REAL ESTATE FINANCING AND SECURITY DEVICES

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This outline focuses on the financing aspect of a real estate transaction. The transaction that requires a loan is examined from the viewpoint of the attorney for the borrower or lender. The emphasis is on the real estate project, either residential or commercial, rather than the single-parcel raw land purchase.

A. ROLE OF ATTORNEY

1. FOR BORROWER. THE ATTORNEY CAN HELP:

A. MAKE A REALISTIC ANALYSIS OF THE PROJECT, e.g., checking projected revenue

B. STRUCTURE THE BORROWING PACKAGE: Advise on type of security, terms and interest rate. Ultimately, the borrower must assure himself that he has received all the funds he has bargained for and given no more in the way of security than he bargained for.

2. FOR INTERIM AND PERMANENT LENDER

The lender often does not approach its attorney until after the preliminary negotiations are completed. The attorney can often assist the lender during negotiations to focus on potential security problems.

A. PREPARATION OF COMMITMENT LETTER

B. SELECTION AND PREPARATION OF SECURITY DEVICES AND NECESSARY DOCUMENTATION

Once the documents are drafted and all legal bases have been touched, the lender must determine that he has the security he bargained for and the lien position he bargained for.

B. SOURCE OF FUNDS

1. SAVINGS AND LOAN ASSOCIATIONS

Single largest group of lending institutions that make and hold residential mortgage loans particularly for 1-4 family structures; equipped to service mortgage loans; S&L loans subject to loan-to-value, first lien and other requirements of the *Home Owners' Loan Act of 1933, 12 U.S.C. § 1461 et seq.*

2. MUTUAL SAVINGS BANKS

Second most important lender group in terms of residential mortgage loan holdings, with significant portion of home and multifamily mortgages obtained by purchasers rather than origination with mortgage companies or other loan originators.

3. COMMERCIAL BANKS

Traditionally, a large portion of their loans are short-term ones to businesses, e.g., interim loans for construction. However, they acquire a substantial amount of permanent residential mortgage loans through direct origination, with comparatively little loan purchase activity. Real estate loans by national banks are governed by *12 U.S.C. § 371.*

4. LIFE INSURANCE COMPANIES

Large investors in commercial real estate projects and the only non-deposit-type group of financial institutions that supplies large amounts of funds for residential mortgage lending. Life insurance

companies, especially in inflationary periods, seek various modes of equity participation to increase their loan yields. The bulk of their residential mortgage loans are acquired through purchases, typically from mortgage companies that originate the loans and later handle the servicing.

5. Mortgage Companies

Mortgage companies are not permanent lenders. Instead, they originate mortgage loans in anticipation of sale and expectation of obtaining the loan servicing contracts. Due to this middleman role, new mortgage lending activity by mortgage companies is largely dependent upon the availability of allocations from institutional lenders and commitments from the Federal National Mortgage Association (FNMA).

6. Credit Unions

The number of credit unions active in making and holding residential mortgage loans has risen dramatically in the last few years. Credit unions are typically not involved in commercial real estate lending. The size and number of real estate loans by both state chartered and federally chartered credit union are limited by loan-to-asset restrictions.

7. Federal Government

a. Direct Loans

E.g., Veterans Administration (VA) (home, farm and business loans); Farmers Home Administration of the Department of Agriculture (rural housing loans); Small Business Administration loans to construct, expand, or convert facilities purchase buildings and equipment, or obtain working capital).

b. Guarantees and Insurance

E.g., FHA (mortgage insurance for single-family dwellings, multi- family projects, coop and condominium housing, housing for persons on low and moderate income, housing for elderly persons, nursing homes, hospitals, land developments); VA (guarantees for home, farm and business loans).

c. Secondary Market for Mortgages

E.g., Federal National Mortgage Association (FNMA), a privately owned corporation under federal government sponsorship, which purchases, at market prices, mortgages insured or guaranteed by FHA, VA or the Farmers Home Administration (recent legislation authorizes FNMA to purchase conventional mortgages also); Government National Mortgage Association (GNMA), the government corporation within HUD which purchases FHA and VA insured mortgages for designated programs, at special assistance prices.

8. Other Sources

Private, uninsured pension funds; state and local government retirement funds; fraternal orders; mortgage investment trusts; state and local government credit programs; fire and casualty insurance companies; investment companies; personal trusts and individuals. These groups, among others, are responsible for the remainder of the mortgage loan originations and holdings.

C. COMMITMENT LETTER

1. In General

This is a contract to lend money premised on certain future events and certain consideration. Such a contract may be either oral or written. Courts are tending toward finding that oral promises to finance up to a certain percent of the equity, even tacit assurances of the availability of money in addition to that originally committed, are enforceable promises to lend. However, an oral promise to lend money

more than one year from the date of promise is not enforceable unless in writing pursuant to RCW 19.36.010, a portion of the Washington statute of frauds. Another applicable statute of frauds is found in *RCW 19.36.110*, which requires that all agreements to extend credit for commercial or investment purposes be in writing to be enforceable. This statute of frauds does not apply to a promise relating to a credit card or charge card or to a loan to a natural person primarily for personal, family or household purposes (rather than investment, business, agricultural or commercial purposes). In order for a lender to take advantage of this statute of frauds, the lender must incorporate a conspicuous notice in one or more of the documents relating to a credit agreement notifying the borrower that oral credit agreements are not enforceable.

2. Provisions of Commitment

The provisions contained in the commitment span the terms and conditions of the whole borrowing arrangement.

a. Type of Loan—Construction, Permanent or Combination

The commitment letter may be issued for an interim construction loan, for a permanent loan, or for a combination construction- permanent loan. The interim lender will approve the plans, the architect, the contractor, etc., and will, to the extent possible, obtain permanent lender's "take-out" commitment and approval of project, before lending.

b. Amount of Loan

Loan-to-value ratios for institutional lenders regulated by federal and state statutes. If value is there, the "loan" may involve up to 100% financing. *See* discussion of Security Devices *infra.*

Leverage is the goal of some developers and this is frequently achieved with a minimum cash equity coupled with a high loan.

c. Term

Construction loan term is often dependent on the duration of construction. Permanent loan term is dependent on the payment schedule sought, remaining useful life of property, needs of lender, and regulations governing the lender.

d. Payments

These will be established in a manner consistent with the borrower's cash-flow expectations from the project. Balloon payments may be appropriate.

e. Prepayments

In a declining interest rate market, there is a danger to the lender of refinancing by the borrower. Permanent lenders protect themselves by imposing prepayment penalties or by prohibiting prepayments in the early years of the loan term.

f. Commitment Fee

A nonrefundable fee is often charged to the borrower in order to cover the services performed by the lender in preparing the commitment letter.

g. Time of Acceptance

The commitment is in the nature of a firm offer that must be accepted within a stated period of time to be binding on the lender.

h. Type of Security

See Security Devices, *infra*

I. Secondary Financing; Subordination
The commitment letter may specify the secondary borrowing permissible and provisions for subordination, if any.

J. Takeout Commitment
The interim lender runs the risk that the market value of the completed project will be less than the face value of his loan, in which case foreclosure would not satisfy the loan. The takeout commitment acts as a floor in this event and reduces such a risk for the interim lender.

K. Disbursement Procedure
The commitment may only permit disbursement for part of the construction costs, with the remainder available upon completion or achievement of a certain percentage of rental commitments for the property being constructed.

Normally, the first interim construction loan draw will take out all underlying liens, thus assuring the construction lender first lien position on the land. Subsequently, draws are requested and disbursed on a monthly basis, reflecting the standard in the material vendor trade of discounting for net payment by the tenth. Certified draw requests must be made, in writing, to the lender. *RCW 60.04.221*

The borrower may be required to deposit his equity portion of the costs with the lender, making it subject to disbursement as required.

L. Insurance
Lender will require all risk, fire, liability and frequently rental insurance on the project.

M. Plans and Specifications
The interim lender must approve the plans and specifications. In some cases the permanent lender's approval is also obtained in the early stages of the deal. There must also be firm procedures for making changes in the plans during construction, particularly where this will result in increased construction costs.

N. Architect; Contractor. Also approved by lender(s)

O. Performance Bond
For protection of interim lender, a performance bond for the amount of the construction contract is required.

P. Inspection; Survey
Final disbursement of loan funds may be conditioned on inspection and survey of the property to determine what improvements have been made in accordance with the approved plans and specifications.

Q. Accounting
The borrower is often required to provide the lender with at least detailed annual operating statements.

R. Title Insurance
The borrower is required to obtain a lender's title policy. An extended title policy, insuring against matters that are not public record such as encroachments, will often be required by the lender.

s. Attorneys' Fees

The commitment should specify if the borrower is to pay the legal fees in connection with the closing of the interim and permanent loans.

D. SECURITY DEVICES

1. Home Loans

These may be government insured loans, conventional loans from institutions, or personal loans. Real estate mortgages and deeds of trust are used, with the latter being far more common. When FHA or VA mortgage insurance is used, the forms and structure of the transaction are governed by federal regulations. Generally, the security is simply the real estate itself, including improvements. Normally, unaffixed appliances sold with the home will not be covered in the security device used unless listed specifically, and unless perfected by filing in accordance with the terms of *RCW chapter 62A.9.*

2. Commercial or Business Loans

The lending industry may use the simple note and mortgage/deed of trust, or may utilize more sophisticated modes of documentation in order to achieve on the borrower's part more money and on the lender's part more return. *See Gunning & Roegge, Contemporary Real Estate Financing Techniques: A Dialogue on Vanishing Simplicity,* 3 Real Property Probate and Trust Journal 325 (1968).

Security may be one or more of the following:

1. Real estate
2. Leasehold rights
3. Personal property

3. Note and Mortgage

a. Advantages:

1. Body of case law
2. Fixed rules and procedures.

b. Disadvantages:

1. Lengthy redemption period (12 months if agricultural; 8 months otherwise)
2. No option of non-judicial foreclosure
3. Statutory upset price procedure
4. Lack of possessory rights in mortgage during redemption in most cases. *But see RCW 7.28.230,* as amended in 1969, to permit assignment of rent, possession for the purpose of collecting such rent, and appointment of receiver to collect such rent.

4. Note and Deed of Trust

a. Advantages:

Offers alternate remedies:

1. Judicial foreclosure with deficiency
2. Non-judicial foreclosure without deficiency
3. Speedy acquisition of security
4. Short form instrument available for use with master forms recorded in all counties of the state;
5. No upset price procedure.

B. Disadvantages:

For the lender, there are no real disadvantages to using a deed of trust versus a mortgage. A lender would normally use a mortgage only if the property is agricultural and could not be foreclosed upon non-judicially.

5. Wrap-Around Mortgage

A "wrap around" mortgage usually takes place when a seller owns property subject to a first mortgage. The seller conveys the property to a purchaser subject to the first mortgage and the seller finances part of the purchase price, taking back a second mortgage. The purchaser's monthly payments are in part to the seller and in part to satisfy the first mortgage. Frequently, the purchaser pays their entire payment to the seller and the seller then pays the first mortgage. This "wrap around" technique is often used to avoid a due on sale clause in the first mortgage, and as such has substantial risk. If the first mortgage lender learns of the sale to the purchaser, the lender can call the entire loan due. *See Gunning & Roegge, supra, p. 337; Creative Real Estate Financing, Institute of Legal Education, Ann Arbor (1968), p. 38.*

A. Face amount of wrap-around mortgage

The new loan has a face amount equal to the outstanding principal balance due on the first mortgage, plus the additional amount needed by the borrower; the amount actually advanced by the second lender, however, is equal to the additional amount needed by the borrower.

B. Interest rate

Near market interest rates; slightly lower rate can be offered because of the lower interest rate on first mortgage.

C. Payments on first mortgage

The borrower obligates himself to make a constant payment to the wrap-around mortgagee based on the face amount and interest on the wrap-around mortgage; the new lender, in turn, becomes obligated to make the payments on the first mortgage. In a minority of cases, the wrap-around lender assumes the first mortgage.

D. Advantages

For borrower: He obtains his additional financing and possibly a lower interest rate than if he were to refinance the existing first mortgage.

For wrap-around lender: Permits him to make loans on property that he might not otherwise be able to make because of size; permits a high return in the early years to the extent that the interest payments on the first mortgage are less. *E.g.*, assuming annual constant payments, where there is a wrap-around loan with face amount of $600,000 and an existing first mortgage balance of $400,000 (at 5 1/2% interest), interest at 7 1/2% on the $600,000 loan would require a payment of $45,000 the first year of which $22,000, or 5 1/2% of the $400,000, would be paid over as interest to the first mortgagee; the new lender's return is therefore $45,000 minus $22,000, *i.e.*, a $23,000 return for one year on an advance of $200,000-an 11-1/2 % return for the first year.

6. Sale and Leaseback

A. In general

Typically, the property is deeded to the "lender" who simultaneously leases it back to the "borrower" under a long-term net lease. This type of transaction is used for industrial property, office buildings

and shopping centers-for improved property or land only. *See Gunning & Roegge, supra; The Practical Lawyer, Vol. 16, No. 1, p. 51 (1970).*

B. SELLING PRICE
A negotiated price usually at or below cost.

C. INITIAL LEASE TERM
May be 20 to 30 years for a top-rated corporation, depending on useful life of property.

D. OPTIONS TO RENEW
Generally option to renew more than once for shorter, 5 to 10 year, terms.

E. RENT
A negotiated amount, generally sufficient to amortize the cost of the property over the initial term and provide the purchaser with an amount equal to existing interest rates for mortgages; for renewal terms, the rent will be a lower amount, often based on the value of the land only

F. CONTINGENT RENTAL
Many times the lease will provide for contingent rental as a participation in the income received from subtenants; additional rent also may be charged where the lessor is paying the debt charges on existing mortgages on the property.

G. OPTION TO REPURCHASE
The leaseback may provide for optional or mandatory repurchase by the seller tenant for a negotiated price. Great care must be exercised in drafting the repurchase section of a sale leaseback in order not to imply that the scheme is simply a mortgage.

H. ADVANTAGES:

FOR SELLER-LESSEE: permits 100% financing of his investment; entire amount of rent payments deductible for federal income tax purposes, particularly useful where tax shelter arising from depreciation has been depleted; minimizes fixed liability of the seller-lessee and thereby preserves ability of the corporation to incur additional long- term debt financing.

FOR PURCHASER-LESSOR: rental received may be greater than the interest and amortization that would be received from a mortgage; depreciation deduction is obtained; equity participation obtained from appreciation of the residual value of the property upon expiration of the lease.