Chapter 10

Mortgages and Seller Financing

Chapter 10 Goals:

- Understand what a mortgage is
- Understand how mortgages directly influence the value of properties
- Recognize different mortgage options based on borrower qualifications
- Understand basic loan qualifications
- Be aware of mortgage provisions that effect the cost of borrowing
- Explain different provisions that regulate the mortgage market
- Recall unlawful mortgage practices
- Understand various acts that guide the mortgage and real estate industry

Chapter 10: Mortgages & Seller Financing

This chapter explores the commons ways in which a buyer can finance a real estate purchase: a mortgage and seller financing.

Key Terms

acceleration clause amortization bait and switch advertising balloon payment construction loan controlled business arrangement defeasance clause due-on-encumbrance clause due-on-sale clause financing statement Garn Act good faith estimate holder in due course hypothecate	installment lease option lock-in clause lump sum mortgage mortgage assumption mortgage loan disclosure statement note note payable negotiable instrument obligatory advances predatory lending prepayment penalty	promissory note Real Estate Settlement Procedures Act (RESPA) security agreement seller financing straight note subject to successor liability Truth in Lending Act (TILA) Truth in Lending Disclosure Statement uniform settlement statement usury wraparound mortgage

Mortgages

An Introduction

A **mortgage** is a loan provided to a borrower by a lender in exchange for the borrower paying back the principal loan balance amount with interest. Mortgage financing is at the cornerstone of residential real estate purchases.

In California, the most common form of a mortgage is a trust deed. This means that the title of a borrower's property is held by an independent third party (usually a trustee or escrow company) as a means of securing a lender's mortgage loan.

To **hypothecate** means to use a property as collateral for securing a mortgage without exchanging the property's title or ownership. When a borrower agrees to a mortgage, a lender secures its financial investment with a voluntary lien on the borrower's property; a lien gives a lender legal interest in the property and allow the lender to foreclose on that property in the event that the borrower defaults on mortgage payments.

California Civil Code Section 2920 defines a mortgage as:

- *"(a) A mortgage is a contract by which specific property, including an estate for years in real property, is hypothecated for the performance of an act, without the necessity of a change of possession."*
- *"(b) For purposes of Sections 2924 to 2924h, inclusive, "mortgage" also means any security device or instrument, other than a deed of trust, that confers a power of sale affecting real property or an estate for years therein, to be exercised after breach of the obligation so secured, including a real property sales contract, as defined in Section 2985, which contains such a provision."*

Mortgages have a statute of limitations of four years. This means if a borrower hasn't made a mortgage payment in four years without action from the lender, a lender can no longer go after that borrower for defaulted debt.

Security Agreement

A **security agreement** is a legal document that secures a lender's interest in a property being used as collateral for a refinance or purchase loan. It sets forth the terms of the agreement between the parties, including what happens if the property is sold or foreclosed.

A security agreement gives a lender partial ownership of a property. This ensures that in the event of a borrower's default, a lender can seize and foreclose on the property in order to recover its investment. Therefore, a security agreement substantially reduces a lender's risk.

A **financing statement** is a filed document that gives notice of a lender's security interest. Such a statement must be publically registered/filed in order to "perfect" a lender's interest in a property. (A lender's interest is automatically "perfected" for purchase loans. However, a lender must manually "perfect" its interest for a refinance loan.)

A lender must also provide a prospective borrower with a **uniform settlement statement**. This statement itemizes all fees and charges.

Negotiable Instrument

A **negotiable instrument** is a document that guarantees a borrower's payment of debt to a lender. Negotiable instruments can be banknotes, bills of exchanges, or promissory notes.

The document should be in writing, provide clear and straightforward terms, and be signed by both parties.

A negotiable instrument may be transferred to a third party -- such as a collection agency or lawyer -- in order to allow a lender to recoup its investment. When a borrower defaults on a debt, it is common for the lender to sell the negotiable instrument below market value to other lenders who attempt to collect the debt.

Holder in Due Course

A **holder in due course** refers to a party who has accepted a negotiable instrument and exchanged something valuable for it. More simply, such a party "holds" a negotiable instrument, which in the case of real estate is a mortgage note.

It is common for lenders to sell mortgage debt to interested buyers prior to a borrower's default on the debt as a way of protecting its financial interests, cutting financial losses before they get any worse or to make a profit. It is usually sold for less than the principal loan amount.

A holder in due course may purchase a note with the intent of collecting interest or foreclosing on the note and recouping payment through a foreclosure and subsequent sale. A note holder may sell the debt to another party to free up capital for a new mortgage originator to reduce liability from bad debt.

A holder of due course may purchase a negotiable instrument held by a lender, therefore becoming the new "lender". This entitles the holder in due course to receive the borrower's future payments.

A holder in due course is granted superior protection to other governing or conflicting laws.

Uniform Commercial Code Section § 3-302. desribes a holder in due course as:

(a) Subject to subsection (c) and Section 3-106(d),"holder in due course" means the holder of an instrument if:

(1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alterationor is not otherwise so irregular or incomplete as to call into question its authenticity; and

(2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in Section 3-305(a).

(b) Notice of discharge of a party, other than discharge in an insolvency proceeding, is not notice of a defense under subsection (a), but discharge is effective against a person who became a holder in due course with notice of the discharge. Public filing or recording of a document does not of itself constitute notice of a defense, claim in recoupment, or claim to the instrument.

In the event that a borrower's debt is sold, the lender is not required to give that borrower notice. Should a borrower pay the old lender not knowing of the transfer to the holder in due course, the wrongful payment must be transferred to the new lender. In this situation, payment to the old lender qualifies as a valid attempt by a borrower to make a payment.

Valid defenses against a holder in due course:

- *Incapacity*: The seller of the debt lacked the capacity to sell the debt
- *Illegal*: The transfer of the debt was illegal
- *Forgery*: The transferee was forged and not the intent of the maker or payee
- *Alteration*: Alteration of the terms of the sale without the approval of either party is illegal and serves as a valid defense

Promissory Note

A **promissory note** – sometimes known as a "**note payable**" or simply a "**note**" – is a signed document that contains a written record of the sum a borrower owes to a lender. A note protects the interests of a lender by establishing a clear record of debt.

If the note is unconditional and easily saleable, it is a negotiable instrument.

Promissory notes are used in real estate by lenders, banks, and government lending agencies, such as Fannie Mae or Freddie Mac.

The provisions included in a valid promissory note depend on the terms of the agreement and the type of credit being extended. In general, however, a note includes:

- Principal debt amount
- Payment terms, including the amount that must be paid to stay current on the note and options on how to pay it off
- The date on which the loan must be paid off

A note may include a monthly interest rate on the principal loan amount. If a borrower defaults on a debt, the lender may have the option to increase the interest rate.

A **defeasance clause** is a provision that cancels a debt upon the payment or settlement of the promissory note.

Mortgage Brokers

A mortgage broker is a mortgage professional who acts as an intermediary between a borrower and lender. Mortgage brokers assist borrowers in qualifying for mortgages and in finding the most compatible lenders and loan programs available.

The California Business and Professions Code defines a mortgage broker as one who *"engages as a principal in the business of making loans or buying from, selling to, or exchanging with the public, real property sales contracts or promissory notes secured directly or collaterally by liens on real property, or who makes arrangements with the public for the collection of payments or for performance of services in connection with real property sales contracts or promissory notes secured directly or collaterally by liens on real property."*

A mortgage broker has a duty to provide all vital loan information to a prospective borrower, including commissions and fees. A mortgage broker is also responsible for delivering copies of a deed to all involved parties, including the lender, borrower, and investor, if applicable.

Any individual who solicits mortgage business is subject to the regulations set forth by the Real Estate Commissioner. Any individual, property owner, or other party involved in more than eight trust deed transactions or promissory notes in a year must be a licensed broker.

In return for assisting the client find a loan, the mortgage broker is compensated by the client and/or lender, typically through points or fees. The maximum commission a lender/broker can earn in commission for a first position loan is 5% of the principal loan amount for a program of three years or less, and 10% for programs that are three or more years.

California's Business and Professions Code has further regulations relating to mortgage brokers and mortgages:

- Real estate licensees are prohibited from advertising or offering prospective lenders or clients a gift, or any other item of value, with the intent of inducing the lender to make a loan, or purchase a promissory note. (10236.1)
- A real estate broker who benefits directly or indirectly from obtaining the use of funds other than the commission and fees must disclose this to the Department of Real Estate and the lender providing the loan. (10231.2)
- It is unlawful for mortgage brokers to accept funds from lenders, unless the borrower has been approved, or a loan has been arranged for the broker's client. (10231)

- A mortgage broker who services a promissory note/mortgage that is secured by real property must have written authorization from all parties including the borrower, lender, or owner of the note. A broker who acts as the servicer for the lender is responsible for all accounting related items that affect the lender. Accounting includes keeping track of the unpaid principal balance, disbursements, payments, collections, the status of a notice of default, and other accounting items. (10233)

- If a real estate broker who services a loan receives payment other than the scheduled payment, the broker must inform the note holder within 10 days of acceptance of such payment. In addition to disclosing acceptance of payment, the broker must inform the source of payment, who the payment was directed to, and the reason for making the payment. (10233.1)

- It is the duty of every real estate licensee who negotiates the approval of a loan to have the loan recorded with the local county recorder's office. Prior to the release of funds, the broker must verify the loan's recording, unless otherwise indicated by the lender in writing. (10234)

- In an attempt to equip consumers with as much necessary information about their loan as possible the Real Estate Commissioner's office requires the borrower's mortgage broker to provide their clients with a copy of the deed of trust within a reasonable amount of time of the loan's recording. The rule also requires the copy of the deed to be given to any other parties who hold an interest in the loan including the investor and lender. (10234.5)

- It is unlawful for real estate licensees to knowingly mislead consumers in advertising, including print, internet, published, televised advertising, and other advertising mediums. (10235)

Bait and switch advertising is an illegal practice in which a broker advertises a product or inventory that it does not have the aim of selling with the intent of "baiting" customers into buying another product.

Conversely, a **controlled business arrangement** allows a mortgage broker to offer multiple services -- such as financial products, hazard insurance, title insurance, and other services or products -- through various subsidiary companies that act under the umbrella of that broker.

Case Review: *Direnfield v. Stabile* (1988)

The case, *Direnfield v. Stabile* (1988) 198 Cal.3d 126., involved a real estate agent who arranged a loan transaction with a high interest rate without being employed by a broker.

A real estate agent (Stabile) arranged for two borrower loans with a private lender (Direnfield). Shortly after, Stabile ended his employment with his broker, but failed to acquire a new broker. Without disclosing this to Direnfield, Stabile approved a third borrower loan for Direnfield at an interest rate of 30%.

When the borrower discovered that Stabile was not working with a licensed broker, he sued Direnfield for charging a usurious -- or illegally high -- interest rate. (In California, a private lender cannot charge more than 7% interest unless the transaction is under a licensed broker.) The case ultimately resulted in a settlement. Direnfield subsequently initiated a lawsuit against Stabile to recoup its losses.

The Superior Court contended that Stabile was guilty of concealing his unlawful employment status. It ruled in favor of Direnfield. Stabile could not pay back the funds, so Direnfield applied to the Department of Real Estate. The court ordered the Real Estate Recovery Fund to make payments to Direnfield for the money he lost.

Mortgage Regulations

Truth in Lending Act (TILA)

The **Truth in Lending Act (TILA)** is a federal law passed in 1968 that created a uniform system for calculating and disclosing loan interest rates. Initially regulated by the Federal Reserve Board, the Act's provisions are now enforced by the Consumer Financial Protection Bureau.

Prior to the Act, the ways lenders calculated and advertised their loan rates were not standardized. Consequently, consumers were unable to accurately compare loan products from different lenders. The creation of a standardized system allows consumers to better understand and compare available loan products.

Lenders must provide borrowers with documentation about the specific loan they are receiving. For example, if a borrower is applying for an adjustable rate mortgage, the lender must provide him or her with a copy of the Federal Reserve's Consumer Handbook on Adjustable-Rate Mortgages.

One of the documents that lenders must provide to borrowers is a **Truth in Lending Disclosure Statement.** Mortgage disclosures must be provided within three days of a borrower's submission of an application. This statement provides borrowers with a simplified version of the mortgage terms, including:

- Annual Percentage Rate (APR)
- Loan amount
- Monthly mortgage payments
- Late charges
- Prepayment penalties
- Insurance payments

One of the Truth in Lending Act's main provisions requires lenders to use an annual percentage rate (APR) as the standard mortgage description term for mortgage products. APR is the cost of credit expressed as a yearly rate in a percentage.

The right of rescission gives a borrower the right to cancel a home equity loan or line of credit with a new lender, or to cancel a refinance transaction with another lender within three days of closing.

Case Review: *Pacific Shore Funding v. Lozo* (2006)

The case, *Pacific Shore Funding v. Lozo* (2006) 138 Cal.4th 1342., involved a lender who violated the Truth in Lending Act.

A borrower (Lozo) was granted a mortgage by a lender (Pacific Shore Funding) in the amount of $28,000. Less than three years later, Lozo obtained a second loan from Pacific Shore Funding in the amount of $71,600. Lozo used the second loan to pay off the balance of his first mortgage, then rescinded the first loan.

Pacific Shore Funding brought suit against Lozo, alleging that borrowers are not entitled to rescind a first loan after they refinance a second loan with the same lender. Lozo filed a cross complaint. He argued that the first loan was subject to the Truth in Lending Act, which had been violated by the lenders. Lozo contended that Pacific Shore Funding had "failed to properly and timely provide mandated disclosures and had rejected their attempt to rescind the first loan agreement." Therefore, Lozo argued that he was able to rescind the loan.

The Superior Court argued that Lozo's repayment of the first loan terminated his rights to rescind the loan under the Truth in Lending Act. It ruled in favor of Pacific Shore Funding. Lozo appealed.

The Court of Appeals reversed the lower court's ruling. It contended that a single violation of the Truth in Lending Act (TILA), whether it be substantive or technical, extended a borrower's period of rescission. Therefore, Pacific Shore Funding's failure to provide Lozo with the required disclosure forms extended Lozo's rescission period from three days to three *years*, and his notice of rescission was timely. The court ordered Pacific Shore Funding to refund all interest and fees, including loan points, closings costs, and prepayment penalties.

Real Estate Settlement Procedures Act (RESPA)

Because each mortgage typically contains hundreds of pages of difficult to understand paperwork, the federal government passed the **Real Estate Settlement Procedures Act (RESPA)** in 1974. RESPA is a federal consumer protection law that helps borrowers be better informed while shopping for mortgage and loan services.

The Act requires lenders to disclose all pertinent loan information and mortgage costs during the loan process. It also restricts the types of fees that lenders may impose on borrowers.

RESPA applies to first mortgages, including purchases, refinancing, property improvement loans, and equity lines of credit. (It does not apply to second mortgages, loan assumptions, construction/home improvement loans, or land sales.)

Under RESPA, lenders must provide potential borrowers with the following information within three days of them submitting a completed loan application:

- *Mortgage Servicing Disclosure:* indicates whether a lender will continue to service a loan, or transfer it to another lender.
- *Special Information Booklet:* provides the rights of borrowers and the various settlement services.
- *Good Faith Estimate (GFE)*

A **good faith estimate (GFE)** provides an estimation of a borrower's loan settlement costs, or the costs a borrower will pay at the closing of a mortgage loan. This document allows borrowers to easily compare various lenders' mortgage loan costs and terms in order to select the best one. A GFE includes:

- the cost of running credit
- loan points
- application fee
- appraisal fee
- attorney fees
- escrow deposits
- property inspection and survey fees
- title search and title insurance

A mortgage broker supplies the prospective borrower with a copy of the appraisal, the loan application, and a copy of the credit report.

In addition to RESPA's requirements, California requires lenders to provide borrowers with a **mortgage loan disclosure statement**. This disclosure indicates all of a mortgage's terms, including costs, fees, rates, estimated payments, and conditions of the mortgage. A lender must get the potential borrower's signature on the disclosure statement in order to proceed with the loan.

RESPA prevents lenders from charging borrowers for services that are not rendered. It also makes it illegal for a lender to charge for services that are completed in order to comply with the Act, such as printing out additional forms or spending time preparing documents.

All fees charged by a lender must be necessary to the loan approval process. Section 8 of RESPA outlaws kickbacks and referral fees that make the process of applying for a loan more expensive. Should a lender, broker, or other party violate this provision, they could be subject to damages of up to $10,000 and face up to one year in prison. They could also be held liable for up to three times the fee for which the prospective borrower was charged.

The Mortgage Loan Compliance Manual, which was created by the Department of Real Estate, states that mortgage-related expenses for qualifying and obtaining a loan cannot exceed 5% of the total mortgage amount, or $390 if the amount is less than 5%. Regardless of the mortgage amount, costs of mortgages for a regulated loan cannot exceed $700. For example a loan amount of $15,000 can have maximum costs of $700, even if the broker attempts to charge 5 percent because that amount exceeds the maximum $700 cost.

Disclosures in Real Estate

Sellers and agents must provide the necessary disclosures to the appropriate parties to avoid fraud and misrepresentation

Required Disclosures:

- Disclosures Upon Transfer of Residential Property
    - Real Estate Transfer Disclosure Statement
    - Local Option Real Estate Transfer Disclosure Statement
    - Natural Hazards Disclosure
    - Mello-Roos Bonds and Taxes
    - Property Taxes
    - Ordnance Locations
    - Window Security Bars
    - Industrial Uses
    - Methamphetamine Contamination
- Earthquake Guides
- Smoke Detector Statement of Compliance
- Disclosure Regarding Lead-Based Paint Hazards
- California's Environmental Hazards Pamphlet
- Delivery of Structural Pest Control Inspection and Certification Reports
- Energy Conservation Retrofit and Thermal Insulation Disclosures
- Foreign Investment in Real Property Tax Act
- Notice and Disclosure to Buyer of State Withholding on Disposition of California Real Property
- Furnishing Controlling Documents and Financial Statements Concerning Common Interest Developments (CID's)
- Notice Regarding the Advisability of Title Insurance
- Certification Regarding Water Heater's Security Against Earthquake
- Data Base – Locations of Registered Sex Offenders
- Visual Inspection
- Agency Relationship Disclosures
- Disclosure of the Negotiability of Real Estate Commissions
- No Disclosure Required for Manner/Occurrence of Death; Affliction of Occupant with Aids
- Disclosure of Sales Price Information
- Advance Fees
- Seller Financing Disclosure Statement
- California Required Disclosures to Borrowers
- California Required Disclosures to Certain Lenders or Promissory Note Purchasers
    - General Disclosure Requirements
    - Multi-Lender Transactions
    - Construction Loans and Multiple Security Properties in MultiLender Transactions
    - Loan Servicing in Multi-Lender and in other than Multi-Lender Transactions

Disclosures in Real Estate Continued

- Notice of Transfer of Loan Servicing
- Notice of Borrower's or Lender's Right to Copy of Appraisal Report
- Credit Terms – Truth-in-Lending and Regulation Z
- High Cost Loans (Federal)
- California High Cost Mortgage/Loan Disclosures
- Real Estate Settlement Procedures Act (RESPA)
- Advance Disclosures in Loan Transactions Subject to TILA and RESPA
- Disclosure by Agent Receiving Compensation from a Lender
- Adjustable Rate Loan Disclosure
- Equal Credit Opportunity Act – Notice of Adverse Action – Regulation B
- Certain Obligations of Consumer Credit Reporting Agencies
- Disclosure Required by the Housing Financial Discrimination Act of l977 (Holden Act)
- Public Report: Disclosure of Material Facts about a Subdivision
- Disclosure of the Right to Rescind
- Disclosure and Notice of Blanket Encumbrance
- Delivery of Governing Documents and Disclosures to Prospective Purchaser in a Common Interest Development
- Statement of Defects Disclosure for a Common Interest Development Conversion
- Notices to Tenants to Disclose Intent to Convert an Apartment to Individual Ownership
- Definition of Business Opportunity
- Bulk Transfer Law
- Sales Tax Clearance
- Transfer of Liquor License
- Franchise Investment Law
- Fictitious Business Name (DBA)
- Notice of Other Government Agencies

Mortgage Payments & Provisions

Types of Payment

Installment

An installment refers to a borrower's consistent, equal payment of the principal loan amount plus interest.

Amortization

To amortize means to reduce or extinguish a debt by regularly putting money aside.

Therefore, amortization refers to a borrower paying down the principal loan amount over time with fixed payments. The amortization schedule determines how many installments are necessary to pay off the full loan amount, as well as how much of each payment is interest and goes towards the principal loan amount.

Initially, most of a borrower's monthly mortgage payment will go towards interest costs. Over time, however, more will go towards the repayment of the principal loan amount. At the conclusion of the payment schedule, the debt will be fully paid off.

Lump Sum

A lump sum requires a borrower to pay back a debt in a single payment. Lump sums may refer to the full debt amount or a settlement amount.

Some borrowers may make a voluntary "lump sum" payment on a mortgage in order to reduce the amount of interest they have to pay overall. The earlier and larger the lump sum is, the more substantial the overall savings will be.

Straight Note

A straight note is a non-amortizing loan which requires a borrower to pay interest on a loan until the principal loan amount is due; on an agreed-upon date, the borrower will pay the full principal loan amount as a lump sum.

Straight notes are often used as secondary financing in conjunction with a primary trust deed or mortgage. They are typically short-term loans (three to five years).

One advantage of this payment option is that it minimizes a borrower's monthly mortgage.

Balloon Payment

A **balloon payment** is a type of mortgage payment where only a portion of the principal loan amount is amortized over the loan period, thereby leaving the borrower with a large payment at the completion of the term of the mortgage program.

Balloon payments are more common in commercial real estate than residential real estate.

A balloon payment is typically twice that of a borrower's regular principal and interest payments. Due to the large payment amount required at the completion of a loan program, many borrowers have a difficult time making the balloon payment. This is why lenders are required to disclose a balloon payment structure in the truth and lending disclosure provided to the client before they take out a loan.

When a balloon payment is due, many borrowers either sell or refinance their property using current market interest rates in order to avoid paying the large balloon payment. Lenders may automatically reset the mortgage with current interest rates to avoid a defaulting borrower.

Lenders who have provided a balloon payment cannot impose that payment without first providing a 90-day advance notice of the payment's due date. Construction loans and other loans may be exempt from this requirement.

Non-owner occupied properties with loan terms of less than three years cannot have balloon payments. Balloon payments generally occur on longer term programs.

Mortgage Assumption

Mortgage assumption refers to when a seller transfers all mortgage loan terms and conditions to a buyer upon the purchase of the seller's property. Put simply, the buyer "assumes" the seller's loan.

California courts have determined that all loans are assumable, except when mortgage assumption increases a lender's financial risk.

Some lenders may prohibit mortgage assumption, particularly when a loan has a due-on-sale clause. If a lender does not consent to mortgage assumption, both the seller and buyer can be held liable. However, as the new buyer owns the title to the property, he or she is ultimately responsible.

Mortgage Clauses

A lender may include various provisions and clauses in a mortgage contract in order to protect its financial interests.

Due-On-Sale Clause

A **due-on-sale clause** is a mortgage provision that requires a borrower to repay the full principal loan amount plus interest upon the sale or conveyance of the property.

Due-on-sale clauses protect lenders in a rising interest rate market. Sellers with low interest rate loans may try to arrange for a buyer to assume his or her original loan at the same low rate. With a due-on-sale clause, however, a lender can collect the full loan amount from the seller, and subsequently lend the recouped capital to other borrowers at higher interest rates.

Such clauses also prevent a seller from transferring his or her mortgage to a buyer. A buyer who assumes a seller's mortgage via seller financing or a wraparound trust deed is not pre-qualified using a lender's specific standards and has a higher likelihood of defaulting on the loan. This puts a lender's financial interests at risk. Therefore, a lender uses a due-on-sale clause to prevent seller financing or a wraparound trust deed whereby the buyer takes over the existing promissory note.

The **Garn Act** was enacted in 1982 order to strengthen lenders' ability to enforce due-on-sale clauses.

The following are exceptions to a due-on-sale clause:

1. The creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;
2. The creation of a purchase money security interest for household appliances;
3. A transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
4. The granting of a leasehold interest of three years or less not containing an option to purchase;
5. A transfer to a relative resulting from the death of a borrower;
6. A transfer where the spouse or children of the borrower become an owner of the property;
7. A transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;
8. A transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or
9. Any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board.

Due On Demand Clause

A **due on demand clause** allows a lender to demand payment at its discretion.

A due on demand clause is more advantageous to a lender than a due-on-sale clause. With a due-on-sale clause, a borrower must repay a loan upon the sale of a property; a due on demand clause allows a lender to demand repayment from a borrower at any time.

This clause also permits a lender to raise a borrower's interest rate, even if the borrower isn't selling his or her property. If a borrower doesn't accept the lender's higher interest rate, the lender can demand that the borrower pay the entire loan amount.

Late Charges

A borrower must pay a late charge in the event that he or she misses a mortgage payment. The standard late charge for residential real estate is 4%.

California Civil Code Section 1671 states that late charges cannot be punitive to coerce borrowers into timely payments. For example, lenders can only impose a late charge when a borrower is at least 10 days past due on a mortgage payment. Late charges also cannot exceed 10% of the principal loan amount and interest, unless that percentage equates to less than five dollars.

Lock-In Clause

A **lock-in clause** is a provision in a mortgage that "locks in" a borrower at a particular loan interest rate for a specified period of time.

Typically, lock-in clauses are for the initial seven years of a mortgage contract.

In a stable economic market with steady interest rates, a lender may give borrowers a lock-in clause for long periods of time. Conversely, a volatile economic market with rising interest rates may influence a lender to make lock-in periods shorter so that they can capitalize on charging borrowers higher rates.

Lock-in interest rates are typically low. A borrower may be incentivized to refinance his or her mortgage loan by making a "lump sum" prepayment during the lock-in period at the lower rate. This would be done to prevent the borrower from paying higher interests rates after the lock-in period finishes. However, lenders typically prevent this with the inclusion of a prepayment penalty provision in the mortgage contract.

Prepayment Penalties

A **prepayment penalty** is a mortgage provision which triggers a lump sum charge in the event that a borrower chooses to refinance a loan or sell a property within the penalty period.

Lenders provide loans to borrowers with the expectation that they will make a minimum amount of money by charging interest. Conversely, borrowers want the lowest interest rates possible. No lender wants to spend three months putting resources into approving a borrower, only to have that borrower refinance with another lender shortly after.

Therefore, a prepayment penalty ensures that a lender makes money in one of two ways:

- a borrower keeps a loan active -- allowing a lender to collect interest -- for a minimum period of time
- a borrower disrupts the original loan terms, but pays the lender a prepayment penalty for doing so

For example, if a borrower wishes to refinance her home loan, but has a prepayment penalty period of three years, she will likely defer on refinancing until after the three years to avoid the penalty.

Typical prepayment penalty periods are between six months and five years.

Prepayment penalties vary based on the percentage of total mortgage debt a borrower is still liable for and/or the amount of months left on the loan.

There are also varying levels of prepayment penalty severity. A standard, or soft, penalty only penalizes borrowers for refinancing during the penalty period. A hard penalty penalizes borrowers for both refinancing and selling the property during the penalty period.

California Civil Code Section 2954.9 (a) (1) states that a borrower with a loan for a property containing one to four units is "entitled to prepay the whole or any part of the balance due, together with accrued interest, at any time."

Prepayment penalties cannot be used by FHA or VA lenders.

Although the purpose of prepayment penalties is to protect lenders' interests, lenders do not have the right to impose unreasonable punitive measures. For example:

- Civil Code Section 2954.9 (b) indicates that any amount that does not exceed 20 percent of the original loan amount can be prepaid regardless of the prepayment penalty period. This refers to a borrower's right to prepay a sum of the mortgage without penalty.
- A lender may not charge a prepayment penalty in the event that a borrower's property is affected by a natural disaster
- Prepayment penalties for loans secured for single family residences may only be charged if the prepayment is paid within seven years after the loan's execution

Acceleration Clause

An **acceleration clause** allows a lender to "accelerate" its debt collection when a borrower fails to meet his or her credit obligations.

Acceleration clauses do not trigger automatically; rather, they are a result of a borrower missing a mortgage payment, failing to pay property taxes or mortgage insurance, or a falling behind on payments to junior liens.

Some lenders may give a borrower the option to catch up on missed payments. However, other lenders may require a borrower to pay back the full principal loan amount plus interest. In doing so, the lender begins the foreclosure process.

Acceleration clauses apply to both residential and commercial mortgages.

Due-on-Encumbrance Clause

A **due-on-encumbrance clause** allows a lender to accelerate its debt collection when an encumbrance puts the lender's investment at risk, such as when a borrower transfers, or receives another loan on a property.

Primary residences and owner-occupied residences are exempt from due-on-encumbrance clauses (Civil Code Section 2949). A lender may accelerate debt collection on a borrower's secondary or investment properties, however.

Due-on-encumbrance clauses are often found to be invalid in court.

Case Review: *Wilson v. Steele* (1989)

The case, *Wilson v. Steele* (1989) 211 Cal.3d 1053., involved real estate buyers who purchased a note secured by a trust deed. The deed was purchased from an unlicensed contractor who lent the homeowner, Williams, the money for construction. When the assignee, Steele, tried foreclosing on the property he was prevented. Steele claimed he was protected as the holder in due course and therefore should be entitled to the interest in the property.

The issue the court was tasked to answer was whether a contractor's unlicensed status is a defect which may be asserted against the contractor's assignee who is a holder in due course. The superior court granted judgment in favor of the Steele's and terminated an injunction that prevented the Steele's from foreclosing on the property.

The plaintiff, Wilson, who was the William's family estate special administrator, reasoned that the unlicensed status of the contractor who sold the note meant that the contract was invalid, void, and otherwise not enforceable. The court of appeal agreed on the basis that the contracts formation was invalid because the contractor was not licensed and therefore could not legally be a part of a construction agreement. Although a holder in due course has an interest or stake in a particular property, the illegality of the agreement terminates the contract.

Illegal Lender Practices

Usury

Usury refers to an illegal surcharge of interest on a borrower's debt. Article 15 of California's Constitution states that any loan used primarily for personal or household purposes cannot exceed an annual interest rate of 10%. It is illegal for lenders to charge interest above the federally mandated maximum rate.

Usury laws apply to individual loans and forbearances/deferments.

The following are generally exempt from California's usury laws:

- licensed lending institutions (i.e. banks, credit unions, financial companies)
- loans funded for the purpose of development or construction programs
- loans originating through brokers
- seller-financing programs
- credit cards

Real estate agents are not exempt from usury laws.

Points and fees are calculated when determining whether a lender charged a usury interest rate on the loan provided. Lenders who knowingly charge usurious interest rates are subject to severe penalties. If a rate is found to be usurious, a borrower can:

- bring forward a legal suit to recover damages
- recover a large amount equaling up to 300% of the interest paid for a maximum 12-month period
- void the interest portion in a loan contract entirely

Case Review: *Stickel v. Harris* (1987)

The case, Stickel v. Harris (1987) 196 Cal.App.3d 575., involved a real estate broker who arranged for a loan with a 30% interest rate.

A licensed real estate broker (Butticci) approached a buyer (Stickel) with a short-term investment proposal. Butticci offered to at first pay 25% interest and then 30% interest on any amount loaned, assuring Stickel that neither rate of return was usurious. Stickel agreed and lent Butticci and his partners (known collectively as Harris) $104,000 in two installments.

Shortly after, Harris began experiencing severe financial difficulties. A prior lien holder on the property (Chow) initiated foreclosure proceedings and the interest payments to Stickel were drastically reduced. Stickel brought legal suit against Harris in order to recover the principal loan amount plus interest.

The issue debated in court was whether Stickel's loan with a 30% interest rate was exempt from usury limits. Butticci argued that he had obtained the loan on behalf of the Harris partnership through his capacity as a licensed real estate broker. Therefore, Harris argued that they were not limited by the maximum 10% usury limit.

The court determined that Butticci did arrange for the loan and therefore, the Harris partnership was exempt from the usury law. Stickel appealed. The Court of Appeals affirmed the lower court's ruling because Butticci was a licensed broker. Had Butticci not been licensed, the maximum interest he could have charged would have been 10%.

Predatory Lending

Predatory lending refers to lenders using unfair and deceptive strategies in an attempt to get borrowers to make costly mistakes that reduce a property's equity, or significantly affect the borrower's ability to afford a property.

Predatory lending practices are primarily used against seniors, individuals in low income neighborhoods, and minority property owners.

Predatory lending laws makes it illegal for lenders to:

- Recommend unnecessary mortgage products, such as an excessively expensive title report
- Direct a borrower towards a bad mortgage decision, such as purchasing mortgage products with higher interest rates and/or fees
- Mislead a borrower about negative amortization programs
- Refinance a borrower's loan when the costs outweigh the benefit
- Increase a borrower's interest rate after the borrower defaults on mortgage payments
- Approve a borrower based only on the equity of his or her property, rather than considering the borrower's financial ability to repay a loan. (This allows a lender to lend with the intent of foreclosing on a borrower with significant equity)

Predatory lending defenses are one the most common type of defense for victims of foreclosure. A borrower must prove that a lender willingly misled the borrower about the benefits of the mortgage product to which they agreed.

Construction Loans

Construction loans are loans funded for the purpose of developing land. They are typically short-term, between one to three years.

Lenders base their construction loan approval decisions on a borrower's ability to repay the loan while simultaneously building a property. Such loans must take into account a borrower's financials, the property, and the state of the economy. Therefore, construction loans can be riskier than traditional loans.

As lenders bear increased risk with construction loans, they charge higher rates than standard mortgages. A lender may also require a borrower to purchase a bond in order to protect the lender's initial investment. If a bond is not purchased, a lender may not provide a borrower with the remainder of the funds.

Once a property owner is approved for a construction loan, a construction lender will place funds in a safe account called an interest reserve. The lender imposes a draw schedule that determines the stages at which construction funds should be dispersed from the account.

Obligatory advances refer to the disbursed funds a lender makes over the construction loan period. During construction, a manager will verify that construction is on schedule and in accordance with the terms of the agreement with the lender. If construction falls behind the agreed-upon draw schedule at any stage, the next obligatory advance will be delayed or prevented.

Obligatory advances have seniority over all other liens, except for tax liens.

A borrower typically does not begin making payments to the lender until after the project is complete.

Seller Financing

Seller financing refers to when a buyer borrows money directly from a seller instead of from a lender in the form of a mortgage. Seller financing is one of the best ways to incentivize reluctant buyers to purchase a property.

A buyer and a seller agree on an interest rate, a repayment schedule, and the consequences of default. The buyer then pays the seller back directly until the property's purchase price plus interest is paid off.

The seller does not transfer ownership of the property to the buyer at the closing. Rather, the buyer only holds equitable title (or interest) to the property for the duration of the loan. Only upon the final payment to the seller will the buyer gain full and exclusive title and become the legal owner of the property.

Should a buyer fail to make payments to a seller, the seller can begin the foreclosure process. If a seller-financed property goes into foreclosure, the buyer forfeits the money already contributed towards the purchase of that property to the seller.

Seller Financing Disclosure

In the event that seller financing is provided for a residential property between one and four units, a seller financing disclosure statement must be given to both parties (Civil Code Section 2956).

A disclosure must be made in writing, although it can be amended. It is not required that a disclosure be given to a buyer if the buyer is entitled to receive a disclosure through the Truth in Lending Act (California Civil Code Section 2958).

A seller financing disclosure must include:

(a) An identification of the note or other credit documents or security documents and of the property which is the security for the transaction.

(b) A description of the terms of the promissory note or other credit documents or a copy of the note or other credit documents.

(c) Insofar as available, the principal terms and conditions of each recorded encumbrance which constitutes a lien upon the property which is or will be senior to the financing being arranged, including the original balance, the current balance, the periodic payment, any balloon payment, the interest rate (and any provisions with respect to variations in the interest rate), the maturity date, and whether or not there is any current default in payment on that encumbrance.

(d) A warning that, if refinancing would be required as a result of lack of full amortization under the terms of any existing or proposed loans, such refinancing might be difficult or impossible in the conventional mortgage marketplace.

(e) If negative amortization is possible as a result of any variable or adjustable rate financing being arranged, a clear disclosure of this fact and an explanation of its potential effect.

(f) In the event that the financing involves an all inclusive trust deed, the disclosure shall indicate whether the credit or security documents specify who is liable for payment or responsible for defense in the case of an attempted acceleration by a lender or other obligee under a prior encumbrance, and whether or not the credit or security documents specify the responsibilities and rights of the parties in the event of a loan prepayment respecting a prior encumbrance which may result in a requirement for refinancing, a prepayment penalty, or a prepayment discount and, if such specification occurs, a recital of the provisions which apply.

(g) If the financing being arranged or any of the financing represented by a prior encumbrance could result in a balloon payment, or in a right in the lender or other obligee under such financing to require a prepayment of the principal balance at or after a stipulated date, or upon the occurrence of a stipulated event, a disclosure of the date and amount of any balloon payment or the amount which would be due upon the exercise of such right by the lender or obligee, and a statement that there is no assurance that new financing or loan extension will be available at the time of such occurrence.

(h) If the financing being arranged involves an all inclusive trust deed or real property sales contract, a disclosure of the party to whom payments will be made and who will be responsible for remitting these funds to payees under prior encumbrances and vendors under this transaction and a warning that, if that person is not a neutral third party, the parties may wish to agree to have a neutral third party designated for these purposes.

(i) A disclosure on the identity, occupation, employment, income, and credit data about the prospective purchaser, as represented to the arranger by the prospective purchaser; or, specifically, that no representation as to the credit-worthiness of the specific prospective purchaser is made by the arranger. A warning should also be expressed that Section 580b of the Code of Civil Procedure may limit any recovery by the vendor to the net proceeds of the sale of the security property in the event of foreclosure.

(j) A statement that loss payee clauses have been added to property insurance protecting the vendor, or that instructions have been or will be directed to the escrow holder, if any, in the transaction or the appropriate insurance carriers for addition of such loss payee clauses, or a statement that, if such provisions have not been made, that the vendor should consider protecting himself or herself by securing such clauses.

(k) A statement that a request for notice of default under Section 2924b has been recorded, or that, if it has not been recorded, the vendor should consider recording a request for notice of default.

(l) That a policy of title insurance has been obtained or will be obtained and be furnished to the vendor and purchaser, insuring the respective interests of the vendor and purchaser, or that the vendor and purchaser individually should consider obtaining a policy of title insurance.

(m) That a tax service has been arranged to report to the vendor whether property taxes have been paid on the property, and who will be responsible for the continued retention and compensation of tax service; or that the vendor should otherwise assure for himself or herself that the taxes on the property have been paid.

(n) A disclosure whether the security documents on the financing being arranged have been or will be recorded pursuant to Section 27280 of the Government Code, or a statement that the security of the vendor may be subject to intervening liens or judgments which may occur after the note is executed and before any resort to security occurs if the security documents are not recorded.

(o) If the purchaser is to receive any cash from the proceeds of the transaction, a statement of that fact, the amount, the source of the funds, and the purpose of the disbursement as represented by the purchaser.

(p) A statement that a request for notice of delinquency under Section 2924 (e) has been made, or that, if it has not been made, the vendor should consider making a request for a notice of delinquency.

Case Review: *Smith v. Allen* (1998)

The case, *Smith v. Allen* (1968) 68 Cal.2d 93., involved a dispute over seller financing.

A property owner (Allen) agreed to sell his home for $145,000 to a buyer (Smith) using seller financing. At the time of the execution of the agreement, Smith paid $5,000 toward the purchase price and took possession of the property. Allen agreed to convey the property to Smith within six months if Smith made additional payments on the purchase price ($25,000) and interest ($4,193). At that point, Allen executed a promissory note for the remaining balance of $115,000 that would be paid off in monthly payments of $900. The property was conveyed to Smith.

Shortly thereafter, Smith made around $20,000 in repairs and improvements. After making the first nine payments of $900, Smith defaulted on payments. Allen commenced with foreclosure proceedings. At the trustee sale, Allen re-purchased the property, essentially reacquiring the property he sold to Smith.

Smith sued. He alleged that the cost of the repairs/improvements, the reasonable rental value during the period he occupied the property, and the total money expended by him led to the unfair enrichment of Allen in the amount of $48,821.14. Smith sought that amount in damages.

The case went all the way to the Supreme Court. The Supreme Court disagreed with the Smith's assessment, stating that the foreclosure sale was valid because Smith's failure to make mortgage payments was grounds for foreclosure even if Allen benefited from the repairs and improvements Smith made.

Case Review: *Petersen v. Hartell* (1985)

The case, *Petersen v. Hartell* (1985) 40 Cal.3d 102., involved a family dispute over seller financing.

A grandmother (Mrs. Gaspar) owned a 160-acre parcel of undeveloped land. Mrs. Gaspar entered into a sales contract with her granddaughter and grandson-in-law (the Petersens) in which she agreed to sell small portions of her land at $1,500 per acre. The Petersens agreed to purchase six acres of the land for a total purchase price of $9,162, with no down payment and monthly installments of $50 or less to be paid to Mrs. Gaspar. There was no provision in the agreement regarding what would happen if the Petersens defaulted on their payments.

Over the next few years, the Petersens paid Mrs. Gaspar $2,900. Then the Petersens separated and defaulted on their payments. A year later, the Petersens made several attempts to send "back" payments to Mrs. Gaspar in the amount of $250. Mrs. Gaspar sent the checks back and told the Petersens that due to their previous defaults, she considered the previous contract void. The Petersens sought to reinstate the contract, but not before Mrs. Gaspar died. The Petersens sued Mrs. Gaspar's administrator (Hartell), seeking specific performance, declaratory relief, damages and to quiet title. They also promised to pay the entire balance due under the original contract if Hartell would deliver a sufficient deed.

The Superior Court denied the Petersen's specific performance claims, contending that their "breach of contract was grossly negligent and willful". The Petersens appealed. The Court of Appeals upheld the lower court's ruling, but entitled the Petersens to restitution for the amount they had already paid towards the property ($2,900).

Successor Liability

Successor liability is a legal doctrine that establishes the liability of a successor who takes over a previous owner's property and/or loan. A lender may be able to recover damages from a buyer (the "successor") who purchase a seller's property.

Types of Seller Financing

Common seller financing programs include:

- Wraparound Mortgage
- Lease Option
- Subject To

Wraparound Mortgage

A **wraparound mortgage** -- or a "wrap" -- is a type of creative seller financing whereby the seller grants the buyer the right to purchase a property while maintaining the existing loan on the property. In this scenario, the buyer pays the seller mortgage payments directly, which the seller subsequently pays the lender. A wraparound mortgage essentially transfers loan liability for the seller's first mortgage to the buyer.

In the event the buyer does not make the agreed-upon payments, the seller has the right to foreclose on the property.

If the current owner of the property has a low interest rate on the property and rates have increased, a wraparound mortgage can be an enticing offer for buyers as it allows them to purchase real estate with a lower payment and allows them to buy the property without qualifying for a loan. This proves significant for both the buyer and seller, particularly in a slow real estate market.

In a wraparound mortgage, the seller acts as the bank by providing the loan to the buyer. In exchange for the loan and possession of the property, the seller holds a promissory note for the balance of the purchase price, minus down payments. The term "wraparound" stems from the fact that the buyer's new debt is "wrapped around" the seller's debt.

Lease Option

A **lease option** -- or "option to purchase" -- gives a potential buyer the option to temporarily lease a seller's property with the option to purchase that property at an agreed-upon price in the future. A potential buyer is not obligated to purchase the property, however.

The monthly lease payments in a lease option are typically higher than market value. This gives a seller assurances that the buyer is serious about wanting to purchase the property. These lease payments are not deductible from the agreed-upon purchase price in the event that the buyer agrees to purchase the property.

However, the amount paid above market value is viewed as a down payment and is deductible. Other deductible expenses include mortgage interest and property taxes.

A lease option ranges from a few months to three years.

Lease options allow people with poor credit history, or without a down payment, the ability to purchase a property.

Subject To

Subject to refers to a situation in which a buyer purchases a seller's property in its current condition -- including any existing mortgages, liens, and/or encumbrances -- but the terms of a seller's promissory note with the lender remain the same.

This includes the name under which the loan was purchased. Consequently, the buyer assumes control of the property title, but all previous liens stay on the property until the buyer pays them off, or agrees to a settlement.

Typically, most buyers will negotiate with the previous lien holders prior to the final purchase of the property. In instances where this is not possible, the buyer should negotiate with previous lien holders to hold exclusive interest in the property, minus the first lender.

The buyer does not assume personal liability for the liens when they purchase the property, however because the liens are still a part of the property, they are ultimately responsible to pay or settle them. This should be done because if the new owner does not make payment on the liens, even if the liens are not theirs, the lien holders may have the right to foreclose on the property. The best way to avoid foreclosure is to settle the lien with the lien holders prior to the purchase.