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

Question 2-1
Distinguish between a mortgage and a note.
A note admits the debt and generally makes the borrower personally liable for the obligation. A mortgage is usually a separate document which pledges the designated property as security for the debt.

Question 2-2
What does it mean when a lender accelerates? What is meant by forbearance?
The acceleration clause gives the lender the right or option to demand the loan balance owed if a default occurs. Forbearance by the lender allows the borrower time to cure a deficiency without the lender giving up the right to foreclose at a future time.

Question 2-3
Can borrowers pay off, part or all, of loans anytime that they desire?
No. In general, prepayment is a privilege not a right. In cases of residential/consumer loans made by federally related lenders, this option is usually provided to borrowers. In commercial real estate loans it is not.

Question 2-4
What does non-recourse financing mean?
The borrower is not personally liable on the note. The lender may look only to the property (security) to satisfy the loan in the event of default.

Question 2-5
What does assignment mean and why would a lender want to assign a mortgage loan?
Assignment gives the lender the right to sell or exchange a mortgage loan to another party without the approval of the borrower.

Question 2-6
What is meant by a "purchase money" mortgage loan? When could a loan not be a purchase money mortgage?
Purchase money means funds from the loan will be used to purchase a property. It will not provide funds for other uses such as could be the case with a refinancing.

Question 2-7
What does default mean? Does it occur only when borrowers fail to make scheduled loan payments?
Default means that the borrower has failed to (1) make scheduled loan payments or (2) violated on a provision in the note or mortgage.

Question 2-8
When might a borrower want to have another party assume his liability under mortgage loan?
If the loan was made with a favorable interest rate, the seller of the property may want to include this low rate loan as an additional incentive to sell the property.

Question 2-9
What does deficiency judgment mean?
If default occurs and the property is sold, if the dollars from the sale is not enough to pay off the loan balance, the borrower is liable for the difference.

Question 2-10
What is a land contract?
An agreement between a buyer and seller to purchase and sell real estate. However, passage of title is usually deferred until some future date or deferred until some event or condition occurs (e.g. Payment of money, rent, etc.).

Question 2-11

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

Question 2-12

Name possible mortgageable interests in real estate and comment on their risk as collateral to lenders.
Fee simple estates, life estates, estates for years, remainders, reversions, leasehold interests, and options.
<u>Fee Simple estate</u> - represents the most complete form of ownership of real estate. The holder is free to divide, sell, lease, or borrow against them as he/she wishes. Little risk to lenders because the owner completely owns all rights to the real estate.
<u>Life estate</u> - is a freehold estate that lasts only as long as the life of the owner of the estate or the life of some other person. Because of the uncertainty surrounding the duration of the life estate, its marketability and value as collateral are severely limited.
<u>Remainder</u> - exists when the grantor of a present estate with less ownership rights than his/her own conveys to a third person the reversionary interest he/she or his/hers heirs would otherwise have in the property upon termination of the grantee's estate.
<u>Reversion</u> - exists when the holder of an estate in land (the grantor) conveys to another person (a grantee) a present estate in the property that has less ownership rights than his/her own estate and retains for himself/herself or his/her heirs the right to take back, at some time in the future, the full estate which he/she enjoyed before the conveyance. A reversionary interest can be sold or mortgaged because it is an actual interest in the property.

Question 2-13

What is meant by mortgage foreclosure, and what alternatives are there to such action?
Foreclosure involves the sale of property by the courts to satisfy the unpaid debt.

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

Question 2-14

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

Question 2-15

What dangers are encountered by mortgagees and unreleased mortgagors when property is sold "subject to" a mortgage?
The mortgagor will be responsible if the person acquiring the property subject to the mortgage defaults. In turn, if the original mortgagor then defaults, the bank will have to foreclose on the property which may not be worth what is left to pay on the mortgage.

Question 2-16

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

Question 2-17

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

The mortgagee can use his/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 or by obtaining a new loan.

Lenders will normally bid the full amount of their claim only where it is less than or equal to the market value of the security less foreclosure, resale, and holding costs.

Question 2-18

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

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

Question 2- 19

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

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

Question 2- 20

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

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

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Problem 2-1

An open-end mortgage is one that provides for additional loan amounts to become available to the borrower. It also provides that the lender's security will not be affected and that any subsequent improvements will become a part of the lender's security.

Problem 2-2

If the mortgage has *not* explicitly allowed for future advances, the Second National Bank is not protected against intervening liens. The bank is only protected up to the amount of the original loan amount of $30,000.

Problem 2-3

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

Problem 2-4

Normally, absent a release, Mr. Black is liable if the original terms are not changed. Modifications of the mortgage terms can result in courts deciding that Mr. Black is not longer liable. Extending the loan term and increasing the interest rate is likely to terminate the liability of Mr. Black because Mr. Black is not a party to the modification. Mr. Black can normally be held liable only to the amount of debt that would be owned based on the original loan agreement to which he was a party.

Problem 2-5
Mr. Nelligan's right would not be terminated if he was not joined as a party to the foreclosure suit. Thus, Mr. Nelligan will still have a lien on the property which is now owned by Ms. McBride. Furthermore, because Ms. Rosen's claim has been settled by the foreclosure, Mr. Nelligan may now enjoy a first lien.

Problem 2-6
Assuming Ms. Rosen and Ms. McBride have no knowledge of Mr. Nelligan's mortgage, then Mr. Nelligan's right to the property would be terminated by the foreclosure.

Problem 2-7
In this case, Mr. Nelligan's only recourse would be to sue Ms. Rosen on the *note*, assuming that Ms. Rosen had signed a note making her personally liable for the debt. Recall that the note creates the obligation to pay.

Problem 2-8
If the land contract is considered an equitable mortgage, then Bob becomes, in effect, a mortgagor and Sam becomes a mortgagee. Sam would have to foreclose to repossess the property. Bob's rights would be the same as any mortgagor in default. For example, lien theory states Bob would be able to retain possession until the foreclosure is complete.

Problem 2-9
Under Chapter 13, the reorganization plan *cannot* modify the rights of a mortgagee whose lien is secured only by property used by the debtor as his/her personal residence. Thus the court would not be expected to approve the plan to reduce the scheduled payments by 50 percent for three years.

Problem 2-10
Generally, in addition to the $80,000 first lien, the lender also has first lien on <u>any</u> improvements made on land serving as security for the mortgage loan under the initial mortgage terms (<u>see</u>: <u>after acquired property clause</u>). In other words, depending provisions contained in the existing mortgage document, ABC Bank also probably has a first lien on the new building constructed by Mr. Smith, even though Mr. Smith built the building with his own funds. Whether Duce Bank is willing to provide $16,000 in new financing may be problematic at this point. Mr. Smith should have approached Duce Bank <u>before</u> constructing a new building on land serving as security for the initial mortgage loan.

Problem 2-11
Mrs. Brown has probably violated a covenant in the mortgage agreement (<u>see:</u> <u>preservation and maintenance of the property</u>) with ABC Bank by destroying part of the security held by ABC Bank. In other words, the land and building are part of the realty serving as security for the mortgage loan. By tearing down the building, she has, in essence, destroyed some of the security. The lender may give her notice that she has violated this covenant and is in default and call the remaining loan balance due immediately. Mrs. Brown should have notified the lender prior to the tear down. Let's hope that (1) the total value of the proposed new project far exceeds the outstanding loan balance, plus the cost of any new improvements and (2) that ABC Bank can be persuaded to finance the new project.