Real Estate Finance and Investments

Seventeenth Edition

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Preface

Introduction to *Real Estate Finance and Investments*

This book prepares readers to understand the risks and rewards associated with financing and investing both residential and commercial real estate. Concepts and techniques included in the chapters and problem sets are used in many careers related to real estate. These include investing, development financing, appraising, consulting, managing real estate portfolios, leasing, managing property, analyzing site locations, corporate real estate, and managing real estate investment funds. This material is also relevant to individuals who want to better understand real estate when making their own personal investment and financing decisions.

As this current edition is being revised, there is a lot of uncertainty as to the impact that COVID-19 will have on different sectors of the commercial real estate market and it is more important than ever to be able to evaluate the risk and return for lenders and investors. This requires an understanding of the legal issues that can impact the rights of lenders and investors, the characteristics of the various vehicles for lending and investing in real estate, the economic benefits of loans and investments, and how local economies may affect the investment performance of properties as well as the goals of lenders and investors. Managers of real estate funds need to understand how the risk of the fund may be changing and how current economic events might impact the future performance of the fund and the need to change allocations across property types and geographic areas.

This book is designed to help both students and other readers understand these many factors so that they can perform the necessary analysis and make informed real estate finance and investment decisions. As the book's title suggests, we discuss both real estate *finance* and real estate *investments.* These topics are interrelated. For example, an investor who purchases a property is making an investment. This investment is typically financed with a mortgage loan. Thus, the investor needs to understand both how to analyze the investment and how to assess the impact that financing the investment will have on its risk and return.

Similarly, the lender, by providing capital for the investor to purchase the property, is also making an investment in the sense that he or she expects to earn a rate of return on funds that have been loaned. Therefore, the lender also needs to understand the risk and return of making that loan. In fact, one of the risks associated with making loans secured by real estate is that, if a borrower defaults, the lender may take ownership of the property. This means that the lender also should evaluate the property using many of the same techniques as the investor purchasing the property.

Organization of the Book

From the above discussion it should be clear that many factors have an impact on the risk and return associated with property investments and the mortgages used to finance them. This is true whether the investment is in a personal residence or in a large income-producing investment such as an office building.

Part I begins with a discussion of the legal concepts that are important in the study of real estate finance and investments. Although a real estate investor or lender may rely heavily on an attorney in a real estate transaction, it is important to know enough to be able to ask the right questions. We focus only on those legal issues that relate to real estate investment and financing decisions.

Part II begins with a discussion of the time value of money concepts important for analyzing real estate investments and mortgages. These concepts are important because real estate is a long-term investment and is financed with loans that are repaid over time. This leads to a discussion of the primary ways that mortgage loans are structured: fixed rate and adjustable rate mortgage loans.

Part III considers residential housing as an investment and covers mortgage loan underwriting for residential properties. This is relevant for individuals making personal financial decisions, such as whether to own or rent a home, as well as for lenders who are evaluating both the loan and borrower.

Part IV covers many topics related to analyzing income property investments. We provide in-depth examples that include apartments, office buildings, shopping centers, and warehouses. Many concepts also may be extended to other property types. These topics include understanding leases, demonstrating how properties are appraised, how to analyze the potential returns and risks of an investment, and how taxes impact investment returns. We also consider how to evaluate whether a property should be sold or renovated. Finally, we look at how corporations, although not in the real estate business per se, must make real estate decisions as part of their business. This could include whether to own or lease the property that must be used in their operations, as well as other issues.

While the first four parts of this book focus on investing or financing existing properties, **Part V** discusses how to analyze projects proposed for development. Such development could include land acquisition and construction of income-producing property of all types to acquisition of land to be subdivided and improved for corporate office parks or for sale to builders of residential communities. This section also includes how projects are financed during the development period. Construction and development financing is very different from the way existing, occupied properties are financed.

Part VI discusses various alternative real estate financing and investment vehicles. We begin with joint ventures and show how different parties with specific areas of expertise may join together to make a real estate investment. We use, as an example, someone with technical development expertise who needs equity capital for a project. A joint venture is created with an investor who has capital to invest but doesn't have the expertise to undertake the development. We then provide a financial analysis for the investment including capital contributions from, and distributions to, partners during property acquisition, operation, and its eventual sale. In this section, we also discuss how both residential and commercial mortgage loan pools are created. We then consider how mortgage-backed securities are (1) structured, (2) issued against such pools, and (3) traded in the secondary market for such securities. This also includes a discussion of the risks that these investments pose. **Part VI** also includes a discussion of real estate investment trusts (REITs). These public companies invest in real estate and allow investors to own a diversified portfolio of real estate by purchasing shares of stock in the company.

Finally, in **Part VII,** we discuss how to evaluate real estate in a portfolio that also includes other investments such as stocks and bonds. This includes understanding the diversification benefits of including real estate in a portfolio as well as ways to diversify within the real estate portfolio (including international investment). This is followed by a chapter on real estate investment funds that are created for high net worth individuals and institutional investors. We discuss different fund strategies and structures and how to analyze the risk and performance of the funds relative to various industry benchmarks.

Wide Audience

From the above discussion, it is clear that this book covers many topics. Depending on the purpose of a particular course, all or a selection of topics may be covered. If desired, the course also may emphasize either an investor's or a lender's perspective. Alternatively, some courses may emphasize various industry segments such as housing and residential real estate, commercial real estate, construction and development, mortgage-backed securities, corporate real estate, or investment funds. In other words, this book is designed to allow flexibility for instructors and students to cover a comprehensive range of topics or to emphasize only those topics that are the focal point of a specific subject.

Changes to the Seventeenth Edition

Many of the examples through the book have been updated to reflect the current interest rate and tax environment. Newer financial instruments such as Collateral Loan Obligations (CLOs) have been incorporated into the discussion of mortgage-backed securities.

The new accounting regulations requiring operating leases to be included as an asset and liability on the balance sheet was added to Chapter 15 on corporate real estate.

This edition continues to expand the discussion of the role of real estate in a multi-asset portfolio in Chapter 22. Up to date data on the performance of different asset classes was used to illustrate creation of "efficient frontiers" and the reduction of risk through diversification. The capital asset pricing model (CAPM) was added in this edition to provide a link to the importance of beta as a way to determine whether a real estate fund was able to "beat the market" on a risk-adjusted basis and earn alpha.

We also continued to expand Chapter 23 that deals with the private equity real estate funds. The discussion of when time-weighted returns are more relevant than IRRs for certain types of funds was expanded. The calculation of preferred returns and promotes was extended to incorporate calculations based on more than one property sale and the need for clawbacks and holdbacks. The concept of "risk adjusted attribution analysis" was also introduced as a way to better understand why a fund may have performed differently than a benchmark.

Also new to this edition, select end-of-chapter problems are assignable online in Connect.

Excel Spreadsheets and RealNex Software

This book is rigorous yet practical and blends theory with applications to real-world problems. These problems are illustrated and solved by using a blend of financial calculators, Excel spreadsheets, and specialized software designed to analyze real estate income property. Excel spreadsheets, provided on the book's website at **www.mhhe.com/bf17e,** are an aid for students to understand many of the exhibits displayed in chapters throughout the text. By modifying these exhibits, students also may solve many end-of-chapter problems without having to design new spreadsheets. The book's website also contains additional helpful materials for students and instructors. Using a password-protected instructor log-in, instructors can find a solutions manual, test bank, and PowerPoint presentations.

Students can also register online to get free access to a cloud-based real estate valuation program called RealNex. We chose this program because it is very easy and convenient to use by anyone with an Internet connection (including iPads and other mobile devices). RealNex is used in several chapters to supplement the use of Excel spreadsheets when doing investment analysis and solving valuation problems. Once students (or professors) register, they will also have access to data files that replicate examples in the book. Students can register at the following website: **http://info.realnex.com/edu**

Supplements

Several ancillary materials are available for instructor use. These include

- **Solutions Manual**—developed by Jeffrey Fisher and William Brueggeman
- **Test Bank**—developed by Joshua Kahr, Columbia University
- **PowerPoint slides**—developed by Stephanie Yates, University of Alabama

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William B. Brueggeman

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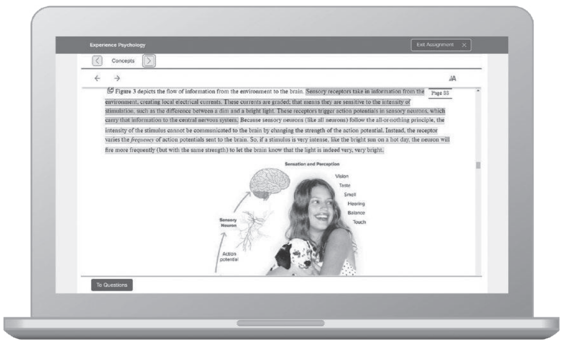

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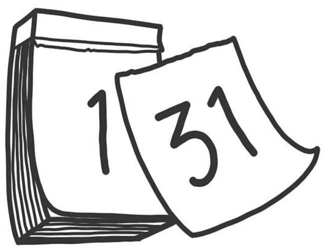

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Chapter 1

Real Estate Investment: Basic Legal Concepts

This is not a book about real estate law; however, a considerable amount of legal terminology is used in the real estate business. It is very important to understand both the physical nature and property rights being acquired when making real estate investments. In this chapter, we survey many important terms pertaining to real estate. Additional legal terms and concepts will appear in later chapters of this book on a "need to know" basis.

Many of the legal terms currently used in the real estate business have evolved from English common law, which serves as the basis for much of the property law currently used in the United States. For example, the term *real* in real estate comes from the term *realty,* which has, for centuries, meant land and all things permanently attached (the latter would include immovable things such as buildings and other structures). All other items not considered realty have been designated as *personalty,* which includes all intangibles and movable things (e.g., automobiles, shares of stock, bank accounts, and patents). The term *estate* has evolved to mean "all that a person owns," including both realty and personalty. Hence, the portion of a person's estate that consists of realty has come to be known as *real estate.* However, in current business practice, although the term "realty" is sometimes used, we generally use the term *real estate* to mean land and all things permanently attached.

Understanding the distinction between realty and personalty is important because our legal system has evolved in a way that treats the two concepts very differently. For example, long ago in England, disputes over real estate usually involved issues such as rightful ownership, possession, land boundaries, and so forth. When such disputes were brought before the court, much of the testimony was based on oral agreements, promises, and the like, allegedly made between the opposing parties, and these disputes were difficult to resolve. Decisions that had to be rendered were extremely important (recall that England's economy was very heavily dependent on agriculture at that time) and affected people's livelihood. Court decisions may have required one of the parties to vacate the land plus turn over any permanent improvements that had been made (houses, barns, etc.) to other parties. As the number of disputes increased, a pragmatic solution evolved requiring that all transactions involving real estate be evidenced by a *written, signed contract* in order to be enforceable.[1]

Parallel developments included (1) a system, whereby land locations and boundaries could be more accurately surveyed and described in contracts, and (2) an elaborate system of public record keeping, whereby ownership of all realty within a political jurisdiction

[1] This requirement was included as part of the *Statute of Frauds and Perjuries,* which was passed in England in 1677 with the intent of reducing the number of disputes and questionable transactions brought before the court.

could be cataloged. Any transactions involving realty could then be added to this record, thereby creating a historical record of all changes in ownership and providing notice of such changes to the general public and especially to any parties contemplating purchasing or lending money on real estate. Similar practices continue today in the United States as we require written contracts, requirements, survey methods, and public record systems detailing the ownership of real estate within all counties in every state. We should note that many transactions involving personalty are not subject to the same contractual requirements as real estate and that oral contracts may be enforceable.

When investing in real estate, in addition to acquiring the physical assets of land and all things permanently attached, investors also acquire certain *rights.* Examples of these rights include the right to control, occupy, develop, improve, exploit, pledge, lease, exclude, and sell real estate. These have come to be known as *property rights.* Hence, the terms *real property* and *real property rights* have evolved.[2] As a practical matter, in business discussions, the terms *real estate* and *real property* are sometimes used interchangeably. However, as we will see, many of the property rights acquired when investing in real estate are independent and can be separated. For example, real estate may be leased or pledged to others in exchange for rent or other consideration. This may be done without giving up ownership. Indeed, understanding the nature of property rights and how they can be bundled and creatively used to enhance value is one goal of this textbook. The reader should refer to Exhibit 1–1 for an outline of these concepts.

Property Rights and Estates

As pointed out above, the term **real estate** is used to refer to things that are not movable such as *land* and *improvements* permanently attached to the land, and **ownership rights** associated with the real estate are referred to as **real property.** Real property has also been contrasted with **personal property.**[3]

It is important to distinguish between physical real estate assets and ownership rights in real property because many parties can have different ownership rights in a given parcel of real estate. Our legal system offers ways for the person financing or investing in real estate to be creative and to apportion these various interests among parties.

We generally refer to **property rights** as the right of a person to the possession, use, enjoyment, and disposal of his or her property. With respect to its application to real estate, *interest* is a broad legal term used to denote a property right. The holder of an interest in real estate enjoys some right, or degree of control or use, and, in turn, may receive payment for the sale of such an interest. This interest, to the extent that its value can be determined, may also be bought, sold, or used as collateral for a loan.

The value of a particular parcel of real estate can be viewed as the total price individuals are willing to pay for the flow of benefits associated with all of these rights. An individual does not have to be an owner per se to have rights to some of the benefits of real estate. For example, a person who leases land, a **lessee,** may have the right to possession and

[2] For nonrealty, the term *personal property* has evolved, and personal property rights would include the bundle of rights which are similar to those listed above but pertaining to personalty.

[3] We should also point out that there are some items known as *fixtures.* These are items that were once personal property but have become real property because they have either been attached to the land or building in a somewhat permanent manner or are intended to be used with the land and building on a permanent basis. Examples include built-in dishwashers, furnaces, and garage door openers. There is significant case law on the subject of fixtures. In practice, when properties are bought and sold, a detailed list of all items that could be considered as either personal property or as a fixture will be documented and included as a part of the contract for purchase and sale. This is done to reduce ambiguity as to the property being conveyed from the seller to the buyer.

EXHIBIT 1–1 Basic Property Concepts Important in Real Estate Finance and Investment

(1)	(2)	(3)	(4)
The General Nature of Property	**Classification of "Things"**	**Examples**	**Property Ownership: Evolution of Legal Requirements/Evidence**
Any "thing" tangible or intangible that can be possessed, used, enjoyed, controlled, developed, or conveyed and that has utility or value is considered to be property.	A. Real Property (Realty)	A. Land and all things permanently affixed (buildings, sidewalks, etc.). Immovables. Fixtures.	A. Written contracts, legal descriptions, surveys, deeds, wills, possession. Public notice.
	B. Personal Property (Personalty)	B. Intangibles and all movable things (e.g., autos, stocks, patents, furniture, etc.).	B. Contracts, oral or written, purchase orders/invoices, and so on.
Property Rights			
Rights that can be exercised by the property owner. These include possession, use, enjoyment, control, and the creation of estates in property.		C. Property owner leases the use of realty to tenant, creates a leasehold estate.	C. Written document (lease) describing realty and the terms of possession in exchange for rent.
Interests in Property			
Created by owners of real estate who pledge and encumber property in order to achieve an objective without giving up ownership.		D. Property owner pledges real estate as security for a loan.	D. Mortgage liens, easements, and so on.
		E. Property owner grants an easement to another party to cross land in order to gain access to another site.	

exclusive use of a property for a period of time. This right of use has value to the lessee, even though the term of the lease is fixed. In exchange for the right to use the property, the lessee is willing to pay a rent for the term of the lease. A holder of a mortgage also has some rights as a nonowner in real estate pledged as security for a loan. These rights vary with state law and the terms of the mortgage, but in general, the lender (or mortgagee) has a right to repossess or bring about the sale of a property if the borrower defaults on the mortgage loan. Although a lender may not possess or use the real estate, the mortgage document provides the lender with evidence of a **secured interest.** Obviously, this right has value to the lender and reduces the quantity of rights possessed by the owner.

It should be clear that some understanding of the legal characteristics of real estate is essential to analyzing the relative benefits that accrue to the various parties who have some rights in a particular property. In most real estate financing and investment transactions, we generally think in terms of investing, selling, or borrowing based on one owner possessing all property rights in the real estate. However, as we have discussed, all or a portion of these rights may be restricted or transferred to others. For example, a property owner may lease a property and pledge it as security for a mortgage loan. Remarkably, these parties generally enjoy their respective rights in relative harmony. However, conflicts arise occasionally concerning the relative rights and priorities among holders of these interests. The potential for such conflicts may also affect rents that individuals may be willing to pay or the ability to obtain financing from lenders and, ultimately, the value of property.

Definition of Estate

The term **estate** means "all that a person owns." The term *real estate* means all realty owned as a part of an individual's estate. The term *estates in real property* is used to describe the extent to which rights and interests in real estate are owned. A system of *modifiers* has evolved, based on English property law, that describes the nature or collection of rights and interests being described as a part of a transaction. For example, a *fee simple estate* represents the most complete form of ownership of real estate, whereas a *leasehold estate* usually describes rights and interests obtained by tenants when leasing or renting a property. The latter is also a possessory interest and involves the general right to occupy and use the property during the period of possession.

Two General Classifications of Estates

(1) Based on Rights: Estates in Possession versus Estates Not in Possession (Future Possession)

Two broad categories of estates can be distinguished on the basis of the *nature of rights accompanying the ownership of such estates.* An estate in possession (a present estate in land) entitles its owner to immediate enjoyment of the rights to that estate. An estate not in possession (a future estate in land), on the other hand, does not convey the rights of the estate until some time in the future, if at all. An estate not in possession, in other words, represents a *future* possessory interest in property. Generally, it does not convert to an estate in possession until the occurrence of a particular event. Estates in possession are by far the more common. When most people think of estates, they ordinarily have in mind estates in possession. Obviously, lenders and investors are very interested in the nature of the estate possessed by the owner when considering the purchase or financing of a particular estate in property.

(2) Based on Possession and Use: Freehold versus Leasehold Estates

Estates in possession are of two general types: freehold estates and leasehold estates. These types of estates are technically distinguished on the basis of the definiteness or certainty of their duration. A **freehold estate** lasts for an indefinite period of time; that is, there is no definitely ascertainable date on which the estate ends. A **leasehold estate,** on the other hand, expires on a definite date. Aside from this technical distinction, a freehold estate connotes ownership of the property by the estate holder, whereas a leasehold estate implies only the right to *possess* and *use* the property owned by another for a period of time.

Examples of Freehold Estates

It is beyond the scope of this chapter to review all the possible types of freehold estates. We will discuss two of the most common examples, however, to convey the importance of knowing the type of estate that is associated with a particular transaction.

Fee Simple Estate

A **fee simple estate,** also known as a *fee simple absolute estate,* is the freehold estate that represents the most complete form of ownership of real estate. A holder of a fee simple estate is free to divide up the fee into lesser estates and sell, lease, or borrow against them as he or she wishes, subject to the laws of the state in which the property is located. Apart from government restrictions, no special conditions, limitations, or restrictions are placed on the right of a holder of a fee simple estate to enjoy the property, lease it to others, sell it, or even give it away. It is this estate in property that investors and lenders encounter in most investment and lending transactions.

Life Estates

It is possible to have a freehold estate that has fewer ownership rights than a fee simple estate. One example is a **life estate,** which 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. Upon the death of that person, the property reverts back to the original grantor (transferor of property), his or her heirs, or any other designated person. Most life estates result from the terms of the conveyance of the property. For example, a grantor may wish to make a gift of his or her property prior to death, yet wish to retain the use and enjoyment of the property until that time. This can be accomplished by making a conveyance of the property subject to a reserved life estate. A life estate can be leased, mortgaged, or sold. However, parties concerned with this estate should be aware that the estate will end with the death of the holder of the life estate (or that of the person whose life determines the duration of the estate). Because of the uncertainty surrounding the duration of the life estate, its marketability and value as collateral are severely limited.

Estates Not Yet in Possession (Future Estates)

The preceding discussion concerned estates in possession, which entitled the owner to immediate enjoyment of the estate. Here, we discuss estates not in possession, or **future estates,** which do not convey the right to enjoy the property until some time in the future. Two very important types of future estates are the reversion and the remainder.

Reversion

A reversion exists when the owner of a property wants to create and convey an estate to another party, but only for a specified period of time or the life of that party. When the end of the time period is reached, the estate is re-conveyed to the owner. Reversions are used in many cases when the owner wants to allow another party the right to occupy and use a property for a time but does not want to give up ownership. The owner intends to re-occupy the property at a future date and perhaps use it again or sell at that time. A reversionary interest can be sold or mortgaged because it is an actual interest in the property.

Remainder

A remainder exists when an owner wishes for another party to occupy and use a property for a specified number of years or for his life, then upon expiration of that time or upon his death, the estate is conveyed to a third party. In other words, an owner allows one party to occupy and use, then ownership eventually goes to a third party.

The above two cases are examples of many scenarios that are possible when a property owner wants to achieve certain results in the future as opposed to the present. Attendant issues that also must be resolved in these cases include responsibility for maintenance, insurance, property taxes, and so on, before the reversion or remainder occurs.

Examples of Leasehold Estates

There are two major types of leasehold estates: estates for years and estates from year to year. There are two other types, but they are not common.[4] Leasehold estates are classified on the basis of the manner in which they are created and terminated.

[4] *Estate at Will:* An estate at will is created when a landlord consents to the possession of the property by another person but without any agreement as to the payment of rent or the term of the tenancy. Such estates are of indefinite duration. *Estate at Sufferance:* An estate at sufferance occurs when the tenant holds possession of the property without consent or knowledge of the landlord after the termination of one of the other three estates.

Estate for Years: Tenancy for Terms

An **estate for years** is the type of leasehold estate investors and lenders are most likely to encounter. It is created by a lease that specifies an exact duration for the tenancy. The period of tenancy may be less than one year and still be an estate for years as long as the lease agreement specifies the termination date. The lease, as well as all contracts involving transactions in real estate, is usually written. Indeed, a lease is generally required by the statute of frauds to be in writing when it covers a term longer than one year. The rights and duties of the landlord and tenant and other provisions related to the tenancy are normally stated in the lease agreement.

An estate for years can be as long as 99 years (by custom, leases seldom exceed 99 years in duration), giving the lessee the right to use and control the property for that time in exchange for rental payments. To the extent that the specified rental payments fall below the market rental rate of the property during the life of the lease, the lease has value (leasehold value) to the lessee. The value of this interest in the property can be borrowed against or even sold. For example, if the lessee has the right to occupy the property for $1,000 per year when its fair market value is $2,000 per year, the $1,000 excess represents value to the lessee, which may be borrowed against or sold (assuming no lease covenants prevent it).

While a property is leased, the original fee owner is considered to have a *leased fee* estate. This means that he or she has given up some property rights to the lessee (the leasehold estate). The value of the leased fee estate will now depend on the amount of the lease payments expected during the term of the lease plus the value of the property when the lease terminates and the original owner receives the reversionary interest. Hence, a leased fee estate may be used as security for a loan or may be sold.

Estate from Year to Year

An **estate from year to year** (also known as an estate from period to period, or simply as a periodic tenancy) continues for successive periods until either party gives proper notice of its intent to terminate at the end of one or more subsequent periods. A "period" usually corresponds to the rent-paying period. Thus, such a tenancy commonly runs from month to month, although it can run for any period up to one year. Such estates can be created by explicit agreement between the parties, although a definite termination date is not specified. Since these estates are generally short term (a year or less), the agreement can be, and frequently is, oral. This type of estate can also be created without the express consent of the landlord. A common example is seen when the tenant "holds over" or continues to occupy an estate for years beyond the expiration date, and the landlord accepts payment of rent or gives some other evidence of tacit consent.

If present tenants are to remain in possession after the transfer or sale of property, the grantee should agree to take title subject to existing leases. The agreement should provide for prorating of rents and the transfer of deposits to the grantee. Buyers of property encumbered by leases should always reserve the right to examine and approve leases to ensure that they are in force, are not in default, and are free from undesirable provisions.

Interests, Encumbrances, and Easements

An *interest* in real estate can be thought of as a right or claim on real property, its revenues, or production. Interests are created by the owner and conveyed to another party, usually in exchange for other consideration. In real estate, an interest is usually thought to be less important than an estate. For example, an owner of real estate in fee simple may choose to *pledge* or *encumber* his property as a condition for obtaining a loan (mortgage loan). In this case, the lender receives only a *secured interest,* but not *possession, use, and so on,* of the property. The nature of the secured interest is usually documented in a mortgage which explains the actions that a lender may take in the event that the loan terms are not met by the property owner. In the interim, the property owner *retains possession and use* of the property. Another example of the creation of an interest in real property occurs when an owner encumbers a property by granting an easement, or the right to ingress or egress his property, to another party.

An **easement** is a **nonpossessory interest** in land. It is the right to use land that is owned or leased by someone else for some special purpose (e.g., as a right of way to and from one's property). An easement entails only a limited user privilege and not privileges associated with ownership.[5] Examples of easements would be the following: property owner A allows property owner B to use a driveway on A's land to provide owner B with better access to his property. In some retail developments, owners A and B may execute reciprocal easements to allow access across both properties, thereby enhancing customer traffic flow and shopping opportunities.

Assurance of Title

When making real estate investments, buyers of property typically want assurance that they will become the legal owner of the property and that the seller is lawfully possessed and has the right to convey title. Exhibit 1–2 contains a basic flow diagram that should help the reader understand concepts relating to real estate ownership.

When considering the purchase of real estate, buyers must be in a position to assess the quantity and quality of ownership rights that they are acquiring. **Title assurance** refers to the means by which buyers of real estate "(1) learn in advance whether their sellers have and can convey the quality of title they claim to possess and (2) receive compensation if the title, after transfer, turns out not to be as represented."[6] Lenders are also concerned about title assurance because the quality of title affects the collateral value of the property in which they may have a secured interest. Before we examine the mechanisms used for title assurance, we must briefly review the concepts of title and deed.

The Meaning of Title

Title is an abstract term frequently used to link an individual or entity who owns property to the property itself. When a person has "title," he is said to have all of the elements, including the documents, records, and acts, that prove ownership. Title establishes the quantity of rights in real estate being conveyed from seller to buyer. The previous section briefly examined some of the various types of ownership rights and possessory interests that can be involved in a parcel of real estate. We saw, for example, that one person may hold title in fee simple ownership, convey title to a life estate to someone else, and convey the right to reversion upon termination of the life estate to yet another person. Hence, there are many possible combinations of rights and interests.

[5] When a property owner provides another with an interest such as an easement, the property owner is said to have encumbered the property. This may be transferred as a part of subsequent sales to successive owners unless it is defeated, or the owner of the interest releases or recognizes the interest to the property owner.

[6] Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance and Development,* 2nd ed. (St. Paul, MN: West Publishing, 1981), p. 167.

EXHIBIT 1–2

Flowchart: Ownership of Real Property

Concept	**Discussion**
Ownership ↓	When a person or other legal entity has lawful possession of realty and real property rights they are said to have "ownership."
Proof of ownership ↓	Proof is usually accomplished with documents such as deeds, contracts, wills, grants, property records, and/or evidence of continuous possession and use, and so on.
Title ↓	When a person or entity has legal evidence, or "proof," of ownership, they are said to have "title" to a property. This evidence links ownership by a person to a specific property.
Assurance of title ↓	When investing in real estate, the investor must be able to evaluate the quality and/or completeness of title that they will receive. This is important in the event that the buyer wants to obtain financing and/or resell the property in the future. As part of the contract negotiations, the seller usually agrees to convey title *and* to provide a warranty or guarantee.
(a) General warranty deed ↓	When the seller conveys a *general warranty deed*, she warrants (1) that she is in lawful possession of the property and all property rights, (2) that no other individuals or entities have an ownership interest in the property, and (3) that the title is unencumbered or free of imperfections (with any specific exceptions noted: e.g., easements, leases, or liens). In the event that a buyer who relies on the seller's warranty incurs a loss because of title imperfections, the seller may be liable.
(b) Qualified warranty deeds ↓	In cases when the seller is unsure of the quality of title or is unwilling to provide a general warranty deed, the seller may qualify assurance of title by conveying a "special warranty deed," a "bargain and sale deed," or a "quit claim deed."
Evidence as to the nature and quality of title being conveyed ↓	How can the investor in a property be assured that the seller legally possesses the property and that the record of ownership is clear, or that the title is unencumbered?
(a) Attorney's opinion ↓	An attorney reviews public property records and other evidence to ascertain whether or not the "chain of title" is "clear." When a title is clear, this usually means that all individuals who may have had an ownership interest in the property have conveyed or relinquished such interests in previous conveyances of title. When the *possibility* exists that other parties may have an ownership or other interest, these may be referred to as title "imperfections or defects." If an investor wants clear title, action must be taken to "cure" such defects. This is usually done by an attorney who will contact relevant parties in the chain of title and negotiate a release or conveyance of their interest, possibly in exchange for some consideration.
(b) Title insurance	More commonly, an insurance policy indemnifying against a loss due to possible title imperfections is purchased (usually by the buyer). This may be done because the seller's warranty may be effectively limited. This could happen if the seller files for bankruptcy or does not have the financial capacity to reimburse the buyer for losses due to title imperfections. Title insurance also may be used in lieu of an attorney's opinion because the latter protects the buyer only to the extent that the title search was done negligently by the attorney or her abstractor. Title insurance companies usually conduct a review of the title chain before issuing a title insurance policy.

An **abstract of title** is a historical summary of the publicly recorded documents that affect a title. The quality of the title conveyed from seller to buyer depends upon the effect these documents have upon the seller's rightful possession of his or her property.

Essentially, title exists only for freehold estates. A leasehold estate, on the other hand, is typically created by a contract (called a lease) between a person who holds the title (the **lessor**) and another person (the lessee), whereby possession of the property is granted by the owner to the other person for a period of time. The existence of leases on a property will, however, affect the nature of the rights that can be conveyed to a new buyer because lease terms are binding on the new owner unless waived by the lessee or, in some jurisdictions, unless title is acquired at a foreclosure sale. Because investors and lenders are concerned about the nature and extent of the rights they are acquiring or financing, leases encumbering the property can have a profound impact on a property's value.

Deeds

Usually title is conveyed from one person (the grantor) to another (the grantee) by means of a written instrument called a **deed.** (We use the term *grantor* instead of *seller* because title may also be transferred by the owner [grantor] to an heir [grantee] by means of a will; hence the terms *grantor* and *grantee.*) To be a valid conveyance of ownership interests in real property, all deeds must be in writing and meet certain other legal requirements of the state in which the property is located.[7]

Generally, a purchaser wants the deed to convey a good *and* marketable title to the property. A good title is one that is valid in fact; that is, the grantor does lawfully have the title he or she claims to have to the property. However, a good title, because of the lack of sufficient documentation or encumbrances on the property, may be unmarketable. A marketable title is one that is not merely valid in fact but is also "free from reasonable doubt," one that is "reasonably free from litigation," and "one which readily can be sold or mortgaged to a reasonably prudent purchaser or mortgagee (mortgage lender)."[8]

Encumbrances on a title, such as easements, leases, and mortgages (secured interests), do not automatically make it unmarketable. A purchaser may be willing to take title to the property subject to encumbrances. But the deed should note all encumbrances on the title so that a potential purchaser can rationally decide whether to purchase the property and to arrive at the appropriate price given any risks, costs, or restrictions posed by the encumbrances.

Methods of Title Assurance

There are three general ways in which a buyer has assurance that a title is good and marketable. First, the seller may provide a warranty as part of the deed. Second, there may be a search of relevant recorded documents to determine whether there is reason to question the quality of the title. This is usually done by an attorney and is accompanied by a legal opinion. Third, title insurance may be purchased to cover unexpected problems with the title.

[7] A deed is not the only way by which ownership rights in real property are conveyed. Titles are also transferred by wills, court decrees, and grants of land from the government to private persons. In addition, lawful title to property can be acquired by means of adverse possession. It should also be pointed out that although we use the terms *buyers* and *sellers* in this book, the more general terms *grantor* and *grantee* are frequently used in contracts or other documents in real estate. **Grantors** include sellers but also include property owners who may be transferring title by gift (not sale), by will, and so on. **Grantees** include buyers in a transaction but also may include persons who receive title by gift, as an heir in a will, and so on.

[8] *Black's Law Dictionary,* 7th ed. (St. Paul, MN: West Publishing, 1999).

General Warranty Deed

It is important to understand that any deed, no matter how complete the warranties contained therein, can only convey the quality of title that the grantor actually has to the property. This is why most buyers of real estate usually obtain independent assurance of the validity and marketability of the title from a third party. A **general warranty deed** is the most commonly used deed in real estate transactions and the most desirable type of deed from the buyer's perspective. It offers the most comprehensive warranties about the quality of the title. Essentially, the grantor warrants that the title he or she conveys to the property is free and clear of all encumbrances other than those specifically listed in the deed. As pointed out above, encumbrances listed in a deed could include easements and leases. Generally, the most significant covenants contained in such a deed are the following: (1) a covenant that the grantor has good (legally valid) title to the property, (2) a covenant that the grantor has the right to convey the property, (3) a covenant to compensate the grantee for loss of property or eviction suffered by the grantee as a result of someone else having a superior claim to the property, and (4) a covenant against encumbrances on the property other than those specifically stated in the deed. In a general warranty deed, these covenants cover all conveyances of the property from the time of the original source of title to the present.

Special Warranty Deed

A **special warranty deed** makes the same warranties as a general warranty deed except that it limits their application to defects and encumbrances that occurred only while the grantor held title to the property. Unlike the warranties in a general warranty deed, those in a special warranty deed do not apply to title problems caused or created by previous owners.

Bargain and Sale Deed

A **bargain and sale deed** conveys property without seller warranties. This is sometimes referred to as an "as is" deed. The buyer of property takes title with no assurances from the seller and must take the initiative to determine whether any imperfections exist and, if desired, how to cure such defects.

Sheriff's Deed–Trustee's Deed

A **sheriff's deed–trustee's deed** is a type of bargain and sale deed received by a buyer from a foreclosure or other forced sale because the sheriff or trustee is acting in a representative capacity. No warranties are added.

Quitclaim Deed

A **quitclaim deed** offers the grantee the least protection. Such a deed simply conveys to the grantee whatever rights, interests, and title that the grantor may have in the property. No warranties are made about the nature of these rights and interests or of the quality of the grantor's title to the property. The quitclaim deed simply says that the grantor "quits" whatever "claim" he or she has in the property (which may well be none) in favor of the grantee.[9]

[9] Quitclaim deeds are appropriately and frequently used to clear up technical defects or "clouds" on the title to a property. Where the record indicates a person may have any potential claim to the property, obtaining a quitclaim deed from him will eliminate the risk that such a claim will be made in the future.

Web App

The American Land Title Association (**www.alta.org**), founded in 1907, is the national trade association for the title insurance industry. ALTA members search, review, and insure land titles to protect home buyers and mortgage lenders who invest in real estate. ALTA is headquartered in Washington, DC. There is a "Consumer Information" link on this site that includes a discussion of common title problems. Outline the types of problems that can be encountered due to a problem with the title for a property.

Very few buyers of real estate rely solely on the guarantees of title provided in deeds of conveyance by the seller. The two methods that buyers employ most often to obtain assurance of title independently of the guarantees provided by the seller are an attorney's opinion of title and title insurance.

Abstract and Opinion Method

Obtaining a lawyer's opinion of title used to be the most common method of title assurance before the widespread availability of title insurance. Essentially, the abstract and opinion method is a two-step process. First, there is a search of the title record, which involves locating and examining all of the instruments in the public records that have affected the title of the property in question.[10] Second, when the title search is completed, a lawyer studies the relevant public records and other facts and proceedings affecting the title for the purpose of arriving at an expert opinion of the character of the title. Based upon this study of the abstract or the record, the lawyer will give his or her judgment whether the title is good and marketable. If the title is found to be "clouded," the opinion should state what defects or encumbrances were uncovered by an examination of the records, and it should also state what the lawyer thinks can and should be done to "cure" the defects uncovered.

Because a lawyer's responsibility is limited to what appears in the records, the lawyer cannot be held liable for any defect in the title not disclosed therein. Any liability borne by the lawyer is based upon proof of his or her negligence or lack of professional skill in the examination of the records. Rather than relying on the lawyer's opinion, the title insurance industry has evolved. Many lenders and investors now prefer title insurance, which reduces this risk.

The Title Insurance Method

Title insurance was developed to cure the inadequacies of title validation accomplished through an abstract and legal opinion. Title insurance does all that a carefully drawn abstract and a well-considered opinion by a competent lawyer are expected to do. In addition, it adds the principle of insurance to spread the risk of *unseen hazards* among many property owners.

Elimination of risk arising from unseen hazards in the public record has caused many investors and lenders to prefer this method of title assurance. In fact, title insurance is required for any mortgage that is traded in the secondary mortgage market. The title insurance process starts with a careful analysis of the records. The information available to the commercial title insurance company may be even more complete than that found in the public records.

[10] Most of the instruments that affect title to real estate are recorded, in accordance with the recording acts of the various states, at what is typically called the county recorder's office. But some instruments that affect title may be recorded in other places. The nature of these other places where records are filed varies from state to state.

Skilled technicians at title insurance companies examine all available evidence of the title to determine its character. If their conclusions warrant, the title company will insure the title to a property and assume risks that are not even disclosed in the public records or in its own files. In short, title insurance ensures that the title is good and marketable.

What title insurance is supposed to add to the abstract system and the opinion of skilled lawyers may be summarized as follows: (1) definite contract liability to the premium payer, (2) reserves sufficient to meet insured losses, (3) supervision by an agency of the state in which the title insurance company operates, and (4) protection to the policyholder against financial losses that may show up at any future time because of any kind of title defect, disclosed or hidden. Despite these advantages, the abstract and opinion method may still be used because of its lower cost. In general, one method, but not both, is used when purchasing property, to avoid the duplication of effort and cost.

Kinds of Title Insurance Policies

There are two kinds of title insurance policies. The **owner's policy** insures the interests of a new property owner. The **lender's (or mortgagee) policy** insures the interests of the mortgagee. The owner's policy is payable to the owner (or to the heirs of the owner); the lender's policy is payable to the mortgagee.

Both policies are paid for with a one-time premium. In many states, premiums are regulated by a state insurance commission, as are financial requirements to incorporate and continue to do business. The one-time premium for the owner's policy insures the owner for the entire period of time that she owns the property. The insurance premium may be paid by either the seller or the buyer, depending on the terms of the purchase contract, which are influenced by local custom and market conditions. It is almost universal practice for the borrower to pay the cost of the mortgagee's policy which will insure the lender for the term of the loan. In cases where properties are *refinanced* by the same owner, a title search may be required by a new lender. In these cases it may be possible to obtain a new title insurance policy from the same company at a *reduced cost.*

Recording Acts

All states have enacted statutes known as **recording acts.** Although the recording acts are not uniform among the states, these acts in general provide a publicly accessible system for assessing and establishing claims or interests in real estate as against all other parties. These statutes also provide a set of authoritative rules for resolving priority disputes among competing claimants to interests in real estate. As part of this system, procedures have been established for placing documents affecting claims to real estate interests on the public record and for maintaining these records to make information available concerning almost all interests in real estate. Once an instrument creating a claim on an interest in real estate has been duly recorded, the recording is deemed to give constructive notice of this interest "to the world." Constructive notice means that the recording acts deem a person to have whatever information is contained in the public records—information that could be obtained by a reasonably diligent investigation of the records whether or not the investigator actually has knowledge of the information recorded. Instruments affecting virtually all interests in real estate, including deeds, mortgages, assignments of mortgages, liens, land contracts, long-term leases, easements, restrictive covenants, and options to buy, are covered by recording acts.

Most recording acts say that in order to establish and preserve a claim to an interest in real estate that will take precedence in law against future claimants, the instrument creating that claim must be recorded in accordance with state law. These acts were designed in part to protect an innocent person who purchased an interest in real estate in good faith unaware that the interest had already been acquired by another. For example, if A conveyed to B, who did not record the instrument establishing his claim, and later A conveyed the same interest to C, who did record, C's claim would be superior to B's if C was unaware of the prior conveyance and paid valuable consideration to A. B's only claim would be to file a suit against A for fraud.

Mechanics' Liens

One cloud on the title which may not be disclosed by the public records is a **mechanics' lien.** In general, mechanics' liens give unpaid contractors, workers, and material suppliers the right to attach a lien on the real estate to which they added their labor or materials. To obtain the payment owed them, they may foreclose such liens by forcing a judicial sale of the encumbered property. They are then paid from the proceeds of the sale. Use of mechanics' liens exists in every state, although the nature of the statutes varies.

Mechanics' liens are permitted to be recorded "after the fact." In other words, 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 the real estate. As a result, until the end of the time allowed for filing (generally 60 days), a purchaser of an interest in newly constructed or improved real estate cannot be sure that the interest will be unencumbered or that the interest will have the priority bargained for. As a precaution, lenders and purchasers of such real estate should require the seller to provide an *affidavit* stating that at closing, all money due to contractors and subcontractors have been fully paid. In the event that liens are filed after the closing, a breach of the seller's covenants in the affidavit can easily be proven, and the seller can be held liable for the discharge of those liens. In practice, owners of properties that are newly constructed or renovated should require contractors, workers, and material suppliers to sign a *lien waiver.* This is an acknowledgment that they have been compensated and that they agree to waive all lien rights. In many situations, if a lender is advancing funds for such work and material, a signed waiver will be required at each stage of construction before additional funds are released.

Limitations on Property Rights

Government Restrictions

Throughout this chapter, we have stressed the importance of property rights in real estate. We should also point out that although our form of government protects the rights of individuals to own real estate and to enjoy real property rights, these rights are restricted. Government restrictions on private property rights do exist. Land use regulations are most prominent at the state and local level. The right to regulate emanates from the "police powers of the state," which are based on the protection of the health, safety, and general welfare of its citizens (societal considerations). As the population in an area grows, it may apply to the state to become incorporated as a city, township, or municipality. At this point, the state usually delegates some areas of land use regulation. Incorporated areas then may modify and expand land use controls and develop restrictions on land use. These items are usually enumerated in zoning ordinances and building codes. Common restrictions used to implement controls include zoning ordinances, allowable uses, height restrictions, parking requirements, and building codes, permits, and inspections. The state usually retains control over water or riparian rights, mineral rights, eminent domain, and the like, while the federal government regulates housing and loan discrimination, interstate land sales and securities, and environmental restrictions (pollution of water and air, and endangered species, as well as effects of property use and development on wet lands).

Private Deed Restrictions

In some cases, property owners may choose to incorporate certain **deed restrictions** that limit the use of property by all subsequent owners of that property. Property owners may use such restrictions to achieve personal or business objectives. One example of a personal objective would be to add a deed restriction explicitly prohibiting the sale or consumption of alcoholic beverages on the property forever. In the event that this restriction is violated, the restriction may stipulate that the title will revert to the owner who incorporated the restriction, or to his heirs. An example of a business objective that is commonly achieved through deed restrictions may involve subdivision of a large tract of land into smaller individual tracts to be sold to builders and developers. In order to assure the initial buyers of the subdivided tracts that subsequent buyers will build improvements that conform in quality and use, the owner of the initial larger tract may deed restrict each of the subdivided tracts. Such restrictions may require a minimum and/or maximum building size, minimum quality building materials, landscaping, and the like, thereby providing all owners with some assurance of conformity and general standards in design and building quality. However, resolution of any future violations of deed restrictions may prove to be problematic, particularly after a long period of time. In the first example, the original property owner or all of his heirs would have to bring an action against the current owner to regain title to the property if the deed restriction prohibiting the sale of alcohol were to be violated. In the case of the subdivision, usually a property owners association representing owners of the subdivided properties would have to bring legal action against the property owner who is in violation. In this instance, the court may require the owner in violation to cure the problem or pay the owners association for any loss in property value as opposed to forcing the sale of the property.

Conclusion

This chapter discussed legal considerations important in creating and defining various rights to real property. This is important in the study of real estate finance since it is these rights that are purchased, sold, and mortgaged. Thus, an understanding of the various rights associated with real estate is necessary to properly evaluate a real estate financial decision. Legal considerations affect the risk of receiving the economic benefit associated with one's property rights. For example, we have discussed the importance of having a marketable title. Any defects in the title may result in a loss of benefits to the owner and jeopardize the collateral value of the real estate for the mortgage lender. To some extent, this risk is controlled and minimized by the use of title assurance methods, including title insurance and the use of general warranty deeds.

Knowing the various ways of partitioning property rights may also result in maximizing the value of a particular property, since it allows parties with different needs (e.g., users, equity investors, and lenders) to have claims on the property rights that best meet those needs. Thus, the total value of all the rights associated with a property could exceed the total value of the property itself if there are no leases or other ways to separate rights.

Key Terms

Questions

1. What is the difference between real property and personal property?
2. What is meant by an estate?
3. How can a leased fee estate have a value that could be transferred to another party?
4. What are title records? What is an abstract of title?
5. What is a deed? How is it different from the title?
6. What is meant by a title record? Why are these records so important?
7. What is a future estate? Give an example.
8. Name the three general methods of title assurance and briefly describe each. Which would you recommend to a friend purchasing real estate? Why?
9. Would it be legal for you to give a quitclaim deed for the State of Liberty to your friend?

Chapter 2

Real Estate Financing: Notes and Mortgages

Financing can be a very important component of investing in real estate. In general, when investors desire to obtain financing, they usually pledge, or hypothecate, their ownership of real estate as security for loans. In many cases, investors also pledge personal property to obtain loans. What follows is an introduction to notes and mortgages, two legal instruments that are used frequently in real estate financing.

Notes

A **promissory note** is a document that serves as evidence that debt exists between a borrower and a lender. It usually contains the terms under which the loan must be repaid and the rights and responsibilities of both parties. Unless stated otherwise, the borrower is *personally liable* for payment of all amounts due under the terms of the note. (These loans are said to be made **"with recourse"** to the borrower.) While many loan provisions may be included, notes usually contain at least the following:

A. The *amount borrowed*—generally the face amount of the note, which is usually advanced in total when the loan agreement is executed. However, in cases involving construction loans, amounts could be advanced as a construction progresses, not to exceed a maximum amount.

B. The *rate of interest*—a fixed rate of interest or an adjustable rate. If it is the latter, exactly how the rate may be adjusted (changed) will be specified.

C. The dollar amount, due dates, and number of payments to be made by the borrower—(e.g., $500 per month due on the first of each month following the closing date for 300 consecutive months).

D. The maturity date—the time at which time all remaining amounts due under the terms of the loan are to be repaid.

E. Reference to the real estate serving as *security* for the loan as evidenced by a mortgage document (to be discussed).

F. Application of payments, which are usually made first to cover any late charges/fees/penalties, then to interest, and then to principal reduction.

G. Default—borrower's failure to perform one or more covenants under the terms of the note. Default usually occurs because of nonpayment of amounts due.

H. Penalties for late payment and forbearance provisions—the latter specify any grace periods during which late payments can be made up (usually with penalties) without the lender declaring that the borrower is in default. The lender does not give up the right to declare that the borrower is in default at some future date by allowing a grace, or forbearance, period. Forbearance is used by lenders when they believe that borrowers will make up late payments. They allow time for borrowers to make up such payments when they believe that benefits from this course of action will exceed the time and the expense of declaring the loan in default and embarking on foreclosure proceedings and, perhaps, forcing the sale of the property.

I. Provisions, if any, for *unscheduled (early) payments* or the *full or partial prepayment* of outstanding balances—when included, this is usually referred to as a "prepayment privilege." It allows borrowers to make early payments, or to repay the loan, in part or fully before maturity. If allowable, the note will indicate whether future payments will be reduced or whether the loan maturity date will be shortened. This provision is a *privilege* and not a *right* because the dollar amount and number of payments to be made by the borrower are specified in (C). A prepayment provision is generally included in residential mortgage loans. However, when financing income-producing properties, it may be highly restricted and require payment of a fee or penalty.

J. Notification of default and the acceleration clause—requirement that the lender notifies the borrower that he or she is in default in the event of past due payments, and so on. The lender *may* then accelerate on the note by demanding that all remaining amounts owed under the loan agreement be paid immediately by the borrower.

K. Nonrecourse clause—a provision in the note, whereby the lender agrees not to, or specifies conditions under which it will *not,* hold the borrower personally liable in the event of a default. As noted above, when a borrower executes a note, he is personally liable, or the loan is made "with recourse." This means that if he defaults on the loan, the lender may bring legal action that may result in the sale of the borrower's other assets (stocks, bonds, other real estate) in order to satisfy all amounts past due under the terms of the note. In contrast, the "nonrecourse clause" provides that the lender may only bring an action to force the sale of the property serving as security for the loan. The borrower is released from personal liability. This clause is very important to real estate investors and developers.

L. Loan assumability clause—clause indicating the conditions, if any, under which a borrower will be allowed to substitute another party in his place, who will then assume responsibility for remaining loan payments. This could occur if the borrower wishes to sell a property to another while allowing the new buyer to retain favorable financing terms that may have been previously negotiated. Lenders who deny borrowers this right can do so by expressly prohibiting it and/or by including a "due on sale" clause which requires that all remaining amounts due be paid upon sale of, or transfer of title to, the property. However, if the note provides that a new owner may assume the loan, the lender usually requires that the credit of the new owner be equivalent to that of the previous owner, or be acceptable to the lender. The note will also specify whether or not the original borrower remains personally liable or is released from liability when the loan is assumed by the new borrower.

M. The assignment clause—clause giving the *lender* the right to sell the note to another party without approval of the borrower.

N. Future advances—provision under which the borrower may request additional funds up to some maximum amount or maximum percentage of the current property value under the same terms contained in the original loan agreement. These advances may be subject to an adjustment in the rate of interest.

O. Release of lien by lender—agreement by lender to release or extinguish its lien on the property when the loan is fully repaid.

The Mortgage Instrument

The following is a general discussion of mortgages. Much of this discussion applies to all mortgages. Provisions that are specific to residential and commercial properties and construction loans will be discussed as these topics are introduced. Utilization of mortgage financing has been the most common method of financing the purchase of real estate. This process usually entails the buyer borrowing funds from a lender and then using these and other funds to purchase a property. Funds are usually borrowed with the express intent of using the proceeds to acquire real estate that will serve as a security for a loan. However, loans also may be refinanced from time to time and a new mortgage is made serving as loan security. Real estate is generally regarded by lenders as excellent security for a loan, and lenders acquire a *secured interest* in the real estate with a mortgage.

Definition of a Mortgage

In its most general sense, the **mortgage document** is created in a transaction, whereby one party pledges real property to another party as security for an obligation owed to that party. A promissory note (discussed previously) is normally executed contemporaneously with the mortgage. This note creates the obligation to repay the loan in accordance with its terms and is secured by the mortgage. The elements essential to the existence of a mortgage are an *obligation* to pay or perform and a *pledge* of property as security for that obligation.[1] In general, when a loan is made by a seller to a buyer (borrower) to purchase real estate consisting of an existing property and improvement, it is referred to as a purchase-money mortgage (discussed in more detail later in this chapter). This is in contrast to construction loans, loans made to refinance existing loans, and so on.

Relationship of Note to Mortgage

Normally, the underlying obligation secured by a mortgage is evidenced by a separate promissory note. As pointed out in the discussion of notes, unless the note contains a nonrecourse clause, it provides evidence of the debt and generally makes the borrower (mortgagor) personally liable for the obligation. The mortgage is usually a separate document that pledges the designated property as security for the debt. Therefore, the lender (mortgagee) has two sources from which amounts borrowed can be repaid: (1) the borrower, who is personally liable and (2) the property that serves as security for the note. In case of default, the mortgagee may elect to disregard the mortgage and sue on the note. The judgment awarded the mortgagee as a result of a suit on the note may be attached to other property of the mortgagor which, when sold to satisfy the judgment lien, may enable the mortgagee to recover the amount of the claim more readily than if he or she foreclosed on the mortgage. In practice, the mortgagee will normally elect to *sue on the note and*

[1] The obligation secured by a mortgage need not be monetary. It may be, for example, an agreement to perform some service or to perform some other specified actions. An obligation that is not itself an explicitly monetary one must be reducible to monetary terms. In other words, a dollar value must be placed on it.

Web App

The Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) protect you against discrimination when you apply for a mortgage to purchase, refinance, or make home improvements. Find out what your rights are under these acts. Go to a website like **www.findlaw.com** and use the search feature on the site to find information on mortgage discrimination. Alternatively, search for information on "mortgage discrimination" using one of the general search engines like **www.google.com**. Give examples of what would be considered illegal discrimination by mortgage lenders.

foreclose on the mortgage simultaneously. Mortgages typically include clauses containing important **covenants** for both the mortgagor and mortgagee. These covenants are promises, duties, and responsibilities of the borrower, in addition to payments required under the terms of the note. These are frequently repeated in the promissory note, or the note may incorporate these covenants by reference to the mortgage.

Interests That Can Be Mortgaged

Most people are accustomed to thinking of a mortgage in relation to full, or fee simple, ownership. But any interest in real estate that is subject to sale, grant, or assignment—that is, any interest that can be transferred—can be mortgaged. Thus, such diverse interests as fee simple estates, life estates, estates for years, remainders, reversions, leasehold interests, and options to purchase real estate, among others, are all mortgageable interests as far as legal theory is concerned. Whether, as a matter of sound business judgment, mortgagees would be willing to lend money against some of the lesser interests in land is quite another question.

Minimum Mortgage Requirements

A mortgage involves a transfer of an interest in real estate from the property owner to the lender. Accordingly, the statute of frauds requires that it must be in writing. The vast volume of mortgage lending today is institutional lending, and institutional mortgages are standardized, formal documents. There is, however, no specific form required for a valid mortgage. Indeed, although most mortgages are formal documents, a valid mortgage could be handwritten. The requirements of a valid mortgage document are: (1) wording that appropriately expresses the intent of the parties to create a security interest in real property for the benefit of the mortgage and (2) other items required by state law.

In the United States, mortgage law has traditionally been within the jurisdiction of state law; by and large, mortgages continue to be governed primarily by state law. Thus, to be enforceable, a mortgage must meet requirements imposed by the law of the state in which the property offered as security is located.

Whether a printed form of mortgage instrument is used or an attorney draws up a special form, the following subjects should always be included:

1. Appropriate identification of mortgagor and mortgagee.
2. Proper description of the property serving as security for the loan.
3. Covenants of seisin and warranty.[2]

[2] A *covenant* is a promise or binding assurance. *Seisin* is the state of owning the quantum of title being conveyed.

4. Provision for release of dower rights.[3]
5. Any other desired covenants and contractual agreements.

All of the terms and contractual agreements included in the note can be included in the mortgage as well by making reference to the note in the mortgage document.

Although the bulk of mortgage law remains within the jurisdiction of state law, a wide range of federal regulations also are operative in the area of mortgage law. Moreover, in recent years the federal government has acted to directly preempt state law in a number of areas (e.g., overturning state usury laws,[4] overturning state restrictions on the operation of due-on-sale clauses, and establishing conditions for allowing prepayment of the mortgage debt and for setting prepayment penalties). This has been particularly true in legislation affecting residential mortgages. Commercial property lending and mortgages have generally been exempted from such federal legislation.

In addition, the federal government has exerted a strong but indirect influence on mortgage transactions by means of its sponsorship of the agencies and quasi-private institutions that support and, for all practical purposes, constitute the secondary market for residential mortgages. The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have adopted joint standardized mortgage forms for the purpose of facilitating secondary-market transactions on a nationwide basis. The joint FNMA-FHLMC uniform mortgage form has been so widely adopted by residential mortgage lenders that it has largely replaced the use of mortgage forms used by individual institutions. One reason for the popularity of this form with residential lenders is that it is readily acceptable by the major secondary market institutions, should the lender desire to sell the mortgage after it has been originated.

Important Mortgage Covenants

It is beyond the scope of this chapter to discuss all the clauses and covenants (promises made by the borrower to the lender) that might be found in a mortgage document. We will mention some of the more important covenants, however, so that the reader gains an appreciation of the effect these clauses may have on the position of the borrower and lender. Because loans are secured by properties and are made for very long periods of time, lenders want assurance that borrowers will keep properties in good repair, pay property taxes and generally preserve the value and marketability of properties serving as security for loans. The reader should keep in mind that lenders always want to protect the value of the property serving as security for loans. These covenants are anticipatory in nature as lenders try to protect their interests over the life of a loan.

Funds for Taxes and Private Mortgage Insurance

This clause requires the mortgagor to pay amounts needed to cover property taxes plus mortgage insurance premiums, if required by the lender, in monthly installments in advance of when they are due unless such payments are prohibited by state law. These funds are usually kept in an "escrow account" which is usually managed by the lender who collects monthly payments from the borrower, then makes payments to taxing authorities, insurance companies, and so on when payments come due. The purpose of this clause is to enable the mortgagee to pay these charges out of money provided by the mortgagor when they become due instead of relying on the mortgagor to make timely payments on his own.

[3] *Dower* is the interest in a husband's real estate transferred by law to the widow after his death. The common law counterpart running in favor of the husband as a widower is called *curtesy.* Many states now have a statutory allowance from the decedent's estate in lieu of dower and curtesy.

[4] Usury laws prohibit charging unconscionable and exorbitant rates or amounts of interest for the use of money. A usurious loan is one whose interest rate exceeds that permitted by usury laws.

The mortgagee is thereby better able to protect his or her security interest against liens for taxes, which normally have priority over the first mortgage, and against lapses in insurance coverage. Such funds may be held in an escrow or trust account for the mortgagor.

Charges and Liens

This clause requires the mortgagor to pay all taxes, assessments, charges, and claims assessed against the property that have priority over the mortgage and to pay all leasehold payments, if applicable. The reason for this clause is that the mortgagee's security interest can be wiped out if these claims, or liens, are not paid or discharged, since they generally can attain priority over the interests of the mortgagee. For example, if taxes and assessments are not paid, a first mortgage on the property can be wiped out at a sale to satisfy the tax lien, unless the mortgagee is either the successful bidder at the tax sale or pays the tax due to keeping the property from being sold at the tax sale.

Hazard Insurance

This clause requires the mortgagor to obtain and maintain insurance against loss or damage to the property caused by fire and other hazards, such as windstorms, hail, explosion, and smoke. In effect, this clause acknowledges that the mortgagee as well as the mortgagor has an insurable interest in the mortgaged property. The mortgagee's insurable interest is the amount of the mortgage debt.

Preservation and Maintenance of the Property

This clause obligates the mortgagor to maintain the property in good condition and to not engage in or permit acts of waste.[5] This clause recognizes that the mortgagee has a valid interest in preventing the mortgaged property from deteriorating to the extent that the collateral value of the property is affected.

Breach of Covenants

In the event that the borrower–mortgagor does not comply with loan covenants, he is said to have "breached the covenant or to have broken his promise." In this event, the lender–mortgagee can declare the loan in default and can foreclose. Even if the borrower is making timely payments of interest and principal, breaching a loan covenant constitutes a default although it may be referred to as a "technical default."

Transfer of Property or a Beneficial Interest in Borrower

This clause, known as the **due-on-sale clause,** allows the mortgagee to accelerate the debt (i.e., to take action to make the outstanding loan balance plus accrued interest immediately due and payable) when the property, or some interest in the property, is transferred without the written consent of the mortgagee. The purpose of the due-on-sale clause is to enable the mortgagee to protect his or her security interest by approving any new owner. The clause may also permit the mortgagee to increase the interest rate on the loan to current market rates. This, of course, reduces the possibility of the new owner assuming a loan with an attractive interest rate.

Borrower's Rights to Reinstate

This clause deals with the mortgagor's right to reinstate the original repayment terms in the note after the mortgagee has caused an acceleration of the debt. It gives the mortgagor the right to have foreclosure proceedings discontinued at any time before a judgment is

[5] *Waste* is the abuse or destructive use of property which reduces the value and, therefore, the security for the loan.

entered enforcing the mortgage (i.e., before a decree for the sale of the property is given) if the mortgagor does the following:

1. Pays to the mortgagee all sums that would then be due had no acceleration occurred.
2. Cures any default of any other covenants or agreements.
3. Pays all expenses incurred by the lender in enforcing its mortgage.
4. Takes such action as the mortgagee may reasonably require to ensure that the mortgagee's rights in the property and the mortgagor's obligations to pay are unchanged.

Right of Entry: Lender in Possession

This clause provides that upon acceleration or abandonment of the property, the mortgagee (or a judicially appointed receiver) may enter the property to protect the security. The lender may collect rents until the mortgage is foreclosed. Rents collected must be applied first to the costs of managing and operating the property, and then to the mortgage debt, real estate taxes, insurances, and other obligations of the mortgagor as specified in the mortgage.

Future Advances

While it is expected that a mortgage will always state the total amount of the debt it is expected to secure, this amount may be in the nature of a forecast of the total debt to be incurred in installments. In other words, a mortgage may cover **future advances** as well as current advances. For example, a mortgage may be so written that it will protect several successive loans under a general line of credit extended by the mortgagee to the mortgagor. In case the total amount cannot be forecasted with accuracy, at least the general nature of the advances or loans must be apparent from the wording of the mortgage.

As an illustration of a **mortgage for future advances,** sometimes called an **open-end mortgage,** consider the form of construction loans. Here, the borrower arranges in advance with a mortgagee for a total amount, usually definitely stated in the mortgage, that will be advanced, in stages, under the mortgage to meet the part of the costs of construction as it progresses. As the structure progresses, the mortgagor has the right to call upon the mortgagee for successive advances on the loan. All improvements become security under the terms of the mortgage as they are constructed.

Subordination Clause

By means of this clause, a first mortgage holder agrees to make its mortgage junior in priority to the mortgage of another lender. A **subordination clause** might be used in situations where the seller provides financing by taking back a mortgage from the buyer, and the buyer also intends to obtain a mortgage from a bank or other financial institution, usually to develop or construct an improvement. Financial institutions will generally require that their loans have first mortgage priority. Consequently, the seller must agree to include a subordination clause in the mortgage, whereby the seller agrees to subordinate the priority of the mortgage to the bank loan. This ensures that even if the seller's mortgage is recorded before the bank loan, it will be subordinate to the bank loan.

Assumption of Mortgage

When the mortgagor transfers his or her rights to another, the question arises, "Does the grantee (buyer) agree to become liable for payment of the mortgage debt and relieve the mortgagor (seller) of his or her personal obligation?" If this is the intention of both parties, the **assumption of the mortgage** by the grantee may accomplish the purpose. The deed, after specifying the nature of the mortgage which encumbers the property, will contain a clause to the effect that the grantee assumes and agrees to pay the amount of the obligations owed to the mortgagee as part consideration for the conveyance of title. Where an assumption is undertaken by the grantee, it should be couched in language that leaves no doubt about the intent.

An assumption agreement takes the form of a contract of indemnity. It shifts the responsibility for the payment of the debt from the grantor to the grantee. Thereafter, the grantor stands in the position of a surety (guarantee) for the payment of the debt. However, such an arrangement binds only the parties to it: the grantor and the grantee. Since the mortgagee is not ordinarily a party to such an agreement, he or she is not bound by it. As a consequence, the mortgagee may still hold the original mortgagor liable. Thus, if a property is sold with a loan assumption and the new owner defaults on the loan, the lender can hold the previous owner liable unless the previous owner was released from the debt.

Release of Grantor from Assumed Debt

When a mortgagor owning property grants that property to another and the grantee assumes the grantor's mortgage, the lender may or may not release the grantor from personal liability for the mortgage debt. The decision of release will depend on the value of the property as security, the grantee's financial capabilities, and other factors affecting the lender's attitudes toward the transaction. A mortgagee cannot be expected to release an antecedent mortgagor if the result will be to increase the credit risk unless the mortgagee is compensated in some way (e.g., a higher interest rate).

Acquiring Title "Subject to" a Mortgage

In contrast to the assumption of the personal obligation to pay the debt, grantees may not be willing to accept this responsibility. In this case, they may ask grantors to allow them to take title **"subject to" the mortgage.** So long as the grantees are financially able and think it will be to their advantage, they will keep up payments on the mortgage and observe its other covenants. Under normal conditions, if they purchased the property at a fair price, it will be to their advantage to avoid default on the mortgage to protect their own equity.

But should the grantees reach the conclusion that there is no longer any advantage to making further payments, or should they become financially unable to do so, they may default on their payments. By so doing, they run the risk of losing whatever equity they have in the property. However, grantees cannot be held personally liable for the amount of the debt that they assumed. Grantors are still personally liable and may be held liable for any deficiency judgment resulting from the foreclosure sale.

It is obviously riskier for grantors to sell property subject to the mortgage. Given a choice, they would generally prefer that responsible grantees assume the mortgage unless they are compensated for the additional risk they undertake as a surety (e.g., by receiving a higher price for the property).

Property Covered by a Mortgage

The property that is covered by the mortgage as security for the loan includes not only the land and any existing buildings on the land but also easements and fixtures. In addition, the mortgage agreement may provide that property covered by the mortgage also includes rights to natural resources (e.g., mineral, timber, oil and gas, and water or riparian rights) and even rights to rents and profits from the real estate. An easement that runs with the property is generally regarded by the law as being covered by the mortgage, regardless of whether the easement is created before or after the mortgage is executed. Such an easement, if in existence at the time the property is mortgaged, is covered by the mortgage even if it is not mentioned in the mortgage. Foreclosure of the mortgage will not extinguish this easement. An easement created subsequent to the recording of a mortgage, however, will be extinguished by the foreclosure.

Issues involving fixtures have generated a considerable amount of legal controversy. In general, a **fixture** is an item of tangible personal property (also referred to as *chattel*) that has become affixed to or is intended to be used with the real estate, so as to be considered part of the property. The law is in general agreement that fixtures are covered by the mortgage, with the exception of "trade fixtures"[6] installed by a tenant.

A mortgage also will usually contain what is called an **after-acquired property clause** as part of its description of the type of property to be covered by the mortgage. This provision states in effect that property acquired subsequent to the execution of the mortgage that becomes part of the real estate *is included in the security* covered by the mortgage. After-acquired property includes additional improvements erected on the property or fixtures that become part of the property at any time in the future for as long as the debt remains outstanding. The courts have generally affirmed the validity of after-acquired property clauses, and the Uniform Land Transactions Act (ULTA) expressly accepts their validity.[7]

Junior Mortgages

In simple real estate financing transactions, such as those involving single residences, the character of the mortgage structure is easily defined. The senior or prior mortgage is usually called a **first mortgage.** All others are given the class name of **junior mortgages** In any particular situation, there may be one or more junior mortgages or none at all. One junior lien, usually called a **second mortgage,** is sometimes used to bridge the gap between the price of the property and the sum of the first mortgage and the amount of money available to the purchaser to use as a down payment. Traditionally, second mortgages are short term and carry a higher rate of interest than first mortgages because of the additional risk associated with their junior status.

Recording of Mortgages

Unless the statutes of the state require it, recording is not essential to the validity of a mortgage because it is an agreement between the mortgagor and the mortgagee. The act of recording creates no rights that did not exist before, but it does give others notice of the existence and effect of the mortgage. A recorded mortgage protects its holder by giving him or her priority over the subsequent acts of the mortgagor. For example, if a mortgagee failed to record the mortgage, the mortgagor could mortgage the property to a second lender. If this second lender had no notice of the prior unrecorded mortgage, the second lender would have a lien prior to that of the original mortgagee. In general, the priority of successive liens is determined by the time they are accepted for record.

As we have discussed, the recording acts provide opportunities for the protection of holders of interests in property, but at the same time they place responsibilities upon them to make use of these opportunities. Failure to inspect the records for prior liens or to record the mortgage may result in loss to the mortgagee. In most states, *junior lienors* of record without notice of the existence of a senior mortgage will have priority over an unrecorded senior mortgage. Even subsequent recording of a senior mortgage lien will generally not elevate it to a higher priority.

[6] Trade fixtures are personal property used by tenants in businesses. Such fixtures retain the character of personal property (e.g., shelves used to display merchandise).

[7] For a discussion and case law materials related to after-acquired property clauses, see Grant S. Nelson and Dale A. Whitman, *Real Estate Transfer, Finance, and Development,* 2nd ed. (St. Paul, MN: West Publishing, 1981), pp. 633–39; see also Robert Kratovil and Raymond J. Werner, *Modern Mortgage Law and Practice,* 2nd ed. (Englewood Cliffs, NJ: Prentice Hall), pp. 114–17.

Other Financing Sources

Seller Financing

A source of credit for a real property buyer is often the seller. If the seller is willing to take back a mortgage as part or full payment of the purchase price, it is referred to as **seller financing.** This type of financing is used when

1. Third-party mortgage financing is too expensive or unavailable.
2. The buyer does not qualify for long-term mortgage credit because of a low down payment or difficulty meeting monthly payments.
3. The seller desires to take advantage of the installment method of reporting the gain from the sale.
4. The seller desires to artificially raise the price of the property by offering a lower-than-market interest rate on the mortgage, thereby creating more capital gains and less interest or ordinary income.[8]

Any mortgage given by a buyer to the seller to secure payment of all or part of the purchase price of a property is usually called a **purchase-money mortgage.** It can be a first mortgage, which might be the case if the seller is providing all of the financing necessary to consummate the transaction. It also could take the form of a second mortgage that is provided by the seller and is used to bridge the gap between an available first mortgage and the buyer's down payment. As such, it must be differentiated from mortgages given to secure a loan from a third party for the purchase of the property. The third-party lender (e.g., a financial institution) will normally want its mortgage to be a first mortgage. Thus, the purchase-money mortgage must either be recorded after the third-party loan or contain a subordination clause, as defined earlier.

Land Contracts

One form of financing real estate that has been widely used over the years is commonly referred to as a land contract. The term **land contract** has a variety of aliases, including real estate contract, installment sales contract, agreement to convey, and contract for deed. As the last term implies, the land contract seller promises to convey title at such time as the purchaser completes the performance of the obligation called for in the contract. Such performance usually means payment of the purchase price in stipulated installments, much the same way as under a note and mortgage.

It should be emphasized that a land contract is not a mortgage. Under the land contract, the sellers retain the title in their name. The deed record shows that the sellers are still the owners of the property, but the land contract is supposed to tie their hands to make sure that the sellers or their assigns ultimately transfer title to the vendees or their heirs or assigns.

The land contract may be used as a substitute for a purchase-money mortgage and would normally not be preferred if the latter were available. However, in cases where there is no down payment or a small down payment, and a very long period of time during which a buyer must make periodic payments to the seller, sellers of land may refuse to give a deed and take back a mortgage until a very substantial part of the purchase price has been paid.

[8] The use of this technique has been limited by the "unstated interest rule."

Several points of comparison exist between purchase-money mortgages and land contracts. A land contract buyer does not have title to the property and therefore cannot control whether the property will be mortgaged subsequent to the execution of the land contract or be made subject to covenants, easements, or mechanics' liens in the future by the contract seller. Most land contracts contain a clause allowing the seller to mortgage property up to an amount equal to the buyer's indebtedness to the seller. The buyer would have this protection if mortgage financing were used because limits would be made explicit and the buyer would have title. Furthermore, the possibility of forfeiture of the land contract interest may exist without any of the procedural protections afforded mortgages. It is suggested that all such points of comparison should be considered in making the decision whether to buy or sell on land contract or to obtain mortgage financing. In general, land contracts are used in many of the same situations as purchase-money mortgages (e.g., where the buyer has difficulty obtaining third-party financing).

Recording of Land Contracts

State laws provide for the recording of conveyances of land and instruments affecting title. Land contracts generally are considered instruments affecting title and are consequently admissible to record. Recording land contracts is not essential to their validity; it merely gives notice of their existence to third parties.

Default

We have discussed the various property rights associated with real estate. Next, consider some of the problems that result when one of the parties does not fulfill a contractual obligation associated with its property right. The legal ramifications of these problems affect the financial security of other parties' rights and are thus an important aspect of real estate finance.

One of the most important risks in making a mortgage loan is that the borrower will default on the note in some way, so that the lender may not receive the expected mortgage payments. The risk associated with mortgage loans depends in part on the rights of the lender if and when such default occurs. Thus, it is important to understand the legal ramifications of mortgage default.

What Constitutes Default?

Default is a failure to fulfill a contract, agreement, or duty, especially a financial obligation such as a note. It follows that a **mortgage default** can also result from any breach of the mortgage contract. The most common default is the failure to meet an installment payment of the interest and principal on the note. However, failure to pay taxes or insurance premiums when due may also result in a default, which may precipitate an acceleration of the debt and a foreclosure action. Indeed, some mortgages have clauses that make specific stipulations to this effect. Even a failure to keep the security in repair may constitute what is commonly referred to as a *technical default.* However, because a breach of contract resulting in a technical default can usually be cured by a borrower, it seldom results in an actual foreclosure sale. Furthermore, it may be difficult for the mortgagee to prove that the repair clause in the mortgage has been broken unless the property shows definite evidence of the effects of waste. This means that even though there is a breach of contract, the mortgagee may postpone doing something about it. However, in the case of technical default accompanied by abandonment, the probabilities are that the mortgagee will act quickly to protect his or her interests against vandalism, neglect, and waste. This may occur even though the borrower may be current on the loan payments.

Alternatives to Foreclosure: Workouts

Foreclosure involves the sale of property by the courts to satisfy the unpaid debt. The details of this process are discussed later. Because of the time involved and the various costs associated with foreclosure (and possibly repair of any damage to the property), lenders often prefer to seek an alternative to actual foreclosure.

Although mortgage contracts normally indicate definite penalties to follow any breach therein, experience has shown that in spite of provisions for prompt action in case of a default in mortgage payments, many commitments are not met in strict accordance with the letter of the contract. Instead, whenever mortgagors get into financial trouble and are unable to meet their obligations, adjustments of the payments or other terms are likely to follow if both the borrower and lender believe that the conditions are temporary and will be remedied.

The term **workout** is often used to describe the various activities undertaken to deal with a mortgagor who is in financial trouble. Many times the parties make a workout agreement that sets forth the rules by which, during a specified period of time, they will conduct themselves and their discussions. The lender agrees to refrain from exercising legal remedies. In exchange the borrower acknowledges his or her financial difficulty and agrees to certain conditions such as supplying current detailed financial and other information to the lender and establishing a cash account in which any rental receipts from the property are deposited and any withdrawals are subject to lender approval.

Six alternatives can be considered in a workout:

1. Restructuring of the mortgage loan.
2. Transfer of the mortgage to a new owner.
3. Voluntary conveyancy of the title to the mortgagee (lender).
4. A "friendly foreclosure."
5. A prepackaged bankruptcy.
6. A "short sale" with the lender agreeing to a sale price less than the loan balance.

Restructuring the Mortgage Loan

Loans can be restructured in many ways. Such restructuring could involve lower interest rates, accruals of interest, or extended maturity dates. If the original loan is nonrecourse to the borrower, the lender may want to obtain personal recourse against the borrower as part of the loan restructuring agreement. This makes the borrower subject to significantly more downside risk if the restructuring fails. The lender also may want a participation in the performance of the property to enhance the lender's upside potential as compensation for being willing to restructure the loan. For example, the lender could ask for a percentage of any increase in the income of the property over its current level.

Recasting of Mortgages

Once a mortgage is executed and placed on record, its form may change substantially before it is redeemed. It may be recast for any one of several reasons. A mortgage can be renegotiated at any time, but most frequently it is recast by changing the terms of the mortgage (either temporarily or permanently) to avoid or cure a default.

Where mortgage terms such as the interest rate, amortization period, or payment amounts are changed, mortgagees must exercise care to avoid losing their priority over intervening lienors. The mere extension of time of payment will not generally impair the priority of the extended mortgage. Courts, however, are watchful to protect intervening lienors against prejudice, and mortgages may lose priority to the extent that changes in the interest rate, payment amounts, or the amount of indebtedness place additional burdens on the mortgagor.[9]

Extension Agreements Occasionally, a mortgagor in financial difficulty may seek permission from the mortgagee to extend the mortgage terms for a period of time. This is known as a mortgage **extension agreement.** A mortgagor may request a longer amortization period for the remaining principal balance or a temporary grace period for the payment of principal or interest payments or both. In responding to such a request, the mortgagee needs to consider the following issues:

1. What is the condition of the security? Has it been reasonably well maintained or does it show the effects of waste and neglect?
2. Have there been any intervening liens? These are liens recorded or attached after the recordation of the mortgage but before any modifications to it. If so, what is their effect upon an extension agreement? If such liens exist, it is possible that the extension of an existing mortgage may amount to a cancellation of the mortgage and the making of a new one. If so, this could advance the priority of intervening liens.
3. What is the surety status of any grantees who have assumed the mortgage? Will an extension of time for the payment of the debt secured by the mortgage terminate the liability of such sureties? The best way for mortgagees to protect themselves against the possibilities implied in these questions is to secure the consent of the extension agreement from all sureties to the extension. As parties to it, they can have no grounds for opposing it. But if they are not made parties to the extension—particularly if changes in the terms of the mortgage through the extension agreement tend to increase the obligations for which the sureties are liable—then care should be exercised to ensure that those sureties who refuse to sign the agreement are not released by the extension agreement. The possibility of foreclosure and a deficiency judgment against them may be a sufficient inducement to obtain their agreement to be parties to the extension.

The exact nature of an extension agreement depends upon the bargaining position of mortgagor and mortgagee. If mortgagors can refinance the loan on more favorable terms, they will probably not apply for an extension agreement. Alternatively, they may have to make changes that favor the mortgagee, such as an increase in the interest rate.

Alternative to Extension Agreements An alternative to an extension agreement has the mortgagee agree informally to a temporary extension without making any changes in the formal recorded agreement between the parties. If the mortgagor is unable to meet all monthly mortgage payments, these too may be waived temporarily or forgiven in whole or in part. For example, simply raising the question of such an agreement suggests that the mortgagor cannot pay the matured principal of the loan. Therefore, some informal arrangement may be made to permit the mortgagor to retain possession of the property in return for meeting monthly payments, which may or may not include principal installments. The use of this kind of informal agreement can be troublesome, but, in general, if it is reached, the amounts demanded will be adjusted to the present payment capacities of the borrower. Should the borrower's financial condition improve, the lender may again insist that the originally scheduled payments resume.

[9] Recasting of mortgages to admit interests not present at the time the mortgages were executed is sometimes necessary. For example, the mortgage may make no provision for an easement of a public utility company that requires access to the rear of the site covered by the mortgage. Since the installation of the services of the utility will normally add to rather than subtract from the value of the security, the mortgagee will usually be glad to approve the change. Nevertheless, it will require a recasting of the mortgage to the extent indicated.

The use of such an alternative to a definite extension agreement may serve the temporary needs of both mortgagors and mortgagees. If the latter feel that the security amply protects their lien, the mortgagees can afford to be lenient in helping mortgagors adjust their financial arrangements during a difficult period. If the mortgagors also feel that any real equity exists in the property, they will wish to protect it if at all possible.

Transfer of Mortgage to a New Owner

Mortgagors who are unable or unwilling to meet their mortgage obligations may be able to find someone who is willing to purchase the property and either assume the mortgage liability or take the property subject to the existing mortgage. The new purchaser may be willing to accept the **transfer of mortgage** if he or she thinks the value of the property exceeds the balance due on the mortgage. In either case, the seller retains personal liability for the debt. However, if the seller is about to default and expects to lose the property anyway, he or she may be willing to take a chance on a new purchaser fulfilling the mortgage obligation. The risk is that the new buyer will default, and the seller will again have responsibility for the debt and get the property back.

Recall that if purchasers acquire the property subject to the existing debt, they do not acquire any personal liability for the debt. Thus, they can only lose any equity personally invested to acquire the property. This equity investment may be quite small where the sellers are financially distressed and face foreclosure. Thus, the buyers may have little to lose by taking a chance on acquiring the property subject to the mortgage. If it turns out to be a good investment, they will continue to make payments on the debt, but if they find that the value of the property is unlikely to exceed the mortgage debt within a reasonable time frame, they can simply stop making payments and let the sellers reacquire the property. Thus, we see that in this situation buyers of the property subject to a mortgage have in effect purchased an option. The equity that buyers invest is the payment for this option, which allows them to take a chance on the property value increasing after it is acquired. We can therefore see why purchasers might even give the sellers money to acquire a property subject to a mortgage even if the *current* value of the property is less than the mortgage balance.

For example, suppose that a property has a mortgage balance of $100,000. Property values in the area are currently depressed, and the owner believes that only $99,000 could be obtained on an outright sale. However, a buyer is willing to acquire the property at a price of $101,000 subject to the existing mortgage. Thus, $2,000 is paid for the option of tying up the property in hopes that property values rise above their current level.[10] If the property does not rise in value to more than $100,000 (less any additional principal payments that have been made), the purchaser could simply walk away, and the original owner again becomes responsible for the mortgage. If the property rises in value to more than $101,000, the purchaser stands to make a profit and would continue to make payments on the mortgage.

It should be clear that knowledge of various legal alternatives (e.g., being able to purchase a property "subject to" vs assuming a mortgage) can allow a buyer and seller to arrive at an agreement that best meets their financial objectives. Thus, legal alternatives can often be evaluated in a financial context.

Voluntary Conveyance

Borrowers (mortgagors) who can no longer meet the mortgage obligation may attempt to "sell" their equity to the mortgagees. For example, suppose that the mortgagors are unable to meet their obligations and face foreclosure of their equity. To save the time, trouble, and

[10] The seller would receive $1,000 in cash, but since the seller had –$1,000 in equity, he or she receives the economic benefit of $2,000, which is also the difference between the price paid and the market value of the property.

expense associated with foreclosure, the mortgagees may make or accept a proposal to take title from the mortgagors. If they both agree that the property value exceeds the mortgage balance, a sum may be paid to the mortgagors for their equity. If the value is less than the mortgage balance, the lenders may still be willing to accept title and release the mortgagors from the mortgage debt. This **voluntary conveyance** might be done because the cost of foreclosure exceeds the expected benefit of pursuing that course of action.

When voluntary conveyances are used, title is usually transferred with a warranty or quitclaim deed from mortgagors to mortgagees. The mortgagors should insist upon a release to make sure that they are no longer bound under their note and mortgage, especially in situations where the mortgage balance is near or in excess of the property value. Otherwise, the mortgagors may find that they still have a personal obligation to pay the mortgage note. The conveyance to the mortgagees in exchange for a release from the mortgage debt is frequently referred to as giving **deed in lieu of foreclosure** of the mortgage. A deed in lieu of foreclosure has the advantage of speed and minimizes the expense of transferring the property and the uncertainty of litigation. It also avoids the negative publicity of foreclosure or bankruptcy. A deed in lieu of foreclosure does not cut off subordinate interests in the property. The lender must make arrangements with all other creditors. There are also potential bankruptcy problems. The transfer may be voidable as a preferential transfer. In addition to the legal questions involved in voluntary conveyances, the mortgagee frequently faces very practical financial issues as well. If there are junior liens outstanding, they are not eliminated by a voluntary conveyance. Indeed, their holders may be in a better position than before if the title to the property passes to a more financially sound owner. Unless in some manner these junior liens are released from the property in question—possibly by agreement with their holders to transfer them to other property owned by the mortgagor or even on occasion to cancel them—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 the junior claimants.

Friendly Foreclosure

Foreclosure can be time consuming and expensive, and there can be damage to the property during this time period. A **friendly foreclosure** is a foreclosure action in which the borrower submits to the jurisdiction of the court, waives any right to assert defenses and claims and to appeal or collaterally attack any judgment, and otherwise agrees to cooperate with the lender in the litigation. This can shorten the time required to effect a foreclosure. This also cuts off subordinate liens and provides better protection in case of the borrower's subsequent bankruptcy. A friendly foreclosure normally takes more time than a voluntary conveyance but is less time consuming than an unfriendly foreclosure. This is discussed in more detail in the next section.

Prepackaged Bankruptcy

The mortgagee must consider the risk that the mortgagor will use the threat of filing for bankruptcy as a way of reducing some of his or her obligation under the original mortgage agreement. Bankruptcy can have significant consequences for secured lenders. To the extent that the collateral securing the debt is worth less than the principal amount of the debt, the deficiency will be treated as an unsecured debt. In a **prepackaged bankruptcy,** before filing the bankruptcy petition, borrowers agree with all their creditors to the terms on which they will turn their assets over to their creditors in exchange for a discharge of liabilities. This can save a considerable amount of time and expense compared with the case where the terms are not agreed upon in advance. The consequences of bankruptcy are discussed further in the last section of this chapter.

Short Sale

A **short sale** is a sale of real estate in which the proceeds from the sale fall short of the balance owed on a loan secured by the property sold. In a short sale, the mortgage lender agrees to discount the mortgage loan balance because of an economic or financial hardship on the part of the mortgagor. This is often done during periods when home prices have declined significantly and the financial hardship is more a result of market conditions than actions of the borrower.

In a short sale, the home owner/borrower sells the mortgaged property for less than the outstanding balance of the loan and then turns over the proceeds of the sale to the lender, usually in full satisfaction of the loan. In some cases, the lender may still pursue a deficiency judgment. The lender has the right to approve or disapprove a proposed sale. Typically a short sale is executed to prevent a home foreclosure, because the lender believes that it will result in a smaller financial loss than foreclosing. The decision to proceed with a short sale represents the most economical way for the lender to recover the amount owed on the property. In contrast to a foreclosure, if the borrower has been making payments up until the time the short sale is approved, the short sale may not adversely affect the borrower's credit report, because the lender has agreed to discount the loan. In the event that the property is sold for less than its outstanding low balance and the lender does not pursue a deficiency judgment, this may result in a forgiveness of debt by the lender and could be a taxable event for the owner/borowee.

Foreclosure

In practice, most mortgagees are not anxious to take property from mortgagors, particularly where the mortgagors have candidly communicated with the mortgagees concerning the default and have made realistic proposals to cure the default over a reasonable period of time. Because the management and disposal of property requires skills that are usually outside of the range of expertise of most lenders and therefore costly to acquire, mortgagees prefer to collect the amounts owed them and are likely to be lenient and patient when circumstances warrant it. Seldom do mortgagees insist upon the exact letter of their contract. Nor do they rush into court to insist upon **foreclosure** at the first evidence of default, but after patience and leniency have been extended to delinquent mortgagors, eventually a settlement becomes necessary and foreclosure proceedings are started.

Judicial Foreclosure

In general, the mortgagee possesses two types of remedies to protect his or her interests in case of default by the mortgagor. First, the lender may obtain **judicial foreclosure:** that is, to sue on the debt, obtain judgment, and execute the judgment against property of the mortgagor. In a judicial foreclosure, property subject to attachment and execution[11] is not limited to the mortgaged property. This judgment may be levied against any of the mortgagor's property not otherwise legally exempt[12] from execution.

[11] *Attachment* is the act or process of seizing property of a debtor by court order in order to secure the debt of a creditor in the event judgment is rendered. *Execution* is the process of authorizing the sheriff or other competent officer to seize and sell property of the debtor in satisfaction of a judgment previously rendered in favor of a creditor.

[12] Most states provide by statute that a certain amount of a borrower's property shall be free from all liability from levy and sale as a result of the enforcement (execution) of a money judgment. These statutes typically provide that some amount of personal property and equity in a borrower's home not secured by a purchase-money lien shall be set off and free from seizure and sale in order to provide the borrower with a minimum amount of property to maintain his or her family on their road to financial recovery.

Second, the lender may bring a foreclosure suit and obtain a decree of foreclosure and sale. If the sale of the mortgaged property realizes a price high enough to meet the expenses of the sale and the claims of the mortgagee and still leave a balance, this balance goes to the mortgagor. While foreclosure and sale of the property may be undertaken in two separate actions, they are usually pursued simultaneously in practice.

Redemption

Redemption is the process of canceling or annulling a title conveyed by a foreclosure sale by paying the debt or fulfilling the other conditions in the mortgage. It can be accomplished by paying the full amount of the debt, interest, and costs due to the mortgagee. The *equity of redemption*[13] must be asserted prior to foreclosure. Once the foreclosure sale has been confirmed, the mortgagor can no longer redeem the property, except in states that provide for a statutory period for redemption after foreclosure. The right to redeem after foreclosure is called the right of *statutory redemption,* which exists in about half of the states. Generally, the period for statutory redemption runs about six months to one year after the foreclosure sale. In a number of states, instead of granting the mortgagor a right to redeem after the foreclosure sale, state laws postpone the sale to provide a longer period of time to pay a debt that is in default.

Sales of Property

The advertising of the sale, the place where it takes place, and the method of sale are governed by state law. While details differ, the results are approximately the same in all states.

Fixing a Price

A mortgage foreclosure sale emanates from the assumption that a public auction is a satisfactory way to realize the best possible price in selling property. Hence, in some jurisdictions the highest bidder gets the property irrespective of its cost, the amount of liens against it, or any other consideration. Despite this requirement of a public sale, in most cases only the mortgagee or the mortgagee and a small number of bidders appear at the foreclosure sale and, as a result, the mortgagee is usually the successful bidder. The mortgagee can use his or her 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 (which may be in the form of a loan obtained from another lender with an agreement granting to it the new mortgage), unless the successful bidder can arrange with the mortgagee to keep his or her lien alive by renegotiating or assuming the existing indebtedness. As a consequence, frequently only the mortgagee makes any serious bid for the property. Because lenders generally prefer to avoid owning and liquidating foreclosed properties, they 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. Rarely will lenders bid in excess of their claim in an attempt to outbid other buyers at the sale.

In a few states, an "upset" price is fixed in advance of the sale. This means that an appraisal by agents of the court fixes a minimum value for the property that must be reached in the bidding or the court will refuse to confirm the sale. This is not a common practice because it is quite difficult for the court to fix the price that the property must bring at the foreclosure sale. On the one hand, the court is interested in doing justice to the mortgagor. Since a deficiency judgment may be decreed in case the mortgagee is not completely satisfied from the proceeds of the sale, the lower the price, the larger the deficiency judgment. On the other hand, the mortgagee's rights also must be protected. If the

[13] The *equity of redemption* is the right of a mortgagor to redeem his or her property from default, the period from the time of default until foreclosure proceedings are begun.

court insists on too high a price, no sale would be effected, and hence the mortgagee would receive no satisfaction of his or her claims.

Deed of Trust

The historical development of the law has commonly led, in some jurisdictions, to the finance of real estate by a **deed of trust** instead of a regular mortgage. There are three parties to a loan secured by a deed of trust. The *borrower* (creator of the trust) conveys the title to the property to be used as security to a *trustee,* who holds it as security for the benefit of the *holder of the note* executed by the borrower when the loan was made. The conveyance to the trustee is by deed, but the transfer is accompanied by a trust agreement, either as a part of the deed or in addition to it, setting forth the terms of the security arrangement and giving the trustee the power of sale in event of default.

The deed of trust is commonly used in Alabama, Arkansas, California, Colorado, the District of Columbia, Delaware, Illinois, Mississippi, Missouri, Nevada, New Mexico, Tennessee, Texas, Utah, Virginia, and West Virginia. Deeds of trust are not used extensively in other states because courts there have held that any conveyance of real estate given to secure a debt is a mortgage, irrespective of the form of the instrument used. This interpretation greatly restricts the trustee's power of sale, often requiring the expense and delay of a court process up to and including foreclosure. States imposing this restriction have sought to ensure that a reasonable sale price and all other appropriate benefits are obtained for both borrower and noteholder before the property is sold.

Where the deed of trust is used according to its terms, the trustee is authorized in case of default to foreclose the borrower's equity by a sale of the property at public auction. After a proper time period for advertisement, the trustee must account to both parties for the proceeds of the sale. The parties are entitled to their share as their interest may appear, after expenses of the sale, including compensation to the trustee, have been met. The deed of trust has the advantage of normally being more expeditious than a mortgage foreclosure.

Deed of Trust and Mortgage Compared

The deed of trust is such a mixture of trust and mortgage law that anyone using it should act under the counsel of a local real estate lawyer. In general, however, the legal rules surrounding the creation and evidence of the debt in the form of a note, rights of the borrower left in possession, legal description of the property, creation of a valid lien on after-acquired property, and recording are the same for mortgages and deeds of trust. Similarly, a property subject to a deed of trust may be sold subject to the deed of trust either with or without an assumption of the debt by the purchaser. Borrowers may sell their interest or borrow money using the interest as security. Technically, borrowers have a reversionary interest in the property, and title to the property reverts to them upon payment of the debt. In the event of failure or refusal of a trustee to execute a reconveyance when the borrowers repay their debt, the trustee may be forced to act by legal process, whereby the borrowers would obtain a court order forcing the trustee to act.

In California, where deeds of trust and mortgages are used side by side, several distinctions are made between the two instruments. While a mortgage may be discharged by a simple acknowledgment of satisfaction on the record, a reconveyance of title is considered necessary to extinguish a deed of trust.[14] Recording requirements for mortgages and deeds of trust also differ. Under the recording laws of most states, mortgage assignments may be,

[14] Some states do not require reconveyance to extinguish a deed of trust. Instead, the secured beneficiary of the trust (noteholder) signs a request for release of the deed of trust, which is presented by the borrower to the trustee together with the canceled note and the deed of trust. The trustee issues a release of trust, which is then recorded at the appropriate office of public records for the county.

and in some states must be, recorded. Assignments of a deed of trust, however, need not be recorded, and in some states are not eligible for recordation. The recording of the original deed of trust gives notice of the lien against the property, and only the trustee has the power to clear the record through a reconveyance of the property.

Nature of Title at Foreclosure Sale

The purchaser of property at a foreclosure sale is, in effect, the purchaser of the rights of the mortgagor whose interests are cut off by the sale. Even though the sale is conducted under court supervision, the court makes no representation concerning the nature of the title that a buyer will receive. Any title defects that existed prior to the foreclosure sale will continue with the title as it passes to the purchaser. If a junior lienor has been omitted in the suit for foreclosure, his or her claims will not be cut off by such suit. As long as lienor claims are not cut off, the purchaser acquires the property subject to those liens instead of a fee simple unencumbered.

Parties to Foreclosure Suit

When the holders of a senior mortgage bring suit to foreclose their mortgage, they must join in the suit all who share the mortgagor's interest. These include not only junior mortgage holders but judgment creditors, purchasers at an execution sale, and trustees in bankruptcy, if any. Failure to include all of these might improve their position with the foreclosure of the senior lien. For example, should the senior mortgagee become the successful bidder at the foreclosure sale, and should a junior lienor of record not be joined in the suit, it is possible that when the senior mortgagee takes title to the land, the junior mortgagee may acquire the position of a senior lienor. To avoid this possibility, every foreclosure action should be preceded by a careful search of the record to discover all junior lien claimants who should be joined in the foreclosure suit.

Should any junior lienors think that they have an equity to protect, they have the right to purchase the property at a foreclosure sale, paying off or otherwise providing for the interests of the claimants whose liens are superior to theirs. It might be, for example, that a senior mortgagee has a $50,000 lien on a property that a junior mortgagee with a $10,000 lien considers to be worth more than $50,000. If the junior lienor does not bid for the property, the senior mortgagee may bid it in for $50,000 (in the absence of other bidders) and cut off the junior lienor's equity, causing a loss to the junior lienor. By taking over responsibility for the senior mortgage, the junior lienor could bid up to $60,000 for the property without providing additional funds. In this event, it is not uncommon for a senior claimant to agree in advance upon the method of settlement of his or her claims. This may include an agreement to renew the senior mortgagee's claim, either with or without a reduction in the amount.

The purchaser at the foreclosure sale takes over the property free of the lien of the mortgage being foreclosed, but also free of all holders of junior liens who have been joined in the foreclosure action. If the senior mortgage holder or a third party purchases the property at a foreclosure sale, all such junior liens are of no further force or effect.

If junior lienholders bring suit for foreclosure, they should not join the senior lienholders in the suit. Instead, they should sue subject to the senior lien, but this means they are not obligated to pay off the senior lienholders. Junior lienholders may prefer to keep the senior mortgage alive. Holders of the senior lien may join the action voluntarily and sometimes do so to make sure that their interests are fully protected. They may wish to have the court determine the amount to be assumed by the purchaser which is due them. Or should there be any questions about the order of priority of this lien, senior lienholders may join the foreclosure action to have this question answered. Again, they may have a side agreement with the junior lienors to continue their mortgage unchanged in amount. In case the junior mortgage holders plan to buy the property at the foreclosure sale, they may prefer to pay off the senior lien as well. This must be done with the consent of the lienholders if they are not a party to the suit. This practice represents a redemption of the senior mortgage and follows the English maxim of "redeem up, but foreclose down." This concept is fairly obvious. It simply means that junior mortgagees must honor the prior position of senior mortgagees, but junior mortgagees may wipe out liens junior to theirs. For example, say a property now worth $100,000 is encumbered as follows:

First mortgage, A	$ 90,000
Second mortgage, B	20,000
Third mortgage, C	10,000
Total mortgage liens	$120,000

In a foreclosure action, mortgagee B has a buying power of $110,000 without raising additional funds if he is able to keep the first mortgage undisturbed, or if he refinances it. If he buys the property at the foreclosure sale for no more than $110,000, the third mortgage lien will be completely cut off by foreclosure.

Holders of junior liens destroyed in a foreclosure action are entitled to have the surplus of sale price over senior mortgage claims applied to their claims. If there is no surplus, they are entitled to a judgment for the full amount of their claims. From that time on, they are merely general, unsecured creditors of the mortgagor, unless the latter should own other real estate to which such judgments would attach.

Effect of Foreclosure on Junior Lienors

If a senior mortgage holder brings foreclosure suit and joins junior claimants in the suit, the question arises, "What happens to the claims of those cut off by the foreclosure sale?" Any surplus remaining after satisfying the costs of foreclosure and the claims of the senior lienor is distributed according to the priority rights of junior claims. Sometimes the distribution of this surplus is not as simple as it sounds. Frequent disputes concerning the order of priority require action by the court to establish the order of settlement.

Where a senior mortgage is properly foreclosed, it extinguishes the *lien* of the junior mortgage, but the *debt* secured by the mortgage is unaffected. Where there is no surplus from the foreclosure sale or where it is insufficient to meet all claims, the holders of such claims still maintain their rights to pursue the mortgagors on whatever personal obligation they have incurred by obtaining the mortgage. This legal right may or may not result in satisfaction of the claims of lienholders. Such obligations are not extinguished and may be enforced at some future time, should the mortgagors ever recover their economic status sufficiently to make pursuit of claims against them worthwhile.

Deficiency Judgment

While a sale of the mortgaged property may result in a surplus to which the mortgagor is entitled, it may on the contrary be sold at a price that fails to satisfy the claims of the mortgagee. Any deficit is a continuing claim by the mortgagee against the mortgagor. The mortgagor is personally obligated to pay the debt evidenced by the promissory note. Since mortgages may involve one or more specific properties, the mortgagee will normally look to such property to provide primary security for his or her claim, but any deficiency remains the obligation of the mortgagor. Any deficit remaining after a foreclosure and sale of the property is known as a **deficiency judgment.**

Deficiency judgments are unsecured claims—unless the mortgagor owns other real estate—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.[15] Hence, the value of deficiency judgments is always open to serious question. This is true in part because of the ways by which they can be avoided or defeated.

Debtors seeking to avoid the deficiency judgment may plan accordingly. Since such judgments attach only to real estate or other property that the debtors hold or may acquire in the future, the debtors may see that they do not acquire any future property interests or, if they do, they will be careful to have titles recorded in names other than their own.

Considerable sentiment exists in some quarters in favor of legislation to abolish deficiency judgments altogether, leaving mortgagees with only the property to protect their claims. Several states strictly limit the applicability of deficiency judgments. Of course, this increases the possibility that a borrower will walk away from a property if its market value falls below the loan balance.

Taxes in Default

Payment of property taxes is an obligation of the mortgagor. As such, taxes constitute a prior lien against the security. Transfers of title always take into account accrued but unpaid taxes. Mortgages commonly contain tax clauses giving the mortgagee the right to pay taxes not paid regularly by the mortgagor. The amounts so paid are then added to the claims of the mortgagee. While the lien of taxes gives tax-collecting authorities the right to foreclose in case of default, this right is seldom exercised on first or even second default. Instead, the taxing authority from time to time may pursue an alternative policy of selling tax liens with deeds to follow. Since tax liens constitute superior liens prior to the claims of mortgagees if the taxing authorities have observed statutory procedure, and since they customarily carry high effective rates of interest, mortgagees may prefer to maintain the priority claim of tax liens by paying delinquent taxes and adding them to their claims.

If foreclosure becomes necessary, mortgagees include all taxes they have paid. At the time of a foreclosure sale, the purchaser usually is expected to pay all delinquent taxes, thus making the tax status of the property current.

Tax Sales

Where mortgagees do not act to protect their interests against tax liens, sooner or later taxing authorities will bring pressure to collect delinquent taxes. In effect, if not in form, the **tax sale** procedure is intended to parallel that followed in the foreclosure of mortgages. At the time of the tax sale, the purchaser receives a tax certificate, which is then subject to redemption in nearly all states. The period of redemption is usually two or three years. If the property is not redeemed by the delinquent taxpayer within this period, the purchaser at the tax sale is then entitled to receive a deed to the property.

Tax titles are usually looked upon as weak evidence of ownership. The interest of the tax collector is to find someone willing and able to pay taxes for someone else in return for a claim against the property. The collector is not greatly concerned about passing good title. There is no suggestion of warranty. In addition to any defects in title regardless of delinquent taxes, the unconcern of the tax collector may in turn result in added clouds on the title. Among the latter, the following may occur:

1. Because of inaccurate description of the property or incorrect records of ownership, the notice of sale may be defective.
2. The property owner may have been denied due process or his or her day in court.

[15] Deficiency judgments become a lien on all real estate owned by the judgment debtor in the county or counties where the judgment is entered. To the extent that there is equity in the real estate that is not exempt from execution, the judgment can be considered secured, and the creditor can enforce his lien through foreclosure and sale of the property to which the lien attaches.

3. The line of authority for the sale may not be clear.
4. Irregularities and carelessness, even in minor procedural matters, may cause the tax sale to be invalidated.

All of these depend in part upon the recuperative powers of the delinquent taxpayers. If they have lost interest in the property or lack the financial resources to protect their interests, delinquent taxpayers may interpose no objections to the plans of the purchaser at the tax sale. Nevertheless, the risk is great enough to suggest caution and due attention even to minor details before purchasing tax liens.

In the absence of bidders at a tax sale—which might occur in periods of depression or in the sale of inexpensive vacant land—the property usually reverts to the state, the county, or some other local governmental unit. State and local units can be careless and neglect to take steps to realize a fair price when they dispose of property so acquired. A sale by the governmental unit, given full compliance with statutory requirements, normally offers a very short period of redemption after which the mortgagor and the mortgagee lose to the purchaser all rights to the property. Mortgagees should diligently monitor tax sale notices to ensure that their lien rights on property sold at tax sales are not affected.

Bankruptcy

Bankruptcy may be defined as a proceeding in which the court takes over the property of a debtor to satisfy the claims of creditors. The goal is to relieve the debtor of all liabilities, so that he or she may become financially solvent. The potential for bankruptcy under Chapters 7, 11, and 13 of the Bankruptcy Code affects the value of real estate as collateral. Lenders must be aware of the possibility that a borrower may file bankruptcy and must know how such a filing will change their positions. Both real estate investors and lenders must have a basic understanding of their rights in a bankruptcy proceeding to effectively negotiate with one another and resolve their differences short of a bankruptcy proceeding. It should also be stressed that in many states homestead laws protect certain residential and other property and may exclude such property from consideration in bankruptcy proceedings. Although a comprehensive examination of the Bankruptcy Code is beyond the scope of this text, several areas of bankruptcy law of particular importance to real estate investors and lenders are discussed below.

Chapter 7 Liquidation

The purpose of Chapter 7, or "straight bankruptcy," is to give debtors a fresh start by discharging all of their debts and liquidating their nonexempt assets. Chapter 7 is available to any person regardless of the extent of his or her assets or liabilities. A Chapter 7 petition can be filed voluntarily by a debtor or involuntarily by petitioning creditors, except that a farmer may not be forced into an involuntary proceeding.

Upon the filing of a Chapter 7 petition, the court appoints an interim trustee who is charged with evaluating the financial condition of the debtor and reporting at the first meeting of creditors whether there will be assets available for liquidation and distribution to unsecured creditors. The trustee's job is to oversee the liquidation of nonexempt assets and to evaluate claims filed by creditors. The ultimate objective of a Chapter 7 bankruptcy is the orderly liquidation of the debtor's assets and the distribution of the proceeds according to the legal rights and priorities of the various creditor claimants.

A lender whose loan to the debtor is secured by a mortgage on real estate will normally be paid in full if the value of the security exceeds the balance due under the mortgage. To foreclose on the mortgage and sell the debtor's property, the lender must first petition