $__________ |
| 1.7 Investment category income and profits . . . . . . . . . | (+) $__________ | (+) $__________ |
| 1.8 Investment category capital losses (up to $3,000) . | (-) $__________ | (-) $__________ |
| 1.9 Retirement, pension and annuity plans. . . . . . . . . . | (-) $__________ | (-) $__________ |
| 1.10 **ADJUSTED GROSS INCOME** . . . . . . . . . . . . . . . . . . . . | $__________ | $__________ |
| **2. REAL ESTATE RELATED DEDUCTIONS:** | | |
| 2.1 First/second home interest ($1,100,000 loan cap) . | (-) $__________ | (-) $ NONE |
| 2.2 Property taxes on residences. . . . . . . . . . . . . . . . . | (-) $__________ | __________ |
| 2.3 $25,000 rental loss deduction. . . . . . . . . . . . . . . . . | (-) $__________ | (-) $__________ |
| 2.4 **TOTAL REAL ESTATE RELATED DEDUCTIONS**. . . . . . | (-)$__________ | (-) $__________ |
| **3. OTHER DEDUCTIONS AND EXEMPTIONS:** | | |
| 3.1 Medical and dental. . . . . . . . . . . . . . . . . . . . . . . . | (-) $__________ | (-) $ NONE |
| 3.2 State income taxes . . . . . . . . . . . . . . . . . . . . . . . . | (-) $__________ | __________ |
| 3.3 Other deductions (charitable contributions, etc.) . . . | (-) $__________ | (-) $ NONE |
| 3.4 Personal exemption . . . . . . . . . . . . . . . . . . . . . . . . | (-) $ NONE | __________ |
| 3.5 AMT exemption . . . . . . . . . . . . . . . . . . . . . . . . . . . . | __________ | (-) $__________ |
| 3.6 **TOTAL OTHER DEDUCTIONS AND EXEMPTIONS** . . . | (-)$__________ | (-) $__________ |
| **4. TAXABLE INCOME** (line 1.10 minus lines 2.4 and 3.6) . . . | $__________ | $__________ |
| **5. TAX BATCHING:** | | |
| 5.1 Net profits and short term losses . . . . . . . . . . . . . | (+/-) $__________ | $__________ |
| 5.2 Ordinary income (line 4 minus line 5.1 but not less than zero) . . . . . . . . . . . . | $__________ | $__________ |
| (a) Tax: See SIT and AMT tax bracket rates for line 5.2. . . . . . . . . | $__________ | $__________ |
| 5.3 Unrecaptured depreciation gain . . . . . . . . . . . . . . . . . | $__________ | |
| (b) Tax: 15% in lowest bracket; 25% on balance. . . . . . . . . . . . . | $__________ | $__________ |
| 5.4 Long-term capital gain . . . . . . . . . . . . . . . . . . . . . . . . . | $__________ | |
| (c) Tax: 5% in lowest bracket; 15% on balance. . . . . . . . . . . . . | $__________ | $__________ |
| (Tax: 5.2, 5.3 and 5.4 combined are not to exceed line 4) | | |
| **6. INCOME TAX -** the **greater** amount of . . . (lines a, b, or c) | $__________ | or (lines a, b, or c) $__________ |

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- the mortgages are secured by either the owner's **principal residence** or **second home**.[1]

Without the MID rule, interest paid on a mortgage which funded the purchase or improvement of a principal residence or second home or other personal use is not deductible.

The mortgage interest deductions for the first and second home reduce the property owner's **taxable income.** Ultimately, the subsidy (the deduction) reduces the amount of income tax the homeowner pays**.** As an *itemized*

**mortgage interest deduction (MID)**
An itemized deduction for income tax reporting allowing homeowners to deduct interest and related charges they pay on a mortgage encumbering their primary or second homes.

1 26 United States Code §163(h)

**itemized deductions**
Deductions taken by a taxpayer for allowable personal expenditures which, to the extent allowed, are subtracted from adjusted gross income (AGI) to set the taxable income for determining the income tax due, called Schedule A.

*deduction,* the accrued interest paid is subtracted from the owner's AGI under both the *standard income tax (SIT)* and the *alternative minimum tax (AMT)* reporting rules.

In contrast, the other homeowner's income tax loophole for the deduction of real estate property taxes on the first and second homes applies only to reduce the owner's SIT, not their AMT. Thus, the wealthiest find their AMT enlarged over their SIT at which point the AMT amount becomes the total income tax they will pay.

## Purchase/improvement mortgages

Interest paid on mortgages originated to *purchase* or *substantially improve* an owner's first or second home is deductible on combined principal balances of up to $1,000,000 for an individual and for couples filing a joint return if the mortgage is secured by either home.

Thus, if the mortgage funds are used to acquire, construct, or further improve a principal residence or second home, and the mortgage balances collectively exceed $1,000,000, only the interest paid on $1,000,000 of the mortgage balances is deductible under this purchase/improvement part of the MID rule.

To qualify home improvement mortgages for interest deductions, the new improvements need to be **substantial**. Improvements are *substantial* if they:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Mortgage funds spent on repairing and maintaining property to keep it in good condition and maintain its value do not qualify as funding for substantial improvements.[2]

Further additional deductions are permitted for interest paid on the excess mortgage amounts, up to an additional $100,000. Interest on this additional principal qualifies for deduction as interest paid on a *home equity mortgage* though one might not actually exist.

## Refinancing limitations

If an owner refinances a purchase/improvement mortgage, the portion of the refinancing funds used to finance the payoff qualifies as a purchase/improvement mortgage for future interest deductions.

However, interest may only be written off as a purchase/improvement mortgage on the portion of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement mortgage, unless the excess monies funded the further improvement of the home.

For example, consider a homeowner who borrows $200,000 to fund the purchase of their principal residence. Through the process of monthly

2 26 USC §163(h)(3)(B); Temporary Revenue Regulations §1.163-8T

amortization, the mortgage balance is paid down to $180,000. The owner refinances the residence, paying off the original purchase/improvement mortgage. However, the new mortgage is for a greater principal amount than the payoff demanded on the original mortgage. The excess funds are not used to improve the home.

In this scenario, interest on only $180,000 of the refinance mortgage is deductible as interest paid on a purchase or improvement mortgage, unless:

- the excess funds generated by the refinance are used to improve the residence; or
- the excess mortgage amount qualifies as a home equity mortgage under its separate ceiling of $100,000 in principal.

## $100,000 home equity mortgages

Interest on mortgage amounts secured by the first or second home might not qualify for the purchase/improvement segment of the home mortgage interest deduction, due either to:

- a different use of the mortgage proceeds; or
- the $1,000,000 purchase/improvement mortgage limitations.

The interest on mortgage amounts secured by the first or second residence which do not qualify as a purchase/improvement mortgage is deductible by a homeowner as interest paid on additional or other mortgage amounts up to $100,000 in principal.

For married persons filing separately, the cap for the principal amount of equity mortgages on which interest may be deducted is limited to $50,000, half of the joint $100,000 ceiling.[3]

*Home equity mortgages* are typically junior encumbrances, but also include excess proceeds from financing which:

- does not qualify as purchase/improvement funds; or
- exceed the $1,000,000 ceiling.

The proceeds from home equity mortgages may be used for any purpose, including personal or business uses unrelated to the property.

## Property value ceiling

Interest paid on any portion of a mortgage balance which exceeds the **fair market value (FMV)** of a residence is not deductible. In practice, the *FMV* rule applies almost exclusively to home equity mortgages. This includes refinancing proceeds of a greater amount than the balance paid off on the purchase/improvement mortgage that was refinanced.[4]

> **fair market value (FMV)**
> The price a reasonable, unpressured buyer would pay for property on the open market.

The FMV of each residence is presumed to be the original amount of the purchase price, plus any improvement costs. Thus, any future drop in property value below the balance remaining on a purchase-assist mortgage does not affect the interest deduction.[5]

3 26 USC §163(h)(3)(C)(ii)
4 26 USC §163(h)(3)(C)(i)
5 Temp. Rev. Regs. §1.163-10T(k)(2)

## Qualifying the principal residence and second home

To qualify for the MID, the mortgage needs to be secured by the **principal residence** or **second home**.

A *principal residence* is an individual's home where the homeowner's immediate family resides a majority of the year, also called the **primary residence** or **first home**. The principal residence is close to the homeowner's place of employment and banking institutions which handle the homeowner's accounts. Further, the address of the primary residence is used for tax returns.[6]

A *second home* is any residence selected by the owner from year to year, including:

- real estate;
- mobile homes;
- recreational vehicles; and
- boats.

If the second home is **rented out** for portions of the year, the interest qualifies for the home mortgage interest deduction if the owner occupies the property for more than 14 days or 10% of the number of days the residence is rented, which ever number is greater.[7]

If the owner does not rent out their second home at any time during the year, the property qualifies for the MID whether or not the owner occupies it.[8]

Rental income received on the second home is classified as **investment/portfolio income** when the home qualifies for the MID interest deduction (the owner's occupancy exceeds the time periods under the 14-day/10% rule).

When the second home has been rented and the owner's family occupies the property for more than 14 days or 10% of the days rented, the owner takes the personal interest deduction since they are not allowed to treat the property as an investment. As the second home is not an investment, the owner may not take *depreciation deductions* on it.[9]

A second home, when purchased for personal use and held for profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under Internal Revenue Code (IRC) §1031.[10]

## Taking the deductions

**qualified interest**
Interest on a mortgage which has accrued and been paid and is an allowable interest deduction for ownership of a first and second home.

Interest deductions on home mortgages are only allowed for interest which has *accrued and been paid*, called **qualified interest**.[11]

Interest on first and second home mortgages is deducted from an owner's AGI as an *itemized deduction*. Further, limitations exist on the total amount of all deductions the homeowner may claim.

6 26 USC §163(h)(4)(A)(i)(I)
7 26 USC §280A(d)(1)
8 26 USC §163(h)(4)(A)(iii)
9 26 USC §§163(h)(4)(A)(i)(II); 280A(d)(1)
10 26 USC §1221; IRS Private Letter Ruling 8103117
11 26 USC §163(h)(3)(A)

The tax-exempt sale by §1031 reinvestment

*Numerous benefits and advantages are available to sellers of §1031 like-kind properties who, rather than "cash out" on the sale of their property, couple the sale with the purchase of replacement property or properties. Thus, a reinvestment is arranged that establishes the seller's continuing investment in the ownership of like-kind real estate, a requirement to qualify the sale for profit tax exemption under IRC §1031.*

*Section 1031 (like-kind) property consists of two classifications of property:*

- *investment property, called* ***capital assets*** *[26 United States Code §1221]; and*
- *trade or business property. [26 USC §1231]*

*One or more of these benefits and advantages becomes the motivating factor influencing an investor's decision to sell one property and buy replacement property in a tandem transaction, called a* ***§1031 reinvestment plan****.*

*If a broker knows the advantages of buying and selling under §1031 rules, the broker can:*

- *undertake the duty to determine how their client might benefit from §1031 tax treatment by advising them of the tax benefits;*
- *arrange a reinvestment where the motives of opposing parties to buy or sell may differ; and*
- *be rewarded by receiving two fees for giving advice and assistance in the negotiations of the two transactions.*

*The benefits and advantages available to real estate investors, one or more of which may influence the investor's decision to enter into a §1031 reinvestment plan, include:*

- *an* ***exemption*** *from reporting all or a portion of the profit on the sale;*
- *an increase in* ***debt leverage*** *and* ***income yield*** *by replacing the property being sold with a higher-priced, more efficient and more productive property;*
- *an increase in the* ***depreciation deduction*** *schedules by assuming (or originating) larger amounts of debt on higher-priced replacement property as part of a fresh start for allocation of basis between land and depreciable improvements;*
- *the* ***avoidance of costs*** *incurred to originate new financing by assuming or taking title subject to the existing mortgages on the properties sold or acquired;*
- *an* ***inflation and appreciation hedge*** *to take maximum advantage of an anticipated rapid increase in cyclical property values by acquiring highly leveraged property to replace a lower-leveraged property; and*
- *the* ***relocation*** *of an equity in property, undiminished by taxes, by an investor who personally moves to a new geographic location.*

Conversely, business, rental or investment interest are adjustments that reduce the AGI. When the reportable income and losses from the three income categories are aggregated, they set the AGI from which the MID is taken to set the taxable income. Thus, the two types of home MIDs directly reduce the amount of the owner's taxable income to the extent permitted by the itemized deduction rules which are progressive.

The inability to reduce the owner's AGI by use of the home mortgage interest makes a substantial difference for high income earners. The higher an owner's AGI, the lesser the amounts allowed for rental loss deductions, by *itemized deduction phase out*, and on any tax credits available to the owner.[12]

12 26 USC §163(a), (h)(2)(A)

## Chapter 50 Summary

The federal government encourages residential tenants to become homeowners by allowing them to reduce their income taxes if they finance the purchase of a residence or vacation home. Under the mortgage interest deduction (MID) tax scheme, the interest accrued and paid on mortgages funding the purchase price or cost of improvements for a principal residence or second home is deductible from the homeowner's adjusted gross income (AGI) as an itemized deduction which reduces the owner's taxable income and in turn their income tax.

Interest may be deducted from AGI to lower taxable income on:

- purchase or improvement mortgages up to $1,000,000; and
- home equity mortgages up to $100,000.

Interest paid on home equity mortgages secured by a principal or second residence is also deductible. These deductions are applicable under both the standard income tax (SIT) and alternative minimum tax (AMT) reporting rules.

When an owner refinances a purchase or improvement mortgage, interest may only be written off on the amount of refinancing funds used to pay off the principal balance of the original mortgage.

Interest paid on any portion of a mortgage balance which exceeds the fair market value of a residence is not deductible. In practice, the FMV rule applies almost exclusively to home equity mortgages.

## Chapter 50 Key Terms



**Quiz 15 Covering Chapters 50-52 is located on page 636.**

# Chapter 51

# 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)** | **passive category income** |
| **cost basis** | **pledge** |
| **dealer property** | **portfolio category income** |
| **due-on clause** | **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 balloon payment of $1,037,732.25.

*Editor's note – The balloon payment discussed in this example is for a business carryback mortgage. In contrast, the inclusion of a 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. [See Chapter 11]*

**cost basis**
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

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).

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

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 *balloon payment* will be received by the seller. Again, the profit-to-equity ratio of 93% will be applied to the balloon payment of $1,037,732.25. The profit reported by the carryback seller when the balloon payment is received will be $965,090.99 — 93% of the principal in the final/balloon payment.

**passive category income**
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

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 2020); and
- **long-term gain** in the amount of all remaining inflation-appreciation profit (and taxed up to 20% in 2020).

## 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 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 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.

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 up to 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.

Taxwise, 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.

**all-inclusive trust deed (AITD)**
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]

Here, an **all-inclusive trust deed (AITD)** 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 30]

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.

## 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 (2018 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.

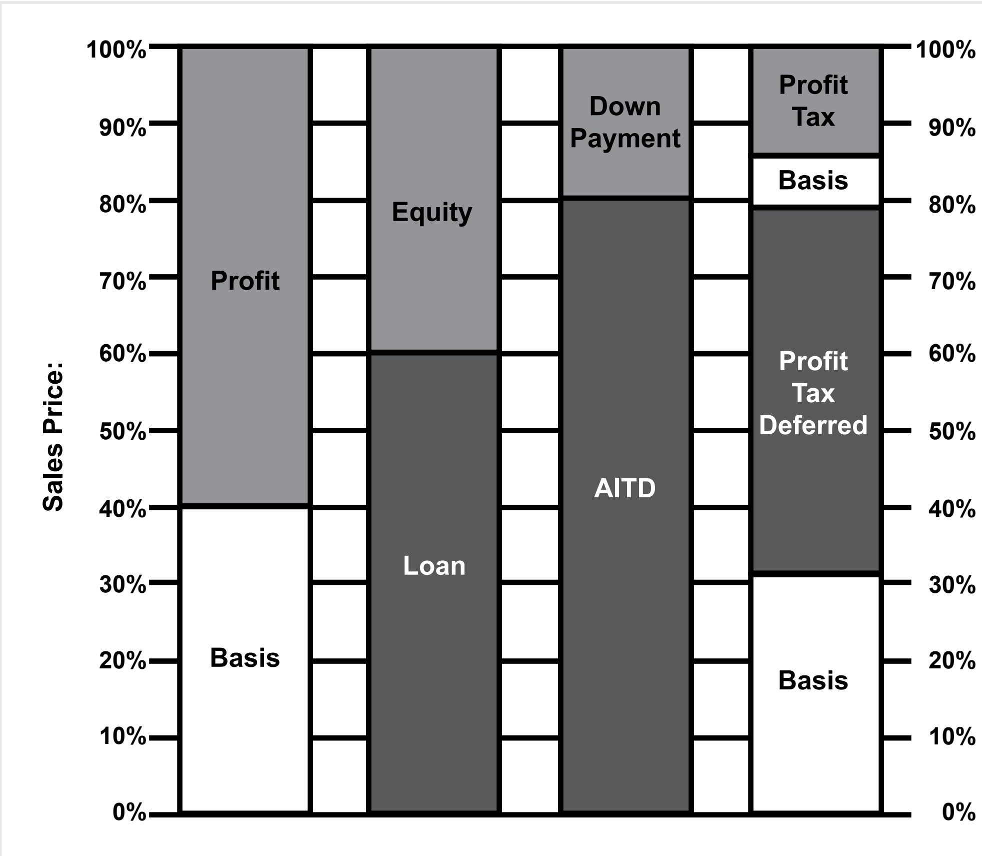



Figure 1

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.

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 mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

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.[6]

## 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.

6 **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.[7]

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

7 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 2019 is $4,246,200 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 2019 is up to $5,944,600, 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 **RP**I 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.[8]

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.[9]

## 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*.[10]

8 26 USC §453A(d)(1)
9 26 USC §453A(d)(2)
10 26 USC §453(c)

To assure a seller they will retain their tax advantages of an installment sale until the balloon payment becomes due, the seller's agent will suggest their client include a *prepayment penalty* clause in the carryback mortgage. [See Chapter 8]

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.[11]

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.[12]

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.

11 Calif. Civil Code §2954.9; 12 CFR §1026.43

12 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 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.

A carryback note needs to qualify for installment sale reporting at the time escrow closes.

## Miscellaneous installment rules

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.[13]

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.[14]

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.[15]

## 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 readjustment of an appreciated asset's cost basis to fair market value for future tax purposes when transferred by inheritance.

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*.[16]

13 26 CFR §15a.453-1(b)
14 26 USC §§453(b)(2)(A), (l)
15 26 USC §453(l)(2)]
16 26 USC §§453(e)(6)(C), 691(a)(4)

## Chapter 51 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 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.

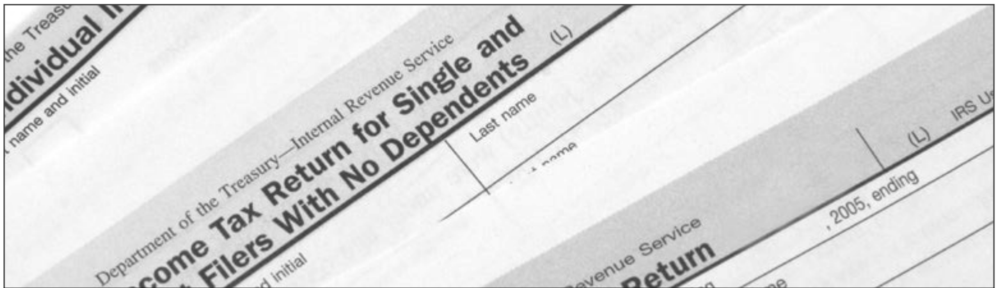
An all-inclusive trust deed (AITD) note carryback or land sales contract avoids debt relief as an installment sale of property since the buyer does not assume or refinance the seller's existing mortgage.

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 51 Key Terms

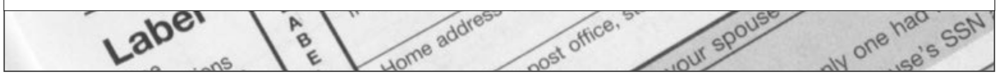


**Quiz 15 Covering Chapters 50-52 is located on page 636.**




# Chapter 52

# 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)** | **imputed interest rate** |
| **cost basis** | **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 **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 37% (in 2020).

**cost basis**
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

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 20% 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 the lowest rate within three 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)

**June 2024**

| Short term, not over 3 years: | AFR |
|---|---|
| Monthly | 5.01% |
| Quarterly | 5.03% |
| Semi-annual | 5.06% |
| Annual | 5.12% |
| **Medium term, between 3 and 9 years:** | **AFR** |
| Monthly | 4.57% |
| Quarterly | 4.58% |
| Semi-annual | 4.61% |
| Annual | 4.66% |
| **Long term, over 9 years:** | **AFR** |
| Monthly | 4.68% |
| Quarterly | 4.70% |
| Semi-annual | 4.73% |
| Annual | 4.79% |

Figure 1

Example Applicable Federal Rates

- 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 2024 in an amount no greater than $2,800,000, called the **minimum 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)

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 *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 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 balloon payment by subtracting one month's interest at the AFR.

1. Interest = $94,797 final payment x .08/12 = $632
2. $94,797 - $632 = $94,164 principal amount in the balloon payment

9 26 USC §453

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 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.

10 26 USC §469(c)(7)

11 26 USC §469(c), (e)

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 2019 is more than $4,246,200, 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 **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.

12 26 USC §1274A(b); IRS Revenue Ruling 2015-24

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 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.

## 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.

13 26 CFR §1.1274A-1

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 52 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 52 Key Terms



**Quiz 15 Covering Chapters 50-52 is located on page 636.**

*Notes:*

Chapter 53

# Checklist for packaging a consumer- or business-purpose mortgage

## Documentation, disclosures and mortgage packaging activities

The following is a checklist of activities to be considered by a mortgage broker and lender when packaging a **mortgage application** for funding the purchase or refinance of any type of real estate.

*Editor's note — None of the material in this chapter will be covered in the quizzes or final exam for this course.*

The documentation and disclosures carried out when packaging a mortgage are essentially the same when the mortgage is secured by a one-to-four unit residential property. This is the case whether or not the property is owner-occupied, and whether the mortgage is for a consumer or business purpose.

However, most of these disclosures are mandated for consumer-purpose mortgages without a parallel but necessary legislated mandate for business-purpose mortgages. As a matter of good practice, the same checklist is used as steps to be taken when originating mortgages for any purpose on any type of real estate.

Also, the broker and their agent arranging a consumer mortgage is required to hold a **mortgage loan originator (MLO)** endorsement from the **California Department of Real Estate (DRE)**. Conversely, a lender or broker, making or arranging business mortgages exclusive of any consumer mortgages, does not need to hold an MLO endorsement. However, when making eight or more mortgages of any type in a calendar year, the private mortgage lender is required to also hold a DRE broker license.[1]

1 Calif. Business and Professions Code §10131.1

## Prohibited kickbacks and fees

To avoid overcharging, the **transaction agent (TA)** (but not their broker or another agent) handling the sales transaction which calls for a purchase-assist consumer mortgage may not receive additional fees (**kickbacks**) for services rendered to originate the consumer mortgage — unless the fee is paid by someone other than the homebuyer. When paid by a person other than the homebuyer, the *TA* needs to perform a significant portion of the service provided by the other person to be entitled to receive any fee beyond the fee for TA services in the real estate sales transaction.

A referral is never a compensable service for a TA.[2] [See Chapter 35]

## The stack sheet: a documentation and activity checklist

A **stack sheet** is used by a mortgage broker or lender when setting up a file for making or arranging a mortgage. It is the control worksheet placed in the mortgage packaging file which serves as a checklist of documentation considered and noted for completion by the mortgage broker or lender before funding. [See **RPI** Form 201]

At commencement of the application process, the mortgage broker or lender provides the borrower with a checklist of information and documents needed to process the mortgage application. When a co-borrower is considered for mortgage qualification purposes, the same information and documents will be gathered from them as well. [See **RPI** Form 209 and 209-1; see Chapter 33]

## Pre-application information gathering

Applicable information and documentation to be supplied by the borrower to the mortgage broker or lender varies depending on the:

- *type of mortgage* sought (consumer- or business-purpose);
- *position of the mortgage* (junior or senior);
- *type of property* (residential or nonresidential); and
- *borrower's income source* (wage earner or self-employed).

Initially, the mortgage broker or lender conducts a **pre-application interview** with the borrower to determine the borrower's intentions for their use of the mortgage funds. This interview is best conducted with the TA when funding the purchase of property. Once the borrower's intentions are determined, the mortgage broker or lender prepares the *stack sheet* checklist noting the documentation needed to process the type of mortgage involved. [See **RPI** Form 201; see Chapter 32]

## Documentation to be gathered

Documentation to be gathered by the mortgage broker or lender includes:

- copies of the borrower's two most recent *pay-stubs*;
- when the pay-stubs are not computer-generated, a *letter from the borrower's employer(s)* stating their year-to-date (YTD) income;
- copies of the borrower's *W-2s* and *federal tax returns* for the last two years;

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2 Official Interpretation of 12 Code of Federal Regulations §1026.36(d)(1); CFPB 2013 Loan Originator Rule Small Entity Compliance Guide — January 13, 2014

*Editor's note — Employment is verified for the last two years. In addition, the borrower needs to provide explanations for any gaps in employment of one month or longer.*

- copies of the borrower's *1099s* for the last two years when self-employed;
- copies of the borrower's *bank statements* for all checking and savings accounts for the last three months;
- a *YTD Profit and Loss Statement* when the borrower is self-employed [See **RPI** Form 209-2 (FNMA 1020)];
- a *Balance Sheet Financial Statement* showing the borrower's net worth [See **RPI** Form 209-3];
- a *schedule of additional real estate owned* by the borrower;
- copies of *rental* and *lease agreements* for rental properties owned by the borrower;
- copies of each borrower's *driver license* and *social security card*;
- a copy of the borrower's *military ID card* when applicable;
- a copy of the borrower's *alien registration card* when applicable;
- when the property is part of a common interest development (CID), the project name, address, telephone and fax numbers of the *homeowners' association's (HOA's)* management company;
- a copy of any *bankruptcy discharge papers* including a *written explanation* for petitioning for bankruptcy protection when applicable;
- a copy of any *decree for dissolution of marriage* when applicable;
- when the application is for a home equity (second) mortgage:
  - copies of all *notes* for debts secured by trust deeds on the property; and
  - copies of any *mortgage statements or payment coupons* identifying the mortgage and showing information on the senior mortgage holder; and
- a copy of the *homeowner's insurance policy declaration page* and *property tax bill* when the application is for a home equity mortgage or refinance. [See Chapter 33]

## Taking the application

Upon receipt of the borrower's documentation, the lender or mortgage broker prepares forms to be signed by the borrowers (and any co-borrowers) to complete the **mortgage package**.

These mortgage forms include:

- the *Uniform Residential Loan Application* (URLA) for one-to-four unit residential property (to be used on any type of mortgage or property acquisition [See **RPI** Form 202 (FNMA 1003); see Chapter 33];
- the *Acknowledgement of Changing Conditions* to disclose to the borrower that conditions to close the mortgage may change or affect the lender's funding of the mortgage [See **RPI** Form 202-1];

- the *Loan Purpose Statement – For Reg Z Analysis* to determine the use of mortgage funds either for consumer purposes or for business, investment or agricultural purposes [See **RPI** Form 202-2];
- the *Authorization for Lender Verification of Information* [See **RPI** Form 216];
- the *Fair Credit Reporting Act* disclosure [See **RPI** Form 216-1];[3]
- the *Equal Credit Opportunity Act* disclosure [See **RPI** Form 216-2];[4]
- the *Anti-Steering Disclosure* for consumer-purpose mortgages stating the mortgage broker needs to offer mortgage options from a significant number of lenders with which the mortgage broker regularly does business [See **RPI** Form 208];[5]
- the *Advance Fee Disclosure* for consumer-purpose mortgages stating that no fees may be collected other than those used to obtain the borrower's credit history prior to receiving an initial Loan Estimate from the mortgage broker or lender [See **RPI** Form 208];[6]
- the *Notice to Applicant of Right to Receive Copy of Appraisal Report* to be provided to the borrower within three business days after the mortgage broker or lender's receipt of the borrower's mortgage application [See **RPI** Form 206];[7]
- the *Fair Lending Disclosure* to notify the borrower of prohibitions against discriminatory lending [See **RPI** Form 203 (RE 867)];[8]
- the *Credit Score Disclosure Exemption Notice* to notify the borrower of the originator's obligation to disclose to the borrower their credit scores and the credit bureaus used to obtain them [See **RPI** Form 217];[9]
- the *RESPA Servicing Disclosure Statement* [See **RPI** Form 238-2];[10]
- the *Notice of Right to Rescind – Borrower's Right to Cancel* which notifies the borrower of their right to cancel the transaction on an equity mortgage or refinance on their principal residence within three business days of receiving federally mandated consumer mortgage disclosures [See **RPI** Form 222];
- the *IRS Form 4506* or *4506-T* to request a copy of the borrower's income tax return or a transcript of the income tax return from the Internal Revenue Service (IRS) [See **RPI** Form 215 and 215-1];
- a *Loan Estimate* of all mortgage terms quoted by the mortgage broker or lender within three business days of the mortgage broker's or lender's receipt of the borrower's mortgage application [See **RPI** Form 204-5];[11]
- a special *information booklet* published by the Consumer Financial Protection Bureau (CFPB) to help the borrower understand the nature and scope of real estate settlement costs within three business days after the mortgage broker's or lender's receipt of the borrower's application;[12]

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3 12 CFR §1022 et. seq.
4 12 CFR §1002 et. seq.
5 12 CFR §1026.36(e)
6 12 CFR §1026.19(a)(1)(ii)
7 12 CFR §1002.14(a)(2)
8 21 Calif. Code of Regulations §7114
9 12 CFR §1022.74(d)(1); Calif. Civil Code §1785.20.2
10 12 CFR §1024.33(a)
11 12 CFR §1026.37
12 12 CFR §1026.19(g)

- a *Closing Disclosure*, which summarizes the "final" mortgage terms and details, provided by the mortgage broker or lender at least three days before the borrower closes on the mortgage [See **RPI** Form 402];[13]
- a list of *homeownership counseling organizations*; and
- the *Mortgage Loan Disclosure Statement* when the originator is a mortgage broker.[14] [See **RPI** Form 204 and 204-2 (RE 882 and 885)]

*Editor's note — A list of homeownership counseling organizations approved by HUD can be found at the CFPB's website at consumerfinance.gov.*

When the buyer arranges consumer financing through a mortgage broker, then the broker, not the lender, provides a copy of the special information booklet to the buyer.[15]

However, the booklet does not need to be given to the borrower when the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage secured by a second mortgage;
- a reverse mortgage; or
- the purchase of other than a one-to-four unit residential property.[16]

## Collecting other vital information

In addition to the above documentation, the mortgage broker or lender requests and gathers reports, contracts and other vital information regarding the transaction and property condition.

This supplementary mortgage origination information includes:

- the *Residential Appraisal Report – Detached Single Family Unit or PUD* [See **RPI** Form 207 and 200 (HUD 1004)];[17]

  *Editor's note — The appraisal report for an income-producing property will also include a rent survey reflecting the rental rates commanded by comparable local rental properties.*

- a *tri-merge credit report* (which includes reports by Experian, Trans Union and Equifax);

  *Editor's note — When the borrower is given a negative credit score* usage notice in respo*nse to their application for a mortgage on one-to-four unit residential property, the mortgage broker or lender is required to provide the borrower with an explanation of the derogatory items on the borrower's credit report. In addition, the mortgage broker or lender also needs to inform the borrower of any adverse action taken on their application.[18] [See **RPI** Form 217-1 and 219]*

- a *Verification of Employment* for a present or prior employer, or both [See **RPI** Form 210 and 210-1];

13 12 CFR §1026.19(f)(ii)
14 Bus & P C §10240
15 12 CFR §1024.6(a)(1)
16 12 CFR §1024.6(a)(3)
17 Bus & P C §11321
18 CC §1785.20; 12 CFR §202.9; 15 United States Code §1681m

- a *Verification of Deposit* to verify the borrower's recent activity and balances of their bank accounts [See **RPI** Form 211];
- a *Verification of Rent* to verify the borrower's payment history and their conduct as a tenant [See **RPI** Form 212];
- a *Verification of Mortgage* to verify the payment history and terms of the borrower's existing mortgage [See **RPI** Form 212-1];
- a *Verification of Account* to confirm the payment history and terms of the borrower's existing credit account [See **RPI** Form 213]; and
- a *Verification of Homeowners Insurance* to verify information regarding the borrower's existing homeowners insurance policy. [See **RPI** Form 214]
- a copy of the *purchase agreement* for a purchase-assist mortgage [See **RPI** Form 150];
- a copy of the *escrow instructions* [See **RPI** Form 232 and 401];
- a copy of the seller's *Condition of Property Disclosure – Transfer Disclosure Statement (TDS)*, any *home inspection report* and any other reports on components of the property and its improvements (for a purchase-assist mortgage) [See **RPI** Form 304]; and
- a copy of the *preliminary title report*.

Additional items the mortgage broker or lender may require for a mortgage secured by income-producing property include:

- an Annual Property Operating Data (APOD) worksheet [See **RPI** Form 352]; and
- a Rental Income Rent Roll. [See **RPI** Form 352-1]

*Editor's note – See the* ***(RPI) Realty Publications, Inc. Income Property Brokerage (IPB)*** *suite of forms.*

## Underwriting and loan package transmittal

Once the mortgage package is complete, it is ready for an underwriting review for approval and funding.

Additional documents to be included to initiate the underwriting review are:

- the *Loan Transmittal Summary – Preliminary Submission to Lender* prepared by a broker arranging a mortgage to solicit a lender for funding the mortgage as a summary of information regarding the borrower and the property to be mortgaged [See **RPI** Form 233];
- the *Credit Analysis Worksheet – LTV and Income Ratios* to show the calculations of the borrower's front and back end debt-to-income ratios (DTI) and the loan-to-value ratio (LTV) [See **RPI** Form 230 (HUD-92900-WS)]; and
- the *Lender/Purchaser Disclosure Statement – Loan Origination* to disclose to the lender information regarding the mortgage terms and servicing arrangements made by the mortgage broker. [See **RPI** Form 235-1 (RE 851A)]

# Glossary

## A

**absolute assignment of rents. . . . . 182**
A present transfer of all the owner's rights, title and interest in the rents generated by the real estate. Compare with conditional assignment of rents.

**acceleration . . . . . 162, 476**
A demand for immediate payment of all amounts remaining unpaid on a mortgage or extension of credit by a lender or carryback seller.

**adhesion contract . . . . . 154**
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.

**adjustable rate mortgage (ARM) . . . . . 76**
A variable interest rate note, often starting out with an introductory teaser rate which resets in a few months or years based on a particular index.

**affirmative duty. . . . . 320**
An agent's obligation to voluntarily undertake an advisory activity when in a fiduciary relationship.

**alienation clause. . . . . 161**
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.

**all-inclusive trust deed (AITD) . . . . . 274, 303, 350, 572**
A note entered into by a 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]

**allonge . . . . . 51, 94**
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]

**anti-deficiency . . . . . 200, 244, 296, 465**
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

**anti-deficiency law . . . . . 456**
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) . . . . . 583**
Rates set by the Internal Revenue Service (IRS) and used by carryback sellers to impute and report as minimum interest income when the note rate on the carryback debt is a lesser rate.

**assignment . . . . . 448**
A transfer of rights held under a mortgage or other agreement from one person to another.

**assignment of rents provision . . . . . 181**
A trust deed clause which creates a lien on unpaid rents as additional security to the real estate described in the trust deed.

**assumption agreement** .......... **527**
A promise given by a buyer to the seller or an existing mortgage holder to perform all the terms of the mortgage taken over by the buyer on the sale. [See **RPI** Form 431 and 432]

**average prime offer rate** .......... **108**
An annual percentage mortgage interest rate derived from average interest rates, points and other pricing terms offered by lenders on consumer mortgages which have low-risk pricing characteristics and are used to fund a higher-priced mortgage loan. These rates are published weekly by the Consumer Financial Protection Bureau (CFPB).

## B

**balance sheet** .......... **386**
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values. [See RPI Form 209-3]

**balloon payment** .......... **31, 37, 67, 132, 140**
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]

**balloon-payment qualified mortgage** .......... **31, 138**
A type of qualified mortgage which allows small lenders to include a balloon feature.

**beneficiary** .......... **149, 519**
The holder of a note secured by a trust deed and entitled to the performance of the provisions in the trust deed.

**beneficiary statement** .......... **197, 360**
A written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note. [See **RPI** Form 415]

**bill of sale** .......... **264**
A written instrument given to pass title of personal property from vendor to the vendee. Compare with a grant deed. [See **RPI** Form 408]

**blanket mortgage** .......... **296, 360**
A single trust deed which describes more than one parcel of real estate as security for the referenced debt. [See **RPI** Form 450]

**bona fide purchaser (BFP)** .......... **512**
A buyer other than the mortgage holder who purchases a property for value at a trustee's sale without notice of title or trustee's sale defects.

**business mortgage** .......... **20, 63**
A debt incurred for other than personal, family or household (consumer) purposes and secured by any type of real estate.

**buyer mortgage capacity** .......... **391**
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

**buyer-seller assumption agreement** .......... **245**
A promise given by the buyer to the seller to perform all the terms of a mortgage taken over by the buyer on the property purchased.

## C

**call** .......... **302**
A mortgage holder's demand for the balance of the loan to be immediately paid in full.

**call provision** .......... **69, 138**
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 financing** .......... **271**
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.

**cash collateral** .......... **191**
In Chapter 11 Bankruptcy, cash or cash equivalents from the sale of property in which the lender has an interest.

**certificate of sale** .......... **494**
A certificate issued to the successful bidder on the completion of a judicial foreclosure sale.

**Closing Disclosure** .......... **381**
A disclosure of the buyer's final settlement charges and mortgage terms handed to the buyer on a standard form within three business days before mortgage closing.

**collateral assignment** .......... **298**
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 & 446]

**comparative advantage** .......... **13**
The advantage a person who produces a product at a greater margin of profit has over a competitor.

**compounding on default** .......... **62**
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]

**computation period** .......... **173**
For impound account analysis, the 12-month period beginning on the date of the initial impound deposit during which monthly deposits, disbursements and any applicable interest occur.

**conditional assignment of rents** .......... **182**
A trust deed provision which creates a lien on all rents in favor of the lender. The rents become additional security to the real estate which is also liened by the trust deed. Compare with absolute assignment of rents.

**conforming loan** .......... **63, 108, 378**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

**constructive notice** .......... **267**
To be charged with the knowledge of conditions existing on the property by recorded documents or an occupancy of the property at the time of a transaction.

**consumer mortgage** .......... **20, 48, 62, 94**
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

**conventional mortgage** .................................................................376
A mortgage that is not made, insured or guaranteed by the federal government.

**conversion adjustable rate mortgage (ARM)**................................................. 83
An adjustable rate mortgage (ARM) which may be converted to a fixed rate mortgage (FRM) during the mortgage term.

**cost basis** ........................................................................ 111, 566, 582
The cost incurred to acquire and improve an asset subject to adjustments for destruction and depreciation, used primarily for tax reporting.

**cramdown**...............................................................................462
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

**creditworthiness** ........................................................................391
An individual's ability to borrow money, determined by their present income and previous debt payment history.

**cross-collateralization** ......................................................... 296, 325
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**.........................................................................567
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**.............................................................................343
The amount of principal and interest paid on a debt periodically, also referred to as the loan payment amount.

**debt-to-income ratio (DTI)**.............................................................391
The percentage of monthly gross income that goes towards paying debt.

**declaration of default and demand for sale**...............................................504
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

**deed-in-lieu of foreclosure** ............................................... 151, 329, 532
A grant deed conveying the mortgaged real estate to a mortgage holder which is accepted from the property owner in exchange for cancelling the mortgage debt to avoid foreclosure. [See **RPI** Form 406]

**default rate provision**...................................................................132
A note provision increasing the note rate on the remaining principal when the final/balloon payment becomes delinquent.

**deficiency** ..............................................................................455
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

**deficiency judgment** .................................................................. **245**
A money award obtained by a mortgage holder to recover money losses experienced when the value of the mortgaged property is less than the remaining mortgage debt at the time of the judicial foreclosure sale.

**discharge-of-indebtedness income** ...................................................... **458**
Reportable income resulting from a mortgage holder's discount on a payoff of a mortgage debt. Called a short pay.

**discount point** .......................................................................... **409**
The amount of money the borrower or seller must pay the lender to get a mortgage at a stated interest rate.

**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)** ............ **20**
A federal consumer protection law which created minimum standards and oversight for consumer mortgage origination.

**dragnet clause** .......................................................................... **154**
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.

**due-on clause** ........................................................ **3, 98, 110, 224, 574**
A trust deed provision used by mortgage holders to call the debt due and immediately payable, a right triggered by the owner's transfer of any interest in the real estate, with intra-family exceptions; also called an alienation clause.

## E

**eminent domain** .......................................................................... **160**
The right of the government to take private property for public use. The government pays the owner the fair market value of the property taken.

**Energy Efficient Mortgage (EEM)** ......................................................... **424**
A Federal Housing Administration (FHA) mortgage which finances energy-efficient improvements.

**entitled person** .......................................................................... **198**
The original borrower on a note and trust deed, their successor-in-interest or an authorized agent of either who may request, in writing, a beneficiary statement or payoff demand statement.

**equity purchase investor** ................................................................ **213**
A person who acquires title to a seller-occupied, one-to-four unit residential property in foreclosure for dealer, investment or security purposes.

**equity purchase transaction** ............................................................. **214**
A sales transaction in which a one-to-four unit residential property in foreclosure, occupied by the owner as their principal residence, is acquired for dealer, investment or security purposes by an investor. [See **RPI** Form 156]

**excluded debts** .......................................................................... **436**
Extensions of credit by sellers of real estate creating a debt obligation in sales transactions which avoid usury laws.

**exculpatory clause** ........................................................ **50, 71, 96, 459**
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]

**exempt debts** .......... **436**
Private party transactions exempt from usury laws involving the origination of a loan secured by real estate and made or arranged by a real estate broker. See non-exempt lender.

## F

**fair market value (FMV)** .......... **561**
The price a reasonable, unpressured buyer would pay for property on the open market.

**fair value hearing** .......... **495**
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

**Federal Home Loan Bank Board (FHLBB)** .......... **10**
The Depression-era regulatory body established to fund savings and loan associations (S&Ls) and provide mortgage market liquidity. The FHLBB became the Office of Thrift Supervision in 1989, and then dissolved in 2011 shifting its duties to the Consumer Financial Protection Bureau (CFPB) and other federal agencies.

**Federal Housing Administration (FHA)-insured mortgage** .......... **252, 418**
A mortgage originated by a lender and insured by the FHA, characterized by a small down payment requirement, high loan-to-value (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

**federally related mortgage** .......... **400**
A consumer mortgage made, insured, guaranteed, assisted or otherwise connected to the federal government, controlled by the Real Estate Settlement Procedures Act (RESPA).

**Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)** .......... **11**
Federal legislation enacted in 1989 in the wake of the savings and loan (S&L) crisis to strengthen regulations on lenders and appraisers and improve the availability of mortgage funds.

**fixed payment ratio** .......... **423**
A debt-to-income ratio (DTI) used to determine eligibility for an FHA-insured mortgage limiting the buyer's total fixed payment on all debts to 43% of the buyer's gross income, also called the DTI back-end ratio.

**forbearance** .......... **446**
An agreement by a mortgage holder to temporarily forego exercise of their rights on a default while the property owner takes steps to bring the mortgage payments current.

**foreclosure decree** .......... **490, 540**
Decree by a court ordering the sale of mortgaged property and the payment of the debt owing to the lender out of the proceeds.

**formal assumption** .......... **9, 240**
A buyer's promise to perform all the terms of the mortgage, given to the mortgage holder on the buyer's takeover of an existing mortgage, typically involving a modification of the interest rate and payments and an assessment of points and fees. Compare with a subject-to transaction.

**full credit bid** .......... **511**
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

**fully indexed rate** .................................................................. **80**
The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.

**further encumbrance** .................................................................. **5**
A claim or lien on a parcel of real estate, such as junior trust deeds, CC&Rs, easements, taxes or assessments.

**further-approval contingency** .................................................................. **313, 324, 336**
A provision in an agreement calling for the further approval of an event or activity as a condition precedent to the further performance or cancellation of the transaction by the persons benefiting from the provision. [See **RPI** Form 185 §9]

**future advances clause** .................................................................. **481**
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste. [See **RPI** Form 450 §2.5]

## G

**Garn-St. Germain Federal Depository Institutions Act of 1982** .................................................................. **10**
A federal law which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

**general ability-to-repay (ATR) rules** .................................................................. **26**
A consumer mortgage conforming to the federal ability-to-repay (ATR) rules, without a qualified mortgage (QM) safe harbor or rebuttable presumption status.

**general qualified mortgage** .................................................................. **29**
A type of qualified mortgage (QM) which meets the definition of a qualified mortgage under Regulation Z (Reg Z) and has a debt-to-income ratio (DTI) of 43% or less, other than a balloon-payment QM, small lender QM and temporary QM.

**government-related mortgage** .................................................................. **376**
A mortgage that is made, insured or guaranteed by the federal government.

**grace period** .................................................................. **54, 67, 126**
The time period for the mortgage holder's receipt of a payment following its due date after which the missed payment is delinquent and subject to a late charge. [See **RPI** Form 550 §4.3 and 552 §4.7]

**graduated payment mortgage** .................................................................. **40**
A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

**guarantee agreement** .................................................................. **71, 459**
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** .................................................................. **146, 325**
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** From 439 and 553-1]

# H

**high-cost consumer mortgage (Section 32 mortgage)** .................................. **129**
A class of Regulation Z (Reg Z) consumer mortgage characterized by an annual percentage rate (APR) charge which exceeds the average prime offer rate for a comparable mortgage by various percentage spreads set by the mortgage's priority on title and principal balance, and subject to consumer protection rules.

**holdover tenant** ........................................................................ **219**
A tenant who retains possession of the rented premises after their right of possession has been terminated, called a tenant-at-sufferance.

**home equity mortgage** ................................................................ **558**
A junior mortgage encumbering the value in a home remaining after deducting the principal on the senior mortgage from the market value of the home.

**hybrid adjustable rate mortgage (ARM)** ............................................ **86**
A type of adjustable rate mortgage (ARM) which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

**hypothecation** ........................................................................... **50**
The pledging of something as security without the necessity of giving up possession to it. [See **RPI** Form 242]

# I

**impairment** ............................................................................... **339**
The act of injuring or diminishing the value of an interest held by another in real estate.

**implicit rent** ............................................................................. **342**
The value of the use of a property by the owner.

**impound account provision** ........................................................... **169**
A trust deed provision establishing a reserve of the owner's funds for the payment of annually recurring ownership expenses.

**impound account** .............................................................. **133, 167, 277**
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

**imputed interest rate** ................................................................ **53, 583**
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** ....................................................................................... **80**
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.

**initial interest rate cap** ............................................................... **82**
A limit on the amount the interest rate may change on the first adjustment of an adjustable rate mortgage (ARM).

**installment note** ........................................................................ **36**
A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a balloon payment. [See **RPI** Form 420-422]

**installment sale** .......... **314**
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.

**institutional lender** .......... **377**
A lender which pools deposits and invests them by making mortgages, e.g. a bank, credit union or insurance company.

**inter vivos trust** .......... **234**
A title holding arrangement used as a vesting by a property owner for probate avoidance on death. Also known as a living trust. [See **RPI** Form 463]

**interest-only adjustable rate mortgage (ARM)** .......... **86**
A type of adjustable rate mortgage (ARM) which features an initial period of interest-only payments.

**interlineation** .......... **49**
The process of modifying an instrument or document by inserting additional language between the lines to clarify a particular provision, usually adding something that was omitted.

**introductory interest rate** .......... **80**
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 nown as a teaser rate.

**itemized deductions** .......... **560**
Deductions taken by a taxpayer for allowable personal expenditures which, to the extent allowed, are subtracted from adjusted gross income (AGI) to set the taxable income for determining the income tax due, called Schedule A.

## J

**judicial foreclosure** .......... **488**
The court-ordered sale by public auction of the secured property. Also known as a sheriff's sale.

**jumbo mortgage** .......... **378**
A conventional mortgage with a principal amount exceeding the conforming or super-conforming loan limits set by Fannie Mae and Freddie Mac.

## K

**kickback** .......... **401**
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

## L

**land sales contract** .......... **366**
A contract used in a sale of real estate when the seller retains title to the property until all or a prescribed part of the purchase price has been paid. [See **RPI** Form 168]

**late charge provision** .......... **125**
A provision in a promissory note which calls for an additional charge if payments are not received when due or during a grace period.

**lender overlay**..............................................................................**376**
Lender-imposed standards on consumer mortgages to be met by applicants in addition to standards set by mortgage insurers and investors.

**lender-paid mortgage insurance (LPMI)**.........................................................**428**
Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

**letter of credit** ..............................................................................**462**
A commitment made by a bank to a mortgage holder assuring payment of a stated amount on presentation to the bank, used by mortgage holders as a supplemental security device to avoid anti-deficiency laws.

**lifetime interest rate cap** .................................................................. **82**
A limit on the amount the interest rate can increase over the life of an adjustable rate mortgage (ARM).

**liquidated damages provision** ...............................................................**113**
A provision stating the maximum money losses a buyer owes a seller in the event the seller incurs losses on a buyer's breach.

**lis pendens** ............................................................................ **489, 512**
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** .............................................................................**282**
An employment agreement used by brokers and agents when a client retains a broker to render real estate transactional services as the agent of the client. [See **RPI** Form 102 and 103]

**litigation guarantee** ..........................................................................**489**
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

**Loan Estimate** ........................................................................ **380, 411**
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

**loan level price adjustment** ...................................................................**376**
Adjusted interest rates or fees based on the risk of default a mortgage poses.

**loan-to-value ratio (LTV)** ............................................................ **390, 421**
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

**lock-in clause**......................................................................... **112, 117**
A promissory note provision limiting repayment to no more than the regularly scheduled installment amount, in contrast to an "or more" clause.

## M

**margin**....................................................................................... **81**
The interest points added to an index by a lender as profit on the adjustment of an adjustable rate mortgage (ARM).

**masked security device** .................... **314, 364**
Alternative documentation for a carryback sale, substituted for a note and trust deed in a deceptive attempt to avoid due-on enforcement, Regulation Z (Reg 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]

**material breach** .................... **126**
Failure to perform significant obligations called for in an agreement, such as a promissory note.

**mixed collateral transaction** .................... **264**
A transaction which is evidenced by one note and secured by both real estate (using a trust deed) and personal property (using a UCC-1 Form).

**money judgment (on foreclosure)** .................... **488**
An award for any unpaid balance remaining after a judicial foreclosure sale due to the secured property's insufficient fair market value (FMV) on the date of the sale to satisfy the debt owed, also called a deficiency.

**mortgage commitment** .................... **394**
A lender's commitment to make a mortgage, enforceable only when written, unconditional and signed by the lender for consideration.

**mortgage insurance premium (MIP)** .................... **419**
Default insurance premiums required on a Federal Housing Administration (FHA)-insured mortgage, paid both up-front and annually.

**mortgage interest deduction (MID)** .................... **559**
An itemized deduction for income tax reporting allowing homeowners to deduct interest and related charges they pay on a mortgage encumbering their primary or second homes.

**mortgage loan originator (MLO)** .................... **21**
An individual who receives fees to arrange a consumer mortgage.

**mortgage payment ratio** .................... **422**
A debt-to-income ratio (DTI) used to determine eligibility for an FHAinsured mortgage limiting the buyer's mortgage payment to 31% of the buyer's gross effective income.

**mortgage shopping worksheet** .................... **381**
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage. [See **RPI** Form 312]

**mortgage steering** .................... **408**
A mortgage loan originator (MLO) practice of directing a homebuyer to a consumer mortgage with less favorable terms in order to obtain greater compensation.

**mortgage-backed bond (MBB)** .................... **13**
An asset-backed security representing a claim on the cash flows from payments received on a mortgage.

**mortgagee-in-possession** .................... **185**
A lender who possesses a property, receiving any income it produces, and is obligated to operate or manage the property.

**mortgage-in-fact** .................... **216, 329, 532**
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** .......... **87, 356**
The addition of unpaid interest to the principal balance of a mortgage due to insufficient monthly interest payments.

**nominal interest rate** .......... **549**
The interest rate agreed to between the homebuyer and the lender as stated on the promissory note.

**non-exempt lender** .......... **435**
A lender subject to usury limitations when making a loan.

**nonjudicial foreclosure** .......... **488, 500**
When property is sold at a public auction by a trustee as authorized under the power-ofsale provision in a trust deed.

**nonrecourse debt** .......... **50, 99, 202, 243, 293, 456, 466, 481**
A debt recoverable on default solely through the value of the security interest in the secured property.

**note** .......... **48**
A document given as evidence of a debt owed by one person to another, sometimes called a promissory note. [See **RPI** Form 421 and 424]

**notice of default (NOD)** .......... **501, 516**
The notice filed to begin the nonjudicial foreclosure process. Generally, it is filed following three or more months of delinquent mortgage payments.

**notice of delinquency (NODq)** .......... **516**
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.

**notice of trustee's sale (NOTS)** .......... **503**
The notice recorded, posted and mailed to evidence an impending trustee's sale to the property owner and potential bidders.

**novation** .......... **99, 203, 246**
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.

## O

**one-action rule** .......... **184**
The prohibition of more than one action to recover a mortgage debt, requiring the mortgage holder to first resort to foreclosure on the real estate before pursuing other collection remedies. The enforcement of the assignment of rents provision by collecting rents does not bar a mortgage holder from later foreclosing on the real estate and, if a recourse mortgage, seeking a deficiency judgment.

**option adjustable rate mortgage (ARM)** .......... **87**
An adjustable rate mortgage (ARM) giving the borrower the choice of a full monthly payment, an interest-only payment, and a minimum payment typically less than the interest due.

## P

**passive category income** .......... **569**
Profits and losses from rental real estate, operations and sales, and from non-owner-operated businesses.

**pass-through provisions** .......... 357
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]

**payment cap** .......... 83
A limit on the amount of increase in the borrower's monthly principal and interest at the payment adjustment date on an adjustable rate mortgage (ARM).

**payoff demand** .......... 196
A written demand, prepared by a mortgage holder, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

**perfecting the lien** .......... 260
The preparation and filing of a UCC-1 Financing Statement (UCC-1) to put the public on notice of the lien created by a security agreement.

**periodic interest rate cap** .......... 82
A limit on the amount the interest rate can increase with each future adjustment of an adjustable rate mortgage (ARM).

**personal use loan** .......... 548
A mortgage origination which funds a personal use, such as a loan that funds the purchase or improvement of an owner's principal residence or second home.

**pledge** .......... 576
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** .......... 273, 569, 582
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

**portfolio lender** .......... 377
A lender who both funds and holds a mortgage to collect the interest income.

**power-of-sale provision** .......... 331, 476, 500
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

**pre-foreclosure workout** .......... 502
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

**prepayment penalty** .......... 63, 84, 97 104, 118
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

**prime offer rate** .......... 63
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.

**private mortgage insurance (PMI)** .......... 273, 324, 428
Default mortgage insurance coverage provided to a mortgage holder by private insurers on conventional mortgages with loan-to-value (LTV) ratios higher than 80%.

**privity of estate** ........ **164**
A mutual or successive relationship to the same rights in property; a connection between persons to the same estate in property.

**probate referee (on foreclosure)** ........ **495**
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

**promissory note** ........ **36, 62, 145**
A document given as evidence of a debt owed by one person to another. [See **RPI** Form 421 and 424]

**property profile** ........ **285**
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

**purchase-assist funding** ........ **243, 454**
The use of proceeds from a mortgage to fund the price paid by the borrower to acquire real estate.

**put option** ........ **325, 454**
A provision in all trust deeds which, in tandem with anti-deficiency laws, grants the owner of mortgaged real estate the right to default and force the mortgage holder to first sell the property through foreclosure.

**pyramiding** ........ **130**
The practice of assessing a late charge for the delinquent payment of a previously assessed late charge.

## Q

**qualified interest** ........ **562**
Interest on a mortgage which has accrued and been paid and is an allowable interest deduction for ownership of a first and second home.

**qualified mortgage (QM)** ........ **63**
A consumer mortgage granted safe harbor status under Regulation Z (Reg Z) ability-to-repay (ATR) rules under one of four definitions.

## R

**rate lock** ........ **397**
A lender's conditional, unsigned commitment to fund a mortgage at a quoted interest rate, origination fee and points, regardless of whether interest rates rise or fall prior to funding.

**real estate fixture** ........ **261**
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

**Real Estate Settlement Procedures Act (RESPA)** ........ **388**
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

**real rate of return** ........ **123**
The nominal interest rate on a mortgage minus the rate of inflation.

**recast** .......... **4, 303**
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** .......... **44, 150, 196,466**
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 debt** .......... **95, 202, 295, 325, 467, 482, 488**
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

**redeem** .......... **460, 518**
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.

**redemption** .......... **209, 477**
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

**reinstatement** .......... **56, 217, 476, 518, 527**
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.

**rent skimming** .......... **253**
When an investor receives rents from a parcel of residential rental property during their first year of ownership and does not apply the rents (or an equivalent amount) to the payments due on all mortgages secured by the property.

**residential mortgage** .......... **21**
A consumer mortgage other than a carryback mortgage requiring the licensee arranging the mortgage to be mortgage loan origination (MLO)-endorsed by the Department of Real Estate (DRE).

**restraint on alienation** .......... **3, 118**
A limit placed on a property owner's ability to sell, lease for a period exceeding three years or further encumber a property, as permitted by federal mortgage policy.

**restricted real estate mortgages** .......... **436**
All mortgages made by private party lenders which are neither made nor arranged by a real estate broker.

**retroactive interest differential (RID)** .......... **243**
The mortgage holder's losses, calculated based on the interest differential between the note rate and the market rate on the date of a third party's unlawful interference with the mortgage holder's right to call a mortgage.

**reverse lease-option** .......... **219**
A sale-leaseback agreement with the option to purchase as an addendum.

**right of rescission** .......... **215**
The right to cancel a completed transaction such as a sale or letting of property, including restoration, after the transaction has been closed.

# S

**sale-leaseback and purchase option arrangement** .................................... **206**
A disguised mortgage arrangement created when a seller conveys title to an investor/lender and retains possession under a lease agreement with the right to repurchase title and redeem the property for a fixed dollar sum.

**secondary mortgage market** .................................................... **107**
A market where mortgages are sold by originators to bundlers who aggregate them into pools which become collateral for bonds sold to investors, called mortgage backed securities (MBS).

**secular stagnation** .................................................... **15**
An abnormally lengthy period of sluggish economic growth.

**Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)** .................... **20**
A federal consumer protection law which created a uniform national licensing and registration scheme for mortgage loan originators (MLOs).

**secured loan transaction** .................................................... **206**
A mortgage transaction which places a lien on the owner's interest in a property for the amount of the debt owed the mortgage holder, including financial transactions documented by sellers as sale-leaseback and purchase lease-option arrangements.

**security agreement** .................................................... **260**
An agreement entered into between a mortgage holder and buyer to grant the mortgage holder additional security in the form of a lien on personal property described in the agreement. [See **RPI** Form 436]

**security interest** .................................................... **326**
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]

**self-help** .................................................... **183**
One of several enforcement steps taken by a lender when an owner defaults on a post-1996 trust deed, in which the lender takes possession of the property and collects rents nonjudicially.

**service provider** .................................................... **399**
An individual or company which offers services connected with a prospective or actual consumer mortgage origination.

**shared appreciation mortgage** .................................................... **40**
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]

**small lender qualified mortgage** .................................................... **30**
A type of qualified mortgage (QM) under Regulation Z (Reg Z) which allows small community mortgage lenders to include features otherwise prohibited in consumer mortgages.

**small lender** .................................................... **30**
A lender with assets of $2.202 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, for applications received before April 1).

**specific performance action** .................................................... **540**
An action to compel performance of an agreement, such as a purchase agreement or assignment of rents.

**stepped-up basis** .......... **579**
The readjustment of an appreciated asset's cost basis to fair market value for future tax purposes when transferred by inheritance.

**straight note** .......... **36, 315**
A note calling for payment of the entire amount of principal and accrued interest in a single lump sum when the principal is due. [See **RPI** Form 423]

**subject-to transaction** .......... **8, 241**
A sale of mortgaged property calling for the buyer to take title subject to the mortgage, the principal balance being credited toward the purchase price paid. Compare with formal assumption. [See **RPI** Form 156 §5]

**subordination** .......... **97, 467**
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** .......... **285, 467**
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]

**super-conforming loan** .......... **378**
A conforming loan with a maximum principal amount adjusted for a high-cost area.

**surplus funds** .......... **512**
Funds remaining when the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due the foreclosing mortgage holder.

## T

**temporary qualified mortgage** .......... **30**
A transitional qualified mortgage (QM) under Regulation Z (Reg Z) for lenders originating mortgages insured or guaranteed by the federal government or sold to Fannie Mae or Freddie Mac.

**title insurance** .......... **534**
A form of indemnity insurance by which a title insurance company holds harmless a person who acquires an interest in real estate against a monetary loss caused by an encumbrance on title that is not listed in the policy and the insured was unaware of when the policy was issued.

**trade fixture** .......... **261**
A fixture used to render services or make products for the trade or business of a tenant.

**transaction agent (TA)** .......... **384**
The term lenders use to identify the buyer's agent in a sales transaction.

**treble damages** .......... **438**
A usury penalty computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of an action on a nonexempt private lender mortgage.

**trustee (on a mortgage)** .......... **146, 501, 518**
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.

**trustee's sale guarantee** ....................505
A policy issued by a title insurance company to a trustee before or at the time the notice of default (NOD) is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

**Truth in Lending Act (TILA)** ....................391
A federal consumer mortgage law which controls the terms of a consumer mortgage and requires lenders to disclose mortgage rates and charges.

## U

**U.S. Department of Veterans Affairs (VA) mortgage guarantee** ....................252
A program that assists qualified veterans or their surviving spouses to buy a home with zero down payment. [See **RPI** Form 153]

**unconscionable advantage** ....................450
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.

**Uniform Residential Loan Application (URLA)** ....................384
A standardized mortgage application prepared by the buyer with the assistance of the transaction agent (TA) and the lender's representative. [See **RPI** Form 202]

**unsecured note** ....................336
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]

**upcharging** ....................407
The practice of marking up the price of a third-party service and keeping the difference.

**usury** ....................43, 433, 445
A limit on the lender's interest rate yield on non-exempt real estate mortgages.

## W

**waiver agreement** ....................235, 303
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]

**warehouse lender** ....................377
A lender who funds a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.

**waste** ....................244
The intentional destruction or neglect of property which diminishes its value. [See **RPI** Form 550 §6.8 and 552 §7.4]

# Real Estate Finance, Eighth Edition Quizzes

Instructions: Quizzes are open book. All answers are Multiple Choice.
Answer key is located on Page 638.

## Quiz 1 — Chapters 1-2, Pages 1-34

____ 1. The goals, anticipations and positions of lenders and owners of real estate are:

a. diametrically opposed.
b. adversarial.
c. similar.
d. Both a. and b.

____ 2. Mortgage law prohibits enforcement of any trust deed provision which purports to restrict the owner's right to sell, lease or encumber their property, called a:

a. restraint on alienation.
b. notice of delinquency (NODq).
c. choice-of-law provision.
d. None of the above.

____ 3. Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn) provides general guidelines for ____________ enforcement.

a. balloon payment
b. due-on
c. late fee
d. notice of default (NOD)

____ 4. ____________ became more common during the Millennium Boom as mortgage underwriting standards became lax and underqualified tenants were lured into homeownership.

a. A reduction in the homeownership rate
b. Seller carryback financing
c. Subprime lending
d. All of the above.

____ 5. During the Millennium Boom, ____________ provided the flow of money needed to originate, bundle and sell positions in America's mortgages.

a. the Federal Government
b. mortgage-backed bonds (MBBs)
c. the European Central Bank (ECB)
d. All of the above.

____ 6. A protracted period of lackluster economic growth is referred to as:

a. secular stagnation.
b. the Great Recession.
c. the Millennium Boom.
d. a virtuous cycle.

____ 7. The Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act) applies to:

a. construction loans.
b. business mortgages.
c. residential mortgages.
d. All of the above.

____ 8. California Department of Real Estate (DRE) licensees are required to obtain a(n) ____________ when they take an application for or negotiate a residential mortgage loan for a fee.

a. unique Nationwide Mortgage Licensing System and Registry (NMLS) ID
b. mortgage loan originator (MLO) endorsement
c. Consumer Financial Protection Bureau (CFPB) certification
d. Both a. and b.

____ 9. In the wake of the Millennium Boom, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created the:

a. Consumer Financial Protection Bureau (CFPB).
b. Department of Housing and Urban Development (HUD).
c. California Department of Real Estate (DRE).
d. Department of Corporations (DOC).

___ 10. The ____________ qualified mortgage (QM) is not a type of QM.

a. general
b. business-purpose
c. small lender
d. balloon-payment

## Quiz 2 — Chapters 3-8, Pages 35-115

____ 1. A(n) ____________ calls for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a balloon payment.

a. installment note
b. straight note
c. sleeper note
d. bridge note

____ 2. With a(n) ____________, 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.

a. shared appreciation mortgage (SAM)
b. graduated payment mortgage (GPM)
c. all-inclusive trust deed (AITD)
d. straight note

____ 3. A note is:

a. evidence of the existence of a debt created by an underlying agreement to pay money.
b. the debt itself.
c. a lien placed on property to secure debt.
d. an addendum to a living trust.

____ 4. A(n) ____________ in a note is used to convert a mortgage holder's recourse paper into nonrecourse paper.

a. exculpatory clause
b. choice-of-law provision
c. equitable assignment
d. guarantee agreement

_____ 5. A written modification agreement attached to a note is called a(n):

a. allonge.
b. forbearance.
c. execution.
d. mutual agreement.

_____ 6. To avoid loss of priority on a significant modification to a senior mortgage, a junior mortgage holder needs to agree to the greater risk of loss, called:

a. subordination.
b. hypothecation.
c. pledging.
d. unconscionable advantage.

_____ 7. An agreement entered into in which the buyer assumes the existing mortgage and the mortgage holder releases the seller from further liability is called a(n):

a. novation.
b. cash-to-loan (CTL) transaction.
c. exculpatory clause.
d. seller carryback transaction.

_____ 8. A(n) ____________ in a note gives the mortgage holder the right to levy a charge against a property owner who pays off the outstanding principal balance on a mortgage prior to its maturity.

a. subordination provision
b. exculpatory clause
c. late charge provision
d. prepayment penalty provision

_____ 9. When a prepayment penalty is allowed on fixed rate consumer mortgages classified as qualified mortgages (QMs), the penalty period is limited to ____________ after origination.

a. one year
b. two years
c. three years
d. five years

____ 10. When the mortgage limits a prepayment penalty to only ____________ payoffs, the mortgage holder is not permitted to include the penalty when the property is redeemed or bid on at the trustee's sale.

a. voluntary
b. involuntary
c. partial
d. None of the above.

## Quiz 3 — Chapters 9-12, Pages 117-152

_____ 1. A(n) ____________ clause in a note prohibits prepayment and satisfaction of the mortgage debt.

a. advance fee
b. late charge
c. due-on
d. lock-in

_____ 2. In the context of real estate law, a lock-in clause functions as a(n):

a. mortgage holder's universal right.
b. restraint on alienation.
c. interest rate limitation.
d. None of the above.

_____ 3. The ____________ calls for an additional charge if payment is not received by the mortgage holder when due or within a grace period after which the payment is delinquent.

a. late charge provision
b. lock-in clause
c. choice-of-law provision
d. right of first refusal

____ 4. A complete late charge provision includes:

a. the duration of any grace period following the due date before a payment is con sidered delinquent.

b. the amount of the late charge.

c. a requirement for notice from the mortgage holder to impose the late charge and make a demand for its payment.

d. All of the above.

____ 5. Reasonable monetary losses collectible as a late charge include:

a. the actual out-of-pocket expenses incurred in a reasonable collection effort.

b. the lost use of the principal and interest (PI) portion of the delinquent payment until paid.

c. Both a. and b.

d. Neither a. nor b.

____ 6. The late charge on any mortgage not made or arranged by a broker and secured by an owner-occupied single family residence (SFR) is limited to the greater of $5 or:

a. 6% of the delinquent principal and interest installment.

b. 10% of the delinquent principal installment.

c. 8% of the delinquent interest installment.

d. None of the above.

____ 7. A(n) ____________ is any final payment on a mortgage more than twice the amount of any of the six regularly scheduled payments immediately preceding the final payment date.

a. late payment
b. redemption payment
c. prepayment
d. balloon payment

____ 8. A final/balloon payment notice needs to be delivered at least ____________ days, but not more than ____________ days, before the due date.

a. 90; 150
b. 150; 90
c. 80; 20
d. 70; 30

____ 9. To secure payment of the debt by a parcel of real estate, the security device used is a(n):

a. promissory note.
b. trust deed.
c. UCC-1 Financing Statement (UCC-1).
d. None of the above.

___ 10. The ____________, such as a mortgage holder or carryback seller, is the person entitled to performance of the promised activities referenced in the trust deed.

a. trustee
b. beneficiary
c. payor
d. None of the above.

## Quiz 4 — Chapters 13-17, Pages 153-211

____ 1. Provisions of a(n) ____________ 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.

a. trust deed
b. promissory note
c. purchase agreement
d. None of the above.

_____ 2. Trust deeds are recognized as _____________ where one person or party (the mortgage holder) has superior bargaining power over a weaker person (the borrower).

a. equality agreements
b. bargaining tools
c. adhesion contracts
d. adhesive contracts

_____ 3. The purported rights of a lender or carryback seller, agreed to by the buyer or owner when entering into trust deed financing, are controlled by statutes and:

a. case law interpretations regarding fairness, good faith and reasonable expectations.
b. historical common law doctrines governing the conduct of persons holding interests in real estate.
c. Both a. and b.
d. Neither a. nor b.

_____ 4. Property ownership expenses paid with an impound account include:

a. property taxes.
b. insurance premiums.
c. bond improvements.
d. All of the above.

_____ 5. A consumer mortgage holder is required to pay _____________ on any balance in an impound account.

a. 2% annual compounding interest
b. 3% monthly compounding interest
c. 2% annual simple interest
d. 4% annual simple interest

_____ 6. Following a default, a(n) _____________ in a trust deed gives the beneficiary the right to collect rental income from the income-producing property.

a. impound account
b. future advances clause
c. assignment of rents provision
d. resident management agreement

_____ 7. Once an assignment of rents provision is recorded, it:

a. gives constructive notice of the mortgage holder's security interest in the rents.
b. is fully perfected even though the provision states the lien is unenforceable until a default occurs on the note or trust deed.
c. Both a. and b.
d. Neither a. nor b.

_____ 8. When a junior lienholder who has enforced its assignment of rents provision receives notice of the senior mortgage holder's enforcement, the junior lienholder is required to:

a. cease collecting the rents.
b. send a notice to the tenants cancelling its demand for rents.
c. Both a. and b.
d. Neither a. nor b.

____ 9. Intentional failure to timely send a beneficiary statement within 21 days of receipt of request results in a ____________ forfeiture by a mortgage holder to the person making the request.

a. $100
b. $200
c. $300
d. $400

___ 10. A grant deed given by an owner for the sole purpose of securing the future performance of an obligation, such as the payment of money, is considered a(n):

a. mortgage.
b. transfer of ownership.
c. transfer of title.
d. unenforceable lease.

## Quiz 5 — Chapters 18-22, Pages 213-270

____ 1. An equity purchase (EP) transaction occurs when an owner-occupant transfers title of a one-to-four unit residential property in foreclosure and title to the property is acquired by a buyer for:

a. their primary residence.
b. rental, investment or dealer purposes.
c. Both a. and b.
d. Neither a. nor b.

____ 2. After entering into an equity purchase (EP) sale, a seller-in-foreclosure has a statutory ____________ right to cancel the sales agreement they have entered into with an investor.

a. 20-business day
b. 15-business day
c. ten-business day
d. five-business day

____ 3. In times of ____________, mortgage holders seize any event to trigger the due-on clause in order to increase the interest yield on their portfolio.

a. falling interest rates
b. rising interest rates
c. stable interest rates
d. None of the above.

____ 4. A due-on clause may be triggered by a lease:

a. with a term over three years.
b. for any term when coupled with an option to buy.
c. Either a. or b.
d. Neither a. nor b.

____ 5. The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a ____________ who occupies the property.

a. spouse
b. child
c. Either a. or b.
d. Neither a. nor b.

____ 6. 6. When a written assumption agreement with a mortgage holder involves consumer-purpose financing controlled by Regulation Z (Reg Z), the assumption is subject to:

a. new disclosures by the mortgage holder to the assuming buyer based on the remaining obligation.
b. verification of the assuming buyer's ability to repay the mortgage based on Reg Z Ability-to-Repay (ATR) rules.
c. Both a. and b.
d. Neither a. nor b.

____ 7. The ____________ is a promise given by the buyer to the seller to perform all the terms of the mortgage the buyer is taking over.

a. buyer-seller assumption agreement
b. formal assumption
c. Both a. and b.
d. Neither a. nor b.

____ 8. Under a(n) ____________, a mortgage holder, buyer and seller agree to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

a. beneficiary statement
b. all-inclusive trust deed (AITD)
c. home equity mortgage
d. novation agreement

____ 9. A buyer of property secured by a VA-guaranteed mortgage is able to take over the mortgage if:

a. the mortgage is current.
b. the buyer assumes the mortgage.
c. the buyer is creditworthy.
d. All of the above.

___ 10. A security device called a(n) ____________ perfects a lien on personal property against later claims.

a. UCC-1 Financing Statement (UCC-1)
b. UCC-2 Change Form (UCC-2)
c. mechanic's lien
d. All of the above.

## Quiz 6 — Chapters 23-26, Pages 271-309

____ 1. Carryback financing, also called a(n) ____________, involves 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.

a. installment sale
b. credit sale
c. owner-will-carry (OWC) sale
d. All of the above.

____ 2. Legally, a(n) ____________ provide the most certainty and are the most universally understood of the various documents used to structure seller financing.

a. note and trust deed
b. lease-option sale
c. land sales contract
d. sale-leaseback

____ 3. Under a(n) ____________, a note is 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 trust deed debts remaining of record with the seller retaining responsibility for their payment.

a. all-inclusive trust deed (AITD)
b. wraparound mortgage
c. overriding mortgage
d. All of the above.

____ 4. 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 is known as a(n):

a. subordination agreement.
b. exchange agreement.
c. assumption agreement.
d. None of the above.

____ 5. On a carryback sale of a one-to-four unit residential property, if a mandated ____________ is not included with the purchase agreement, a statutory contingency is triggered giving the buyer the right to cancel the transaction until it is signed by the buyer and the seller.

a. carryback disclosure statement
b. finder's fee agreement
c. exchange agreement
d. All of the above.

____ 6. To demonstrate the financial risk facing the seller if the buyer defaults and the seller forecloses, the seller's agent prepares a(n):

a. foreclosure cost sheet.
b. conflict of interest disclosure.
c. deed-in-lieu of foreclosure.
d. balance sheet.

____ 7. A buyer may secure a carryback note with one trust deed describing multiple parcels of real estate as security for payment of the carryback note, called a:

a. blanket mortgage.
b. business mortgage.
c. reverse mortgage.
d. None of the above.

____ 8. A mortgage holder's demand for the balance of the loan to be immediately paid in full in known as a(n):

a. notice of default (NOD).
b. call.
c. waiver agreement.
d. novation.

____ 9. Without the mortgage holder's ____________ 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.

a. prior written waiver
b. concurrent oral waiver
c. prior enforcement
d. None of the above.

___ 10. Any broker negotiating a transaction as an agent for either party has a(n) ____________ to disclose title conditions affecting ownership or use of the property to both parties, not just their client.

a. agency duty
b. fiduciary duty
c. general duty
d. All of the above.

## Quiz 7 — Chapters 27-29, Pages 311-348

____ 1. Examples of a masked security device requiring carryback disclosure include a land sales contract, a lease-option, and a(n):

a. note and trust deed.
b. all-inclusive trust deed (AITD).
c. unexecuted purchase agreement with interim occupancy.
d. lease for a term greater than 1 year.

____ 2. Carryback disclosure statements are optional in carryback transactions creating ____________ which do not bear interest or include finance charges.

a. adjustable rate notes (ARMs)
b. interest only notes
c. straight notes
d. installment sales

____ 3. A seller, intending to carryback a mortgage, needs to be primarily concerned with:

a. their loan-to-value ratio (LTV).
b. the buyer's ability to pay.
c. Both a. and b.
d. Neither a. nor b.

____ 4. 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(n):

a. security interest.
b. tenancy-in-common.
c. mechanic's lien.
d. right of first refusal.

____ 5. Foreclosure cost calculations are made by an agent and reviewed with a seller who is considering an installment sale when accepting the listing and:

a. within 3 days of closing escrow.
b. when presenting an offer or counteroffer.
c. after closing escrow.
d. All of the above.

____ 6. If a wiped-out owner refuses to vacate the property on expiration of the three-day notice, the carryback mortgage holder proceeds with a(n):

a. reverse mortgage.
b. unlawful detainer (UD) action.
c. bankruptcy petition.
d. None of the above.

____ 7. When a tenant is in possession of a residential unit at the time of a foreclosure sale, they are given a(n) ____________ notice to quit due to foreclosure if the carryback mortgage holder (as the owner-by-foreclosure) intends to force the tenant to vacate.

a. 90-day
b. 60-day
c. 30-day
d. 15-day

____ 8. For the seller's agent to properly disclose the separate financial, tax and risk-of-loss aspects to a seller, a(n) ____________ needs to be attached to any purchase agreement which calls for a carryback mortgage.

a. carryback disclosure statement
b. agency law disclosure
c. conflict of interest disclosure
d. None of the above.

____ 9. To investigate an income-producing property's ability to carry its debt service, the property's income and expenses are analyzed by using the:

a. profit and loss statement.
b. Investment Circular.
c. Annual Property Operating Data Sheet (APOD).
d. balance sheet.

___ 10. 10. A buyer's net worth is the total value of their assets minus their total debt obligations or liabilities, and is the bottom line shown on the financial statement entitled the:

a. agreement to hypothecate.
b. operating agreement.
c. net sheet.
d. balance sheet.

## Quiz 8 — Chapters 30-32, Pages 349-382

____ 1. A(n) ____________ occurs when the balance on an all-inclusive trust deed (AITD) sinks below the balance on a wrapped loan.

a. switch
b. inverse order of alienation
c. negative gain
d. crossover

____ 2. Two types of all-inclusive trust deeds (AITDs) exist, including:

a. equity payoff and earnings payoff.
b. full payoff and interest payoff.
c. interest payoff and non-payoff.
d. equity payoff and full payoff.

____ 3. A(n) ____________, used to confirm the terms of the underlying mortgage are as represented by the seller, is a document issued by a mortgage holder noting future payment schedules, interest rates and balances on a mortgage.

a. beneficiary statement

b. Annual Property Operating Data Sheet (APOD)

c. all-inclusive trust deed (AITD)

d. wraparound security device

____ 4. ____________ were widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by mortgage holders.

a. Equitable conversions

b. Land sales contracts

c. Contract escrows

d. Lease-option sales

____ 5. Even if a land sales contract document is not recorded, entering into a land sales contract triggers:

a. the due-on clause in an existing trust deed as a transfer of an interest.

b. reassessment for property tax purposes as a change of ownership.

c. Both a. and b.

d. Neither a. nor b.

____ 6. A disguised sale structured as a(n) ____________ is still considered a sale.

a. note and trust deed

b. reverse mortgage

c. rental agreement

d. lease-option

____ 7. Under a lease-option sale, which has all the economic characteristics of a credit sale, there is:

a. an agreed-to price.

b. a down payment.

c. balloon payment for the balance of the unpaid purchase price.

d. All of the above.

____ 8. A Federal Housing Administration (FHA)-insured mortgage is a:

a. conventional mortgage.

b. business mortgage.

c. government-related mortgage.

d. lender overlay.

____ 9. Additional minimum requirements imposed by a lender in addition to mortgage insurer and investor guidelines are called:

a. lender overlays.

b. mortgage insurance premiums (MIP).

c. government sponsorships.

d. shopping worksheets.

___ 10. Mortgages with principal amounts at or below the ceilings set by Fannie Mae and Freddie Mac are known as:

a. conforming loans.

b. government-related mortgages.

c. fixed-rate mortgages.

d. jumbo loans.

## Quiz 9 — Chapters 33-35, Pages 383-415

____ 1. Section One of the Uniform Residential Loan Application (URLA) calls for the:

a. borrower's employment history.
b. borrower's assets and liabilities.
c. borrower's signature.
d. type of mortgage sought.

____ 2. The ____________ discloses confidential information used by the title company to search the general index (GI) for conditions affecting title.

a. tax return release
b. balance sheet
c. debt-to-income ratio (DTI)
d. statement of information

____ 3. The Real Estate Settlement Procedures Act (RESPA) is administered and enforced by the:

a. Consumer Financial Protection Bureau (CFPB).
b. U. S. Department of Housing and Urban Development (HUD).
c. California Department of Real Estate (DRE).
d. Federal Housing Administration (FHA).

____ 4. Lenders use the ____________ to evaluate the buyer's ability to make timely mortgage payments, referred to as buyer mortgage capacity.

a. income-to-taxes quotient
b. debt-to-income ratio (DTI)
c. loan-to-volume ratio (LTV)
d. debt-to-expenses percentage

____ 5. To be enforceable, a mortgage commitment needs to be:

a. in writing.
b. given in exchange for consideration.
c. signed.
d. All of the above.

____ 6. Which of the following is an unlawful kickback under the Real Estate Settlement Procedures Act (RESPA)?

a. A lender pays a mortgage loan originator (MLO) for their MLO services.
b. A broker pays an unlicensed assistant for clerical work relating to a mortgage origination.
c. A title company pays for a broker's vacation in exchange for business referrals.
d. All of the above.

____ 7. MLO compensation includes:

a. bonuses.
b. credit report fees.
c. appraisal fees.
d. title insurance fees.

____ 8. 8. A(n) ____________ is a fee an MLO receives before the MLO services are fully completed.

a. rent
b. kickback
c. advance fee
d. steering fee

____ 9. A lender may charge a ____________ to the homebuyer before the Loan Estimate is delivered.

a. appraisal fee
b. title report fee
c. origination fee
d. credit report fee

___ 10. The Loan Estimate form is delivered to the borrower within ____________ after a homebuyer submits a consumer mortgage application.

a. 90 days
b. seven calendar days
c. three calendar days
d. three business days

## Quiz 10 — Chapters 36-37, Pages 417-432

____ 1. A mortgage originated by a lender and insured by the Federal Housing Administration (FHA) is characterized by a:

a. small down payment requirement.
b. high loan-to-value ratio (LTV).
c. Both a. and b.
d. Neither a. nor b.

____ 2. The most commonly used Federal Housing Administration (FHA) program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program:

a. Section 234(c).
b. Section 203(h).
c. Section 203(k).
d. Section 203(b).

____ 3. The buyer needs to pay ____________ as an added cost for the privilege of making a small down payment using a Federal Housing Administration (FHA)-insured mortgage.

a. private mortgage insurance (PMI)
b. a mortgage insurance premium (MIP)
c. Either a. or b.
d. Neither a. nor b.

____ 4. A buyer's effective income before any reduction for the payment of taxes is referred to as:

a. gross effective income.
b. adjusted gross income.
c. net equity income.
d. effective income.

____ 5. Even if the buyer's ratios exceed Federal Housing Administration (FHA) requirements, the mortgage may be approved on the basis of compensating factors if the buyer:

a. makes a large down payment.
b. has a good credit history.
c. has substantial cash reserves.
d. Any of the above.

____ 6. The goal of the ____________ program is to reduce utility charges, allowing applicants to make higher monthly mortgage payments to fund the cost of the energy efficient improvements.

a. Federal Housing Administration (FHA) insurance
b. Veteran's Administration (VA)-guaranteed mortgage
c. Home Affordable Modification Program (HAMP)
d. Energy Efficient Mortgage (EEM)

____ 7. ____________ indemnifies a mortgage holder against losses on their investment in a mortgage when a borrower defaults.

a. Mortgage life insurance
b. Private mortgage insurance (PMI)
c. Hazard insurance
d. Unemployment insurance

____ 8. Some mortgage holders and private mortgage insurance (PMI) carriers offer a ____________ program in which the lender pays the mortgage insurance premium.

a. Guaranteed Payment Mortgage Plan (GPMP)
b. Lender-Assist Mortgage Insurance (LAMI)
c. Lender-Paid Mortgage Insurance (LPMI)
d. Premium-Paid Mortgage Insurance (PPMI)

____ 9. If the borrower is current on private mortgage insurance (PMI) payments and has not taken out other mortgages on their property, they may terminate their PMI coverage when the equity in their property reaches ____________ of its value at the time the mortgage was originated.

a. 7%
b. 10%
c. 15%
d. 20%

____ 10. To qualify for private mortgage insurance (PMI), the borrower needs to:

a. be a natural person, not a corporation, partnership or limited liability company (LLC).

b. take title as the vested owner of the property.

c. Both a. and b.

d. Neither a. nor b.

## Quiz 11 — Chapters 38-39, Pages 433-452

____ 1. The amount of interest a non-exempt lender may charge a borrower is regulated by statutes and the California Constitution, called:

a. ability-to-repay (ATR) rules.

b. usury laws.

c. limitation clause.

d. qualified mortgage (QM) laws.

____ 2. The maximum rate of interest which can be charged on a non-exempt loan secured by real estate is the greater of:

a. 5% per year or the discount rate of the Federal Reserve Bank of San Francisco (FRBSF) plus 5%.

b. 5% per year or the discount rate of the FRBSF plus 10%.

c. 10% per year or the discount rate of the FRBSF plus 5%.

d. 10% per year or the discount rate of the FRBSF plus 10%.

____ 3. Two basic classifications of loan transactions exist relating to interest rates lenders may charge on real estate mortgages are:

a. exempt and brokered.

b. exempt and unbrokered.

c. brokered and restricted.

d. unbrokered and restricted.

____ 4. The discount rate used to calculate the usury threshold rate for mortgages agreed to during a particular month is the Federal Reserve Bank of San Francisco (FRBSF) rate for the ____________ day of the previous month.

a. 1st

b. 10th

c. 15th

d. 25th

____ 5. The most common penalty imposed on a non-exempt lender in violation of usury law is:

a. quadrupled damages.

b. the forfeiture of all interest on the mortgage.

c. a three year prison sentence.

d. None of the above.

____ 6. Activities of a licensed real estate sales agent:

a. always fall within the usury exemption of their broker.

b. never fall within their broker's usury exemption, unless the agent is in the process of obtaining a broker's license.

c. are not within the broker's usury exemption, unless the agent's level of participation in the transaction constitutes arranging the loan.

d. None of the above.

____ 7. An attorney arranging a loan without also being licensed as a broker:

a. qualifies for exemption from usury laws.

b. does not qualify for exemption from usury laws.

c. will be expelled from the State Bar of California.

d. is subject to a forfeiture of all interest paid on the mortgage.

____ 8. ____________ are not subject to the interest limitations of usury laws.

a. The forbearance of rights on the default of a money loan

b. The origination of a mortgage

c. The refinance of an existing mortgage

d. Credit sales

____ 9. A lender may exempt its mortgages from the limitation on interest rates imposed by usury laws by:

a. retaining a licensed real estate broker to arrange the mortgage.

b. becoming licensed as a real estate broker itself.

c. Either a. or b.

d. Neither a. nor b.

___ 10. ____________ occurs when a mortgage holder exploits an element of oppression or surprise to exact unreasonably favorable terms from the opposing person.

a. Waste

b. Unconscionable advantage

c. A short payoff

d. None of the above.

## Quiz 12 — Chapters 40-42, Pages 453-485

____ 1. To satisfy an unpaid mortgage debt on a default, the mortgage holder first forecloses on the real estate before attempting any other method of collection, called:

a. exhausting the security.

b. substituting the security.

c. committing waste.

d. None of the above.

____ 2. The California legislature enacted ____________ laws to set a limitation on the amount recoverable as a money judgment for debts secured by real estate.

a. usury

b. anti-deficiency

c. due-on clause

d. None of the above.

___ 3. Mortgage holders intending to minimize their loss through pre-foreclosure workouts accept the net proceeds from an owner's sale of the secured property in exchange for cancelling the unpaid mortgage balance, called a(n):

a. short payoff.

b. short sale.

c. Both a. and b.

d. Neither a. nor b.

____ 4. When a deficiency judgment is awarded to the mortgage holder, the property owner has the right to ____________ the property within one year after the judicial foreclosure sale by paying the amount of the successful bid, plus interest.

a. reinstate

b. redeem

c. foreclose

d. satisfy

_____ 5. Anti-deficiency rules no longer apply to a carryback debt when the debt to the seller becomes secured by real estate other than the real estate sold, called:

a. substitution of security.

b. exhaustion of the security.

c. waiver of the security.

d. subordination of the security.

_____ 6. A letter of credit is unenforceable if:

a. the mortgage debt is subject to an anti-deficiency defense for funding the purchase of an owner-occupied, one-to-four unit residential property.

b. it is issued to a mortgage holder to cover a future default on the mortgage debt.

c. Both a. and b.

d. Neither a. nor b.

_____ 7. Trust deeds securing a debt obligation contain a boilerplate provision authorizing mortgage holders to call all amounts remaining unpaid due and payable on a material default under the trust deed, called a(n):

a. power-of-sale provision.

b. put option.

c. future advances provision.

d. acceleration clause.

_____ 8. After a notice of default (NOD) is recorded, an owner may bring current any monetary or curable default stated in the NOD prior to five business days before the trustee's sale, called the:

a. redemption period.

b. reinstatement period.

c. auction timeframe

d. sheriff's sale window.

_____ 9. The trustee needs to begin advertising and post a notice of trustee's sale (NOTS) at least:

a. ten days after the notice of default (NOD) is delivered.

b. four months and 15 days prior to the date of the sale.

c. 30 days before the date of the sale.

d. 20 days before the date of the sale.

____ 10. When an owner fails to meet their obligations regarding the care, use and maintenance of the secured real estate, the owner is in default under the ____________ in the trust deed.

a. debt obligation

b. due-on clause

c. waste provision

d. All of the above.

## Quiz 13 — Chapters 43-45, Pages 487-524

_____ 1. A(n) ____________ is the court-ordered sale in a judicial foreclosure by public auction of the secured property.

a. sheriff's sale

b. trustee's sale

c. referee's sale

d. All of the above.

_____ 2. At the fair value hearing, the court may appoint an appraiser, called a(n) ____________, to advise the court on the value of the property.

a. fair market value (FMV) indicator

b. probate judge

c. FMV referee

d. probate referee

____ 3. The key to the mortgage holder's ability to nonjudicially foreclose by a trustee's sale on the mortgaged real estate is the ____________ contained in the trust deed.

a. power-of-sale provision
b. choice-of-law provision
c. liquidated damages provision
d. attorney fee provision

____ 4. When a mortgage is in default and a foreclosure on the property is required, the mortgage holder delivers a(n) ____________ to the trustee.

a. trustee's sale guarantee
b. declaration of default and demand for sale
c. notice of default (NOD)
d. All of the above.

____ 5. A notice of default (NOD) contains statutorily mandated statements which set forth the ____________ on a note or other obligations secured by the mortgage.

a. monetary default
b. unearned future interest remaining to be paid
c. release of liability
d. All of the above.

____ 6. Each bid made at a trustee's sale is a(n) ____________ to purchase the property. However, any subsequent ____________ bid cancels a prior bid.

a. irrevocable offer; higher
b. irrevocable offer; lower
c. revocable offer; higher
d. revocable offer; lower

____ 7. Residual funds which exceed the amount of debt foreclosed and remain after a trustee's sale are called:

a. interpleader action.
b. surplus funds.
c. residual equity.
d. additional financing.

____ 8. A recorded Request for Notice of Default identifies:

a. the person requesting a copy of the notice of default (NOD).
b. the trust deed on which a copy of the NOD commencing foreclosure is requested.
c. Both a. and b.
d. Neither a. nor b.

____ 9. Within ten business days following the recording of the notice of default (NOD), the trustee is required to:

a. mail one copy of the NOD to each person who recorded a request for notice.
b. mail two copies of the NOD to each person who recorded a request for notice.
c. post a copy of the NOD on the property of each person who recorded a request f or notice.
d. email a copy of the NOD to each person who recorded a request for notice.

____ 10. A(n) ____________ assures a junior lienholder they will be notified when a delinquency in installments has existed for more than four months and 15 days.

a. Request for Notice of Default
b. Request for Notice of Delinquency
c. Declaration of Default
d. Request for Notice of Trustee's Sale

## Quiz 14 — Chapters 46-49, Pages 525-555

_____ 1. A(n) _____________ in a trust deed authorizes a mortgage holder to accept partial payments to reinstate a mortgage without waiving its right to foreclose if a delinquency remains.

a. waiver clause

b. non-waiver clause

c. reinstatement clause

d. final/balloon payment clause

_____ 2. A mortgage holder accepting regular installment payments from an owner after declaring a default which cannot be cured by a reinstatement:

a. waives its right to foreclose based on that default.

b. does not waive its right to foreclose based on that default.

c. may only accept a conditional tender of funds.

d. None of the above.

_____ 3. Under a(n) _____________, an owner of property conveys their property to a mortgage holder in exchange for the cancellation of a debt.

a. land sales contract

b. lease-option sale

c. deed-in-lieu

d. deed absolute

_____ 4. On recording a deed-in-lieu, a(n) _____________ needs to be issued to assure the mortgage holder that the title conveyed to them is clear of liens which may have been recorded after the mortgage holder's trust deed was recorded.

a. quit claim deed

b. title insurance policy

c. errors and omissions (E&O) policy

d. hazard insurance policy

_____ 5. An owner who defaults on a mortgage is more inclined to agree to deliver a deed-in-lieu of foreclosure when their gross equity in the property is _____________ of the property's current fair market value (FMV).

a. less than 10%

b. greater than 20%

c. less than 50%

d. greater than 30%

_____ 6. Attorney fees are collectible in an action for judicial foreclosure:

a. on an owner's reinstatement of a mortgage prior to the foreclosure decree.

b. on completion of the judicial foreclosure.

c. Either a. or b.

d. Neither a. nor b.

_____ 7. In the instance of a judicial foreclosure, attorney fees are fixed at the notice of default (NOD) fee schedule for reinstatement until entry of the:

a. lis pendens.

b. foreclosure decree.

c. future advances provision.

d. Both a. and b.

_____ 8. Accrued interest paid on a mortgage which funded a person's trade or business activities, may be written off as a(n) _____________ of the person's business.

a. operating expense

b. tax advancement

c. personal expense

d. equity reduction

____ 9. Points paid to a lender to originate a mortgage are considered ____________ since interest has not yet accrued.

a. nominal interest
b. life-of-loan accrual
c. prepaid interest
d. None of above.

___ 10. When a mortgage is secured solely by property other than the residence purchased or improved with the mortgage funds, such as business or rental property owned by the homeowner, the points are:

a. deducted in the year they are paid.
b. deducted over the life of the mortgage.
c. not deductible.
d. None of the above.

## Quiz 15 — Chapters 50-52, Pages 557-593

____ 1. The ____________ rules allow mortgaged homeowners to deduct from their adjusted gross income (AGI) the interest accrued and paid on first and second homes.

a. Real Estate Settlement Procedures Act (RESPA)
b. mortgage interest deduction (MID)
c. Truth-in-Lending Act (TILA)
d. All of the above.

____ 2. To qualify home improvement mortgages for interest deductions, the new improvements need to:

a. add to the property's market value.
b. prolong the property's useful life.
c. adapt the property to residential use.
d. Any of the above.

____ 3. To qualify for the mortgage interest deduction (MID), a mortgage needs to be secured by the owner's:

a. principal residence.
b. second home.
c. place of business.
d. Either a. or b.

____ 4. Interest deductions on home mortgages are only allowed for interest which has accrued and been paid, called:

a. itemized deduction.
b. qualified interest.
c. adjusted gross income.
d. business expense.

____ 5. All profit taken on a sale is reported in the year of the sale, unless the profit is:

a. excluded, exempt or deferred.
b. exempt, equitable or unrecaptured.
c. deferred, depreciated or assumed.
d. excluded, recaptured or recognized.

____ 6. 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:

a. mortgage over basis.
b. negative equity.
c. subordination.
d. None of the above.

____ 7. The process by which a seller pledges their carryback note as collateral for a mortgage is called:

a. hypothecation.
b. reinvestment.
c. reverse assumption.
d. mortgage over basis.

____ 8. 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 Internal Revenue Service (IRS) ____________ of interest.

a. imputed rate
b. periodic payment schedule rate
c. return of capital rate
d. Applicable Federal Rate (AFR)

____ 9. Applicable Federal Rate (AFR) reporting entails an allocation and conversion of principal to interest by the taxpayer, called:

a. imputing.
b. commingling.
c. hypothecation.
d. amortization.

___ 10. For all carryback sales entered into in an amount no greater than the interest threshold, the minimum reportable interest rate is the lesser of ____________ or the note's Applicable Federal Rate (AFR).

a. 5%
b. 8%
c. 9%
d. 12%

# Answer References

The following are the answers to the quizzes for *Real Estate Finance, Eighth Edition* and the page numbers where they are located.

### Quiz 1

| | | |
|---|---|---|
| 1. | d | 1 |
| 2. | a | 3 |
| 3. | b | 10 |
| 4. | c | 13 |
| 5. | b | 13 |
| 6. | a | 15 |
| 7. | c | 20 |
| 8. | d | 21 |
| 9. | a | 24 |
| 10. | b | 28 |

### Quiz 2

| | | |
|---|---|---|
| 1. | a | 36 |
| 2. | b | 40 |
| 3. | a | 48 |
| 4. | a | 71 |
| 5. | a | 94 |
| 6. | a | 97 |
| 7. | a | 99 |
| 8. | d | 104 |
| 9. | c | 109 |
| 10. | a | 111 |

### Quiz 3

| | | |
|---|---|---|
| 1. | d | 117 |
| 2. | b | 118 |
| 3. | a | 125 |
| 4. | d | 126 |
| 5. | c | 127 |
| 6. | a | 130 |
| 7. | d | 137 |
| 8. | a | 140 |
| 9. | b | 146 |
| 10. | b | 149 |

### Quiz 4

| | | |
|---|---|---|
| 1. | a | 153 |
| 2. | c | 154 |
| 3. | c | 154 |
| 4. | d | 168 |
| 5. | c | 170 |
| 6. | c | 181 |
| 7. | c | 182 |
| 8. | c | 190 |
| 9. | c | 200 |
| 10. | a | 207 |

### Quiz 5

| | | |
|---|---|---|
| 1. | b | 213 |
| 2. | d | 214 |
| 3. | b | 227 |
| 4. | c | 229 |
| 5. | c | 234 |
| 6. | c | 240 |
| 7. | a | 245 |
| 8. | d | 246 |
| 9. | d | 256 |
| 10. | a | 260 |

### Quiz 6

| | | |
|---|---|---|
| 1. | d | 271 |
| 2. | a | 274 |
| 3. | d | 274 |
| 4. | a | 285 |
| 5. | a | 286 |
| 6. | a | 293 |
| 7. | a | 296 |
| 8. | b | 302 |
| 9. | a | 303 |
| 10. | c | 307 |

### Quiz 7

| | | |
|---|---|---|
| 1. | c | 314 |
| 2. | c | 315 |
| 3. | c | 321 |
| 4. | a | 325 |
| 5. | b | 327 |
| 6. | b | 330 |
| 7. | a | 331 |
| 8. | a | 339 |
| 9. | c | 343 |
| 10. | d | 345 |

### Quiz 8

| | | |
|---|---|---|
| 1. | d | 353 |
| 2. | d | 356 |
| 3. | a | 360 |
| 4. | b | 366 |
| 5. | c | 368 |
| 6. | d | 368 |
| 7. | d | 369 |
| 8. | c | 376 |
| 9. | a | 376 |
| 10. | a | 378 |

### Quiz 9

| | | |
|---|---|---|
| 1. | d | 384 |
| 2. | d | 386 |
| 3. | a | 388 |
| 4. | b | 391 |
| 5. | d | 397 |
| 6. | c | 401 |
| 7. | a | 407 |
| 8. | c | 409 |
| 9. | d | 413 |
| 10. | d | 414 |

### Quiz 10

| | | |
|---|---|---|
| 1. | c | 418 |
| 2. | d | 419 |
| 3. | b | 419 |
| 4. | a | 422 |
| 5. | d | 423 |
| 6. | d | 424 |
| 7. | b | 427 |
| 8. | c | 428 |
| 9. | d | 428 |
| 10. | c | 430 |

### Quiz 11

| | | |
|---|---|---|
| 1. | b | 433 |
| 2. | c | 435 |
| 3. | c | 436 |
| 4. | d | 437 |
| 5. | b | 438 |
| 6. | c | 440 |
| 7. | b | 440 |
| 8. | d | 445 |
| 9. | c | 449 |
| 10. | b | 450 |

### Quiz 12

| | | |
|---|---|---|
| 1. | a | 454 |
| 2. | b | 456 |
| 3. | c | 458 |
| 4. | b | 460 |
| 5. | a | 466 |
| 6. | c | 470 |
| 7. | d | 475 |
| 8. | b | 477 |
| 9. | d | 478 |
| 10. | c | 481 |

### Quiz 13

| | | |
|---|---|---|
| 1. | a | 488 |
| 2. | d | 495 |
| 3. | a | 500 |
| 4. | b | 504 |
| 5. | a | 505 |
| 6. | a | 510 |
| 7. | b | 512 |
| 8. | c | 517 |
| 9. | b | 518 |
| 10. | b | 520 |

### Quiz 14

| | | |
|---|---|---|
| 1. | b | 526 |
| 2. | a | 527 |
| 3. | c | 532 |
| 4. | b | 534 |
| 5. | a | 536 |
| 6. | c | 542 |
| 7. | b | 543 |
| 8. | a | 547 |
| 9. | c | 549 |
| 10. | b | 551 |

### Quiz 15

| | | |
|---|---|---|
| 1. | b | 558 |
| 2. | d | 560 |
| 3. | d | 562 |
| 4. | b | 562 |
| 5. | a | 567 |
| 6. | a | 572 |
| 7. | a | 576 |
| 8. | d | 583 |
| 9. | a | 583 |
| 10. | c | 585 |