

Chapter 2

Real Estate Financing: Notes and Mortgages

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Documents in a Real Estate Deal

- Contract for Purchase
- Deed
- Note
- Deed of Trust (Mortgage)
- Other
 - Closing statement
 - Title Policy

DEBT

Debt and Real Estate – Why?

- Real estate is capital intensive
- Real estate has value (to secure debt)
- Investment property has cash flow (to service debt)

Notes (sometimes called a **Promissory Note**)

- A “**Note**” is Evidence of Debt, an “IOU”
- Major Provisions
 - Amount borrowed
 - Rate of interest
 - Dollar amount, due dates, # of payments
 - Interest only, **amortizing** or partial am
 - Maturity date
 - Indicates exactly how payments are applied:
 - Penalties, interest then principal
 - Reference to security for the loan

Notes

- Major Provisions - continued
 - Default
 - Penalties for late payment and *forbearance* provisions
 - Provisions for unscheduled (early) payments or prepayments
 - Notification of default and **acceleration** clause
 - May have a **Nonrecourse** clause
 - Liability is limited to specified collateral.
 - Even if there is a nonrecourse clause, loans can become “recourse” if the “bad boy” provisions (carve-outs) are violated. For example, if the borrower willfully damages the asset, the borrower may be held personally responsible for the damage.
 - Declaration of bankruptcy can also be a “carve-out” event

Notes - Some Details

- Loan assumability (borrower's rights)
- Assignment clause (lender's right)
- Future advances (if any)
- Release of lien by lender (when paid)

Mortgages (and Deeds of Trust)

- Note is evidence of the loan
- A **Mortgage** is evidence of the security
 - Mortgage: Pledges property as security
- State law varies on how this security is handled – major technicality
 - Mortgage states
 - Deed of Trust states (Texas)

Mortgage Instrument

(some states: Deed of Trust format)

- The mortgagor is the borrower. He is “mortgaging” his property.
- The mortgagee is the lender that receives the benefit of the property as security.



Mortgage Instrument (document)

- Appropriate identification of mortgagor and mortgagee
- Description of the property
- **Covenants** (promises)
- Terms of “Note” can be incorporated

Mortgage Instrument

- Important Clauses
 - Escrowed Funds for
 - Property Taxes
 - Insurance (hazard)
 - Mortgage insurance
 - Preservation and Maintenance of the property
 - “Due on sale clause” (if property or beneficial interest is transferred)

Mortgage Instrument

- Important Clauses
 - Borrower's Rights to Reinstate
 - Right of Entry: Lender in Possession
 - Future Advances
 - Subordination Clause
 - Allowing a subordinate mortgage
 - Allowing (agreeing to subordinate to) a senior position (unusual except in certain Seller financing)

Additional Mortgage Concepts

- Assumption
 - Liability
 - Release of grantor from assumed debt
- “Subject to” a Mortgage
 - Liability

Additional Mortgage Concepts

- Property Covered – the “real estate”
 - Land
 - Improvements
 - Easements
 - Fixtures
 - Special case of trade fixtures
 - Mineral Rights
 - After-acquired property (improvements)

Additional Mortgage Concepts

- Senior (1st lien) & Junior Mortgages
- Recording Mortgages
 - Protect Lien Priority
- Seller Financing
 - *Purchase Money Mortgage*
 - Use of Subordination Clause

Additional Mortgage Concepts

- **Foreclosure**

- Lender's ultimate right to "take" the security to satisfy the debt
- Right of lender to force the sale at auction
- More detail to follow

- Process

- Notification
- Acceleration (declaring full Note due)
- Further notices
- Foreclosure action

Default

- Breach of mortgage contract
 - Monetary default (& acceleration)
 - Technical default (cure provisions)

Workouts

- Restructure the loan
 - Recasting
 - Extension Agreement
 - Alternatives
 - Informal extensions

Workouts

- Voluntary Conveyance
 - Deed in Lieu of Foreclosure
 - This can be tricky. For example, the presence of a 2nd mortgage will make it problematic for the borrower to simply give a deed in lieu of foreclosure to the 1st mortgage holder. In that case, the 2nd mortgage would remain in effect and would not be extinguished by a deed in lieu of foreclosure.
- Friendly Foreclosure
- Short Sale
 - Lender agrees to allow borrower/owner to market and sell property for an amount less than (short of) the loan amount.
- Bankruptcy
 - Will “stay” the foreclosure action, but goes into a judicial process

Bankruptcy: different types

- Chapter 7
 - Liquidation
- **Chapter 11** (typically used to prevent foreclosure)
 - Available to any business owner including real estate entity
 - Reorganization
 - Cramdown concept if court settles all claims
- Chapter 13
 - Reorganization for “wage earner”

Foreclosure – more detail

- Parties
 - Senior & Junior Lien Claimants
 - Juniors are “enjoined” and notified
- Property Sale
 - public auction
 - Lender can “credit bid” up to amount of loan outstanding
 - If lender bids and wins auction, lender gains title
 - Subordinate liens are eliminated
- Potential for **Deficiency Judgment** (if recourse loan)
 - If property sale price does not cover debt, borrower can be sued for shortfall
 - Several states limit the applicability of deficiency judgments
 - Many commercial notes limit liability with non-recourse clause
- Property Taxes in Default
 - Tax sales

Foreclosure – Mortgage States

- Judicial Foreclosure
 - Legal process of bringing suit and right to foreclose
 - Court system is integral
- Redemption (ability of borrower to recover his position)
 - Equity of Redemption
 - Prior to foreclosure
 - Statutory Right of Redemption
 - After foreclosure (state by state – mostly residential)

Foreclosure – Deed of Trust States

- Deed of trust
 - Special type of mortgage used in many states including Texas
 - Gives “power of sale” to the third party trustee
 - Court authority not necessary
 - Trustee holds for benefit of lender
 - Trust Deed: Trustor (borrower), Trustee (empowered agent), Beneficiary (lender)
- Things happen fast

Additional Financing Concepts

- Land Contract – Not a mortgage; but similar economics
 - Not really “financing” since no loan or mortgage
 - Original contract to purchase stays in place for longer period of time
 - Seller retains title, though purchaser may get possession
 - Purchaser has equitable title
 - Purchaser continues to make “payments” toward purchase price
 - Seller conveys title when purchaser completes the performance obligations
 - Contract can (should) be recorded