Solutions to Questions - Chapter 2
Real Estate Financing: Notes and Mortgages

Question 2-1

Distinguish between a mortgage and a note.

A note admits the debt and generally makes the borrower personally liable for the obligation. A mortgage is usually a separate document which pledges the designated property as security for the debt.

Question 2-2

What does default mean? Does it occur only when borrowers fail to make scheduled loan payments?

Default means that the borrower has failed to (1) make scheduled loan payments or (2) violated any other provision in the note or mortgage.

Question 2-3

What is meant by judicial foreclosure of a mortgage, and what alternatives are there to such action?

Judicial foreclosure involves the sale of real property by the courts to satisfy the unpaid debt that is secured by the mortgage.

Alternatives:

1. Restructuring the mortgage loan
2. Transfer of the mortgage to a new owner
3. Voluntary conveyance of the title to the mortgagee
4. A "friendly" foreclosure
5. A prepackaged bankruptcy

Question 2-4

What does it mean when a lender accelerates on a note? What is meant by forbearance?

The acceleration clause gives the lender the right or option to demand the loan balance owed if a default occurs. Forbearance by the lender allows the borrower time to cure a deficiency without the lender giving up the right to foreclose at a future time.

Question 2-5

Can borrowers pay off part or all of a loan anytime that they desire?

No. In general, prepayment is a privilege not a right. In cases of residential/consumer loans made by federally related lenders, this option is usually provided to borrowers. In commercial real estate loans it is usually not.

Question 2-6

What does non-recourse financing mean?

The borrower is not personally liable on the note. The lender may look only to the property (security) to satisfy the loan in the event of a default.

Question 2-7

What does assignment mean and why would a lender want to assign a mortgage loan?

Assignment gives the lender the right to sell or exchange a mortgage loan to another party without the approval of the borrower.

Question 2-8

What is meant by a "purchase money" mortgage loan? When could a loan not be a purchase money mortgage?

Purchase money means funds from the loan will be used to purchase a property. It will not provide funds for other uses such as could be the case with a refinancing.

Question 2-9

When might a borrower want to have another party assume his liability under a mortgage loan?

If the loan was made with a favorable interest rate, the seller of the property may want to include this low rate loan as an additional incentive to sell the property.

Question 2-10

What does deficiency judgment mean?

If a default occurs leading to a judicial foreclosure and the property is sold, and if the dollars from the sale are not enough to pay off the loan balance, the borrower is personally liable for the difference.

Question 2-11

What is a land contract?

An agreement between a buyer and a seller to purchase and sell land. However, passage of title is usually deferred until some future date or deferred until some event or condition occurs (e.g. payment of money, rent, etc.).

Question 2-12

How can mechanics' liens achieve priority over first mortgages that were recorded prior to the mechanics' lien?

Mechanics' liens are permitted to be recorded after the fact. State laws generally give contractors, laborers, or suppliers of materials a certain period of time following the completion of work or delivery of materials during which to file their lien. When the lien is filed it relates back and takes priority over all liens filed after the time when materials were first delivered or work was first performed on real estate.

Question 2-13

Name possible mortgageable interests in real estate and comment on their risk as collateral to lenders.

Fee simple estates, life estates, estates for years, remainders, reversions, leasehold interests, and options.

<u>Fee Simple estate</u> - represents the most complete form of ownership of real estate. The holder is free to divide, sell, lease, or borrow against it as he/she wishes. Little risk to lenders because the owner completely owns all rights to the real estate.

<u>Life estate</u> - is a freehold estate that lasts only as long as the life of the owner of the estate or the life of some other person. Because of the uncertainty surrounding the duration of the life estate, its marketability and value as collateral are severely limited.

<u>Remainder</u> - exists when the grantor of a present estate conveys to a third person the interest that his/her heirs would otherwise have in the property upon the grantor's death.

<u>Reversion</u> - exists when the holder of an estate (the grantor) conveys to another person (the grantee) a present estate in the property and retains for himself/herself or his/her heirs the right to get back, at some time in the future, the full estate which he/she enjoyed before the conveyance.

Question 2-14

Explain the difference between a buyer assuming the mortgage and taking title "subject to" the mortgage.

If the purchaser acquires the property "subject to" the existing debt, he does not acquire any personal liability for the debt. When a mortgage is assumed the original borrower may be released from any obligations to the lender.

Question 2-15

What dangers are encountered by mortgagees and unreleased mortgagors when property is sold "subject to" a mortgage?

The mortgagor will be responsible if the person acquiring the property subject to the mortgage defaults. In turn, if the original mortgagor then defaults, the bank will have to foreclose on the property which may not be worth what is left to pay on the mortgage.

Question 2-16

What is the difference between the equity of redemption and statutory redemption?

The equity of redemption is the right of a mortgagor to redeem his/her property from default during the period from the time of default until foreclosure proceedings are begun. Statutory redemption is the right to redeem after foreclosure.

Question 2-17

What special advantages does a mortgagee have in bidding at the foreclosure sale where the mortgagee is the foreclosing party? How much will the mortgagee normally bid at the sale?

The mortgagee can use its claims as a medium of exchange in the purchase, except for costs, which must be paid in cash. Others must pay cash for their purchases or by obtaining a new loan. Lenders will normally bid the full amount of their claim only where it is less than or equal to the market value of the security, less foreclosure, resale, and holding costs.

Question 2-18

Is a foreclosure sale sometimes desirable or even necessary when the mortgagor is willing to give a voluntary deed?

The mortgagee may find it necessary to foreclose instead of taking a voluntary conveyance, because the title conveyed is subject to junior liens. Foreclosure provides the mortgagee with a lawful method of becoming free from the liens of junior claimants.

Question 2- 19

What are the risks to the lender if a borrower declares bankruptcy?

The probability of default or bankruptcy by a borrower and the legal alternatives available to each party affect the expected return to a lender from the loan. Lenders may find that their security is tied up for years during the reorganization of the debtor's financial affairs and that they are unable to foreclose on their liens where such a foreclosure would interfere with the debtor's plan of reorganization. Lastly, lenders may not be able to accelerate balances or raise interest rates because borrowers have the right to cure default in bankruptcy and reinstate the mortgage.

Question 2- 20

What is a deficiency judgment and how is its value to a lender affected by the Bankruptcy Code?

A deficiency judgment is any deficit remaining after a judicial foreclosure and subsequent sale of a property. Unless the mortgagor owns other real estate, deficiency judgments are unsecured claims and take their place alongside other debts of the mortgagor. Unlike the mortgage from which such judgment springs, the latter gives the holder no right of preference against any of the non-real estate assets of the debtor. Therefore, a holder of a deficiency judgment has the same rights to a debtor's nonexempt assets and is affected by the Bankruptcy Code in the same manner as any holder of an unsecured loan.

Solutions to Problems - Chapter 2
Financing: Notes and Mortgages

Problem 2-1

Jones only has the right to prepay the loan if there is a prepayment clause in the loan agreement that provides for early payment. Otherwise, the lender has the right to collect the full amount of interest specified in the original loan agreement. Furthermore, if there is a prepayment clause, it may provide for a penalty if some or all of the loan is prepaid.

Problem 2-2

Generally, in addition to the $80,000 first lien, the lender also has first lien on any improvements made on land serving as security for the mortgage loan under the initial mortgage terms (see: after acquired property clause). In other words, depending on the provisions contained in the existing mortgage document, ABC Bank also probably has a first lien on the new building constructed by Mr. Smith, even though Mr. Smith built the building with his own funds. Whether Duce Bank is willing to provide $16,000 in new financing may be problematic at this point. Mr. Smith should have approached Duce Bank before constructing a new building on land serving as security for the initial mortgage loan.

Problem 2-3

Mrs. Brown has probably violated a covenant in the mortgage agreement (see: preservation and maintenance of the property) with ABC Bank by destroying part of the security held by ABC Bank. In other words, the land and building are part of the realty serving as security for the mortgage loan. By tearing down the building, she has, in essence, destroyed some of the security. The lender may give her notice that she has violated this covenant and is in default and call the remaining loan balance due immediately. Mrs. Brown should have notified the lender prior to the tear down. Let's hope that (1) the total value of the proposed new project far exceeds the outstanding loan balance, plus the cost of any new improvements, and (2) that ABC Bank can be persuaded to finance the new project.