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

w. "Appraisal, Foreclosure, Second Mortgages, and Land Contracts", no date

Appraisal, Foreclosure, Second Mortgages and Land Contracts

I. Fair market appraisal is too important for both lending and foreclosure process, thus corrupting appraisal and integrity of loan theory.

   A. Traditional statutory ratios of original loan balance to fair market value of 50-75%.

   B. Theory of ratio assumes balance invested by owner, a co-insurer against a fall in value, and vested interest to provide motivation and management decisions on a mini-max basis.

   C. Loan ratio regulation classic example of counter productive over-simplicity.

   D. Lenders and borrowers can avoid the result of conservative loan ratios by means of:

      1. Inflated appraisal
      2. Second mortgages
      3. Land Contracts
      4. Mortgage loan guaranty insurance

   E. Economic pressure on the appraiser

II. Three approaches to value and cynically, the fourth approach - the loan desired divided by loan ratio required.

   A. Appraisal control by hiring a staff appraiser, selection of independent appraisers who are optimistic, or knowledgeable review of appraisal submitted. Spot check by independent appraisers after the loan is made.

   B. An appraisal which is too high:

      1. Undermines willingness to pay
      2. Eliminates premise borrower has invested his own money or voluntary sale is way out.
      3. Reduces cushion to pay claim in excess of balance due
      4. Reflects adversely on mortgage lenders money management ability

   C. Liability of appraiser only to man who paid his fee or the securities commission.

   D. Appraisal is critical at time of foreclosure for bidding or voluntary conveyance due to IRS.

   E. Termination of a debt for a borrower regarded by IRS as a sale of the property at a price equal to reduction in liability so that foreclosure can mean taxable gain to the borrower.

   F. Lender has his own problems with ratio of fair market value to debt at time of foreclosure.

1. A loss on the note balance outstanding is a bad debt and ordinary loss
2. Bid price at the auction establishes fair market value, this can provide basis for capital gain on resale or capital loss where lender pays more than fair market value.
3. Voluntary conveyance at more than face amount of the mortgage is taxable income. So is the claim which represents accrued interest taxable income.
4. Voluntary conveyance of property worth less than the mortgage claim produces a bad debt tax credit.
5. To protect himself lender wants to establish a low fair market value, establish evidence deficiency balance is not collectible, and acquire property at a low bid to achieve maximum bad debt deduction and a favorable basis for a future capital gain.

G. Borrower can protect himself against the general rule that a reduction of debt is taxable income (the tax trap) if he can qualify under one of these exceptions:

1. The borrower is insolvent both before and after the mortgage is transferred.
2. The reduced mortgage is a purchase money mortgage so that a reduction is a reduction in sales price.
3. The reduction is made under a bankruptcy or reorganization proceeding.
4. 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.
5. 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 value in the event of foreclosure is directly related to the issue of priority of claim or conversely a strategy of subordination.

A. Subordination means the rights from one claim are submerged <u>voluntarily</u> to those of another.

B. Mortgages can be subordinated to almost anything:

1. Construction loans
2. Tax assessments
3. Easements
4. Lender must be careful that prior claims do not define loan as a second mortgage which would be illegal for certain lenders, ~~suc~~ such as banks.

C. Most important is relationship ~~to~~ of a lease to a mortgage. Foreclosure could extinguish the lease of a tenant who made the property valuable or the tenant who was paying so little rent the landlord went broke.

1. Lender can choose to subordinate loans to lease of a good tenant
2. Subordination also appears to underline lien theory versus title theory In title theory states, default entitles lender to collect the rent upon formal demand.

3. In a lien theory state the lender cannot demand rent payment until receiver is appointed or foreclosure occurs.
4. Customary for lender to subordinate loan to the lease and have the borrower execute a conditional assignment of the lease activated by default.

D. The old time lenders argue that a mortgage is a lien on the land and assignment is a lien on the rents.

IV. The use of second mortgages is correlated to the size of the downpayment and inverse to available loan ratios.

A. If first mortgage is conservative relative to market value, second mortgage may be safe.

B. Mortgage may be safe relative to value but cause default point to be too high. Abuses of second mortgage have given it a bad public image so that few may legally lend on these terms and even less are willing to lend on these terms.

C. High costs of second mortgage residential loans and low statutory loan ratios led to the formation of FHA, VA, and the PMI's to give borrower a low downpayment and the lender the same cushion he might have had with a 70% loan.

D. Second mortgage has several current uses.

1. Purchase money mortgage from a subdivider subordinate to a construction loan.
2. As part of a trust deed program where there is one mortgage and two notes. Also called a piggyback loan.
3. Financing surplus taken in cash from appreciated property values leaving favorable loan undisturbed.
4. A wraparound mortgage

E. In a wraparound second mortgage, a new mortgage note is recorded representing the combined balances of the first mortgage and the funds owed to the second mortgage lender. The borrower makes one regular payment to the second mortgage lender who then makes the payment on the underlying first mortgage.

1. The second mortgage lender is financing part of his investment by using the first mortgage loan, generally taking an overriding interest of one quarter of 1%.
2. He is protected by failure of the borrower to make payments on the first mortgage loan.
3. Borrower as seller can provide additional credit required for purchase when mortgage loans are not available.
4. Borrowers preserve older more favorable interest rates, avoid the need of prepayment penalties in order to refinance, and can alter proportion of payment which are interest deductible.

V. A land contract is an agreement that at some future time the seller will transfer title to the buyer.

A. In Wisconsin and elsewhere it can be written to permit strict foreclosure because title remains with the seller and lender. Lender may retain all payments made by borrower as liquidated damages after a 30 or 60 day grace period.

B. Strict foreclosure protect borrower from suit for a specific performance or damages.

C. Courts may convert a mature land contract to an equitable mortgage

D. The land contract must anticipate all future contingencies affecting land and title so that borrower can receive full warranty title in the future. There should be 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