

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And /  
Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage  
Guaranty Insurance

c. "Second Mortgages and Land Contracts",  
no date

## Second Mortgages and Land Contracts

- I. The appraisal of real estate bears a critical, indeed too important bearing, influence on both making of a loan and the foreclosure process.
  - A. Most lenders are limited by law to mortgages which do not exceed a statutory percentage of fair market value. In the 20's this ratio was typically 50%, but more recently these statutes have tended to standardize at 75% of value. The ratio of the original loan balance to fair market value is called the loan to value ratio.
  - B. The premise of the ratio was that the balance of the money would be invested by the owner, and variation and future values would be born by the equity position first. Moreover it was reasoned that a substantial equity made the ~~borrower~~ <sup>borrower</sup> something like a co-insurer as to future outcome. His vested interest provided considerable motivation to enterprising management and the conservatism of minimum decision making.
  - C. Regulators like to oversimplify problems and create oversimplified check points to regulate anything and over the years the maximum loan ratio for the lender has become a challenge to the borrower to avoid - an overproductive result of unimaginative regulation.
  - D. Borrowers can avoid the result by means of:
    1. Inflated appraisals
    2. Second mortgages
    3. Land contracts
    4. Mortgage loan guaranty insurance
  - E. There is tremendous pressure on the appraiser to rationalize a high value for properties appraised for mortgage loan purposes. Lenders are willing to loan on the ability, the net worth assets, or the economic collateral of a property but must observe regulations and the borrower must help the lender in avoiding regulations the lender is not happy with.
- II. The appraiser is expected to rely on comparative market sales first, capitalized income second and cost to reproduce, if necessary - generally referred to as three approaches to value. The fourth approach to mortgage lending appraisal is often described as dividing the loan desired by the loan ratio required - i.e., a \$75,000 loan may be sought and with a 75% statutory loan ratio, the ideal appraisal would be \$100,000.

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- A. Mortgage ~~companies~~ lenders can control the quality of appraisal work by hiring their own appraisal staff, selecting appraisers who are notoriously optimistic, or reviewing appraisals submitted to debate their findings.

- B
- D. Quality control can assume a general standard error of 5% in truly independent appraisals. Some lenders and all mortgage loan guarantors spot check appraisals by doing independent valuations after the loan has been made, hoping to identify the bias of appraisers to be high or to be conservative. An appraisal which is too high:
1. Undermines the willingness to pay, particularly the borrower who thinks he paid too much.
  2. May eliminate the premise the borrower has invested his own money.
  3. Reduces the real cushion in terms of collateral in excess of debt balance sufficient to pay other accrued charges of the lender in the event of default.
  4. Reflects adversely on mortgage lenders money management ability.
- C
- E. An appraiser is responsible for poor quality workmanship only to the man who paid his fee. Lenders allow the borrower to select the appraiser although more recently lenders may provide a list of approved appraisers in a given market. Perhaps 20% of all foreclosed loans relate back to poor appraisals at the outset, it would be cheaper for the lender to pay the fee and have the appraiser represent the lender viewpoint since the lender is going to spend much money based on the appraisal conclusion.
- D
- F. An appraisal is also critical at the time of foreclosure for the lender who ends up owning the foreclosed property, either through bidding at the auction or a voluntary conveyance for release of debt. The reason is Uncle Sam.
- E
- F. Foreclosure and termination of the obligation for the borrower is regarded by IRS as a sale of the property at a price equal to the amount of reduction and liability. Thus a borrower who used accelerated depreciation may very well find his basis for tax purposes well below the amount of his mortgage on an income property 3 or 4 years after construction. Despite loss of the property on foreclosure the borrower would still be taxed on the capital gain and disallowed excess depreciation on his property.
- F
- G. The lender may also have some interesting opportunities for tax problems and advantages due to foreclosure. The critical element in the decision making process is the ratio of fair market value to debt at the time of foreclosure so that an accurate appraisal is absolutely necessary at the time foreclosure is contemplated.
1. A loss on the note outstanding is a bad debt and ordinary loss which can be applied against ordinary income.
  2. Foreclosure and purchase by the lender at the auction presumes the bid price to be the fair market price so that any gain on a later resale can be a capital gain if the lender waits 6 months. By the same token if the mortgagee pays more than fair market value as determined by appraisal due to voluntary conveyance, the difference can be counted as a capital loss.
  3. If the mortgagee accepts property appraised at more than the face amount of the mortgage, he received taxable income to the degree that value exceeds the claim. In addition, that part of the claim which represents accrued interest is also taxable income.

4. Where the property is worth less than the mortgage the lender receives bad debt tax credit for expenses, accrued interest, etc.
5. To protect himself the mortgagee wants to establish fair market value, establish evidence that a deficiency balance is not collectible, and acquire property with as low a bid as possible to achieve the maximum bad debt deduction as an ordinary loss and provide a low basis for capital gain in future resale. Thus the lender may bid the property for the principal due rather than the total debt unless it appears there is a third party bidder who may pay the total claim. The borrower can protect himself against the general rule that a reduction of mortgage debt is taxable income, if he can qualify under one of these exceptions:

- a. The borrower is insolvent both before and after the mortgage is transferred.
- b. The reduced mortgage is a purchase money mortgage so that a reduction is a reduction in sales price.
- c. The reduction is made under a bankruptcy or reorganization proceeding.
- d. The reduction is a gift from the mortgagee to the mortgagor whereupon the measure of difference is the degree to which proceeds received exceed the adjusted basis at the time of foreclosure.
- e. The loss on foreclosure is based on handling foreclosure as a sale and cancellation of the debt could be income or capital gain. Since a gain or a loss takes place at the end of the redemption period, some debtors will quit-claim the property in order to establish the earlier income tax period. (The borrower loss is any positive difference between his adjusted basis and the amount of debt which is cancelled).

III. Appraisal also has the implication as to the adequacy of potential sales proceeds to meet other claims in addition to the first mortgage claim. Thus a good prediction of sales value establishes the degree of importance that could be placed on priority of claim or conversely the many meanings and degrees of the term subordination.

- A. Subordination should be familiar from <sup>C</sup>Corporate finance, it means the rights from one claim are submerged voluntarily to those of another as in a subordinated bond issue.
- B. Because there are so many interests or rights which may be carved from a single fee, mortgages can be subordinated to almost anything. The following common situations only suggest the possibility.
- C. A second mortgage may be subordinated to a construction mortgage. For example, I could purchase a building site with a purchase money mortgage. This mortgage would be a first mortgage, but could contain a provision which would subordinate it to any mortgage used to finance construction of specified improvements. Construction would make the purchase money mortgage a second mortgage in regard to that for construction money but a first mortgage in regard to all other possible claims. Presumably the existence of a building and additional mortgagor money would provide better rather than less security for the subordinated mortgage.

- D. A first mortgagor may be subordinated to certain tax assessments, easements, or licenses - and the lender must be sure that these claims do not injure the security of a mortgage which may be first of its kind but not first in its claim.
- E. Most critical is the relationship of a lease to a mortgage on the property. In the absence of provision to the contrary, foreclosure of a mortgage on the landlord will extinguish the rights of the tenant under any lease made after the mortgage. By the same token a lease made prior to the mortgage, not made subject to a mortgage, means the tenant will be unaffected by foreclosure proceedings and may remain undisturbed until the expiration of his lease.
1. At first glance it would appear that the lender would decide that all leases be subject to a mortgage. However, the security of a loan for commercial property is the rental income which the landlord expects to receive. In the case of shopping centers large loans are made based on the leases the developer has made with AAA national tenants. The developer may fail because the shopping center is only modestly successful. If the lender foreclosed and gave AAA tenants the right to escape their 15 year leases, the lender would lose his best tenants and his one hope of retrieving his loan. Therefore, in making a loan for a building leased to a number of tenants, the lender will subordinate his mortgage to the good leases but not to the marginal leases which foreclosing could provide opportunity to break.
  2. Subordination also indicates a difference between lien theory and title theory states. In a title theory state, where the mortgage is subordinate to the lease, default by the borrower entitles the lender to collect rent from the tenant, once the tenant has received formal demand. In a lien theory state, the lender is not entitled to demand the rent payment until a receiver has been appointed. Consequently it is customary for the lender to subordinate to the lease and then have the borrower execute an assignment of the lease conditional for its effect on a default on mortgage payment by the borrower.
  3. Where the mortgage is superior to the lease, in a title theory state tenants have no right to retain possession after the landlord has defaulted on his mortgage since the latter has no right to retain possession after default. Under the lien theory state the lender is not entitled to collect rents or to possession until foreclosure is completed.
- F. Where assignment of rents is part of an order, the lawyers have found they have much additional security. The old timers argue in economic terms - holding a mortgage is a lien on land and assignment is a lien on rents. In most lien theory states the assignment is activated by filing for foreclosure and an appointment for a receiver. In title theory state default marks the point of assignment
1. The states differ also on the extent to which a lender or receiver can take possession, reduce rents, or effect prepayment.

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2. In title an intermediate theory states, a lease subsequent to the mortgage is not binding on the lender where the tenant has prepayed the rent or even secured a rent reduction. This privilege has a serious flaw on a mortgage which requires a large down payment in part prepayment of the mortgage. The tenant must have notice of the assignment, a notice which many companies send out to tenants long before the landlord is in financial trouble - thus causing considerable ill will.
  3. In lien theory states advance payments made in good faith by the tenant must be respected by the landlord unless the tenants are notified of an assignment when the leases are made. This explains why new tenants often receive notice of assignment of rents when they first enter the premises. This upsets the tenant who fears his landlord is in trouble and the landlord-borrower resents any hint of his financial affairs to the tenant. Assignment of a lease to a lender does not mean the lender is immediately entitled to the rent, but it does introduce a third party to the contract who must approve any changes in its terms.

- IV. The use of second mortgages is directly proportional to the downpayment and inversely proportional to the loan ratio required by the first mortgagee.
- A. Where loan ratios have been conservative, the second mortgage has flourished. If the loan ratio is 60%, a second mortgage for 20 or 30% may be a safe and legitimate investment.
  - B. The second mortgagee must know the value of property and the credit strength of his borrower. Unfortunately this form of finance is noted for its extravagances and its public image is such that few may legally lend on these terms and less will willingly lend on these terms. As a result those who do command steep interest and severe premiums.
  - C. High costs of second mortgage financing led to development of high ratio, first mortgage loans insured by the FHA, the VA, or PMI's to give the borrower a low down payment and the lender the same cushion he might have had with 75% loan.
  - D. It has several uses in the present market:
    1. As a purchase money mortgage subordinate to a construction loan.
    2. As part of a high ratio loan under the California trust deed plan.
    3. As a means of realizing cash on appreciated property values
    4. Wraparound
  - E. In a wraparound the second mortgage represents the combined balances of the first mortgage and funds owed under the second mortgage. The borrower makes one regular payment, who then makes <sup>the second mortgage lender</sup> the payment ~~of~~ to the first mortgage lender. The second mortgage lender is financing part of his investment by using the first mortgage loan while protecting himself against any failure by the borrower to make payments and precipitate foreclosure by the first mortgage loan. Borrowers use the wraparound to preserve older lower interest rates, avoid the need of prepayment, or today to represent additional credit required for inflated purchase prices when mortgage loans are not available.

- V. A more common device to provide low down payments and avoid the pitfalls of foreclosure is the land contract. The land contract is an agreement that at some future time the seller will transfer title to the buyer. The proper time occurs when the contract matures or when the balance of the loan has been reduced to a specified amount.
- A. A land contract may be written in Wisconsin and elsewhere to permit strict foreclosure. In event of default the seller can, at his option, take back the property in 30 or 60 days following default and retain all payments made up to that time as liquidated damages.
  - B. Strict foreclosure also protects the borrower from being sued for damages or a specific performance when he discovers he has made a poor purchase.
  - C. Courts may not always be clear on the equitable rights of parties to a land contract. It would fall within the vast area of contract for the transfer of land, but installment payments can create a growing equity for the purchaser which may bring about equitable conversion of the property in the eyes of the courts.
  - D. The land contract must anticipate all of the possible future contingencies affecting the land and the title so that when the time comes the seller can deliver the full warranty title which he promises to provide. There must be a provision for:
    - 1. Dower and courtesy
    - 2. Proper legal description
    - 3. Existing mortgage
    - 4. Insurance
    - 5. Tenants
    - 6. Payments
    - 7. Right to mortgage
    - 8. Provision for delivery of deed
    - 9. Rights of assignment
    - 10. Failure to provide good title
    - 11. Default by buyer
    - 12. Forfeiture of equity
    - 13. Right to record
    - 14. Maintenance and repair
    - 15. Condemnation