

THE MORTGAGE DOCUMENTS

KEY TERMS AND PHRASES

Acceleration clause	Lien Theory
Ad valorem tax	Mortgage
Alienation clause	Open-end mortgage
Assumption	Package mortgage
Blanket mortgage	Prepayment
Construction loan	Principal
Contract for deed	Promissory note
Deed of trust	Purchase money mortgage
Deficiency judgment	Recording
Due-on-sale	Redemption
Equitable title	Security instrument
Hazard insurance	Subordination
Junior mortgage	Title Theory

LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Describe the development of lien theory as a key requirement for real estate lending
- Describe how the development of uniform loan origination documents and the expansion of the private mortgage insurance market impacted the growth of the secondary mortgage market
- Understand the key mortgage instruments for securing real estate and the effects of state real estate ownership laws on their application
- Describe the types of real estate financing contracts
- Explain the insurance requirements relevant to financing various types of real estate
- Describe the evolution, benefits, and types of uniform mortgage documents

INTRODUCTION

The use of real estate as the collateral security in loans related to the acquisition of land, homes, and farms can be traced back as far as the ancient businessmen of Ur, the Pharaohs of Egypt, and the Romans of the pre-Christian era. Even then, some form of promise or assignment of the property was used to ensure repayment of an obligation to the lender. The development over many centuries of this type of property assignment illustrates interplay between the rights of a borrower and the rights of a lender.

HISTORY AND DEVELOPMENT

In its earliest incarnation, the mortgage instrument as security for a loan actually granted title to the collateral property to the lender to assure repayment. As time passed and the means to borrow became more readily available, the rights of borrowers became a concern. Another form of mortgage pledge was introduced, granting the lender a lien on property pledged as collateral. This meant primarily that foreclosure would be subject to a court's determination. Both basic forms of mortgage pledges are in use today and their use is determined by state law.

STATE LAWS CONTROL PROPERTY RIGHTS

Property rights in the United States are spelled out primarily under state laws, not by the federal government. Each state has written into its code of law specific rights and procedures that must be adhered to with regard to land ownership and its conveyance. The local variations and shadings in these laws reflect the background and origins of the particular region. For example, the great body of English parliamentary law and common law guided the New England and Mid-Atlantic states in setting up their constitutions and subsequent statutes. French legal codes were reflected in the Louisiana Territory and were especially evident in the growing city of New Orleans. Spanish heritage colored the laws, recognizing Catholic religious ties in marriage as well as patriarchal protection of wife, children, and family relationships in the southwestern states; one result is community property statutes that give special protection to both parties in a marriage. All states, however, require some **security instrument** that gives a creditor the right to sell the security property to satisfy the debt if the debtor fails to pay the debt according to the terms of the agreement.

The Mortgage as a Grant of Title

Initially, as noted above, a loan secured by real estate involved granting legal title to the lender. During the term of the loan, the lender might even have the physical use of that land and be entitled to any rents or other revenues derived from it. The borrower held equitable rights to the property, meaning that title must be returned upon satisfactory repayment of the loan. However, due to the primitive conditions of communications and transportation then in existence, the practice of granting lenders title to properties in exchange for loans tended to foster some abuses by lenders. For example, a slight delay in payments, which might even be encouraged by the lender, could easily create a default and forfeit the borrower's rights to any recovery of the land. Dispossession could be made without notice, with no return of money already paid to the lender.

Sometimes borrowers who felt they had been unjustly deprived of their property appealed to an official to seek a hearing for their grievances and to petition for just redress. If it was subsequently determined that a wrong had been committed, the borrower might be given a chance to redeem the land with a late payment of the obligation. Thus, the right of **redemption** came into being.

However, lenders were not happy with this redemption privilege and initiated a countermove, inserting a clause into subsequent loan agreements that specifically waived the right of redemption. The borrower had to accept this clause or be denied the loan. As written codes of law developed and the unchallenged rule of an absolute monarch slowly declined, the granting or refusal of redemption became a matter of law called *statutory redemption*. This right to redemption of property after foreclosure action that existed in various forms from medieval times has now been incorporated into the laws of a few more than half the states in this country. Most of these states are in the old South or Midwest where state constitutions from reconstruction and losses of farms during the Great Depression prompted a rise in progressive issues to change the laws that were slanted in favor of lenders. Redemption periods vary among the states from three months to two years. Redemption periods can be different for different types of property and loan terms. In some cases, the redemption period is longer in the states with statutory redemption periods for farm land. In Michigan, for example, if a borrower has borrowed less than two-thirds of the value of a single-family home, the redemption period will be

one year; if he or she has borrowed more than two-thirds, the period will be six months, as long as the property has less than three acres and is not more than a three-family dwelling. The equity right of redemption is the right of a borrower to redeem their real property from default during the period of time of notice of default and the time foreclosure proceedings have begun. The *equity right of redemption* exists in all states, and generally once the foreclosure sale has been confirmed, the borrower can no longer redeem property except in those states with a statutory right of redemption.

The Mortgage as a Lien

As the law has developed in the United States, the rights of borrowers have become of greater concern; less than half of all states have adopted the **lien theory** for a mortgage pledge. With this method, the borrower retains legal title to the property and grants a lien to the lender as security for repayment of a loan. In law, to *hypothecate* property is to pledge it as security for an obligation without surrendering possession of it. As we noted in Chapter 1, hypothecation, as it applies to mortgages, operates in the following way: The borrower hypothecates when he or she pledges property as security/collateral for payment of a mortgage in order to borrow against the value of the real estate. In both situations, the borrower retains the use of the real estate or home but the lender has the right to take possession (that is, foreclose) if the borrower fails to pay the debt service obligations when they are due.

A *lien* constitutes an encumbrance on property. It is a declaration of a claim to a parcel of land for some purpose and is recorded in the public record. In states where the lien form of mortgage is prevalent, a defaulted borrower retains possession and legal title until the lien is perfected through court action by the lender. Usually in a lien theory state, the lender must sue to foreclose and gain title to sell the secured property to obtain repayment if a borrower has defaulted.

The concept of a mortgage as a lien shifts considerable power from the lender to the borrower. It is possible for defaulted borrowers to remain in possession of the property for substantial periods of time without making loan payments. Coupled with statutory redemption periods, the result has been numerous problems for lenders trying to recover their losses within a reasonable period of time.

Some states have modified borrowers' rights under the **title theory** and allow lenders to take possession of collateral property in the event of a loan default, without waiting for the conclusion of foreclosure proceedings.

While there is obvious variation in the precise usage of the lien as a form of pledge versus the limited assignment of title as another form of pledge, mortgages can be classified into either of the two forms. The advantages and disadvantages of each can be weighed in terms of their legal significance, but for purposes of finance, it is important mainly to be aware of the existing differences and to know under what laws a particular property can be mortgaged. Lenders have learned to live with various requirements and can obtain adequate security for their loans by adapting mortgage pledges to state-specific laws. The conforming loan documentation required by Fannie Mae and Freddie Mac varies the mortgage instrument for each state.

As a review, when a lender is in a title theory state, the borrower will not hold the title to the property in their name; rather, the lender will be a beneficial holder to title to the property using a deed of trust that places the title to the property in trust with a third party trustee. In a lien theory state, the title to the real property will remain in the name of the borrower and the lender takes a mortgage or security interest that allows them to foreclose using the courts. Some states have hybrid forms of these theories, but a slight majority of states are title theory states.

The Mortgage Instrument

While the broad field of real property law exceeds the scope of this text, it should be noted that a mortgage is a conveyance instrument, as it transfers certain property rights. The transfer of property rights should be handled by qualified attorneys, skilled in interpreting these rights according to the laws of each state. Most states limit any conveyance of property rights solely to written agreements, and all states require certain procedures to record conveyances of land in the public records. One result has been an increasingly accurate record of land titles, with a corresponding increase of protection for the rights of property owners and other interested parties.

Some basic instruments used in real estate loans have essentially the same purpose throughout the country. One of these, the **mortgage**, is the pledge of collateral that has given its name to the entire field of real

estate finance. A mortgage is simply a pledge of property to secure a loan. It is not a promise to pay anything. As a matter of fact, without a debt to secure, the mortgage itself becomes null and void by its own terms; it is, as the French origin of the word indicates, a “dead pledge.” Due to the differences in state laws, the precise definition varies somewhat, but for our purposes, a mortgage can best be defined as a conditional conveyance of property as security for the debt recited therein, which can only be activated by failure to comply with its terms.

The Promissory Note

The **promissory note** is a debt instrument, and is the lender’s basic evidence of the amount owed and who owes it. It creates the obligation to repay a loan. Both promissory notes and mortgage instruments must contain certain standard words and phrases to assure the accomplishment of their purposes, and as such, they are interlocking documents. A lender must have both a promissory note as a written promise to pay and a mortgage or deed of trust to evidence the lender’s right to force the sale of the real estate securing the promissory note if the borrower defaults on his or her obligations under the promissory note or mortgage or deed of trust. Nevertheless, the balance of the terms and conditions can be worded in whatever way the attorney preparing the documents deems proper. The variations can be substantial, and in years past, such variations made the selling of conventional mortgage loans very difficult. HUD/FHA and VA have always required their standardized forms to be used if they underwrite a loan. But there is no such requirement for conventional loans—meaning those not underwritten by government agencies such as FHA and VA. Conventional loans underwritten by federal agencies such as Fannie Mae are known as conforming loans because they must meet, or conform to, the requirements set by the underwriting agencies.

Where Are We Now?

Lien Theory vs. Title Theory

Under Lien Theory:

- Borrower has title (ownership) to the property
- In most cases, the borrower has the right of redemption

- A lender can secure his or her interest in a property by designating a trustee to act on his or her behalf in the event of default by borrower
- Lender must go through due process by having the property sold at auction to recover the debt
- Generally advantageous to the borrower

Under Title Theory:

- Lender holds title to the property
- The borrower can be evicted in the event of default without any judicial procedures
- Generally advantageous to the lender

Deed to Secure Debt

A type of mortgage used in a few states; the title to the property is transferred to the lender until the debt is paid in full. Contrast this with deeds of trust, which are employed in states called title theory states, and with true mortgages, which are employed in states called lien theory states. The deed to secure debt is a hybrid of the two theories.

CONFORMING LOANS

In 1970, Fannie Mae was authorized to purchase residential conventional loans. Prior to that time, it was still an agency and was limited to purchasing HUD/FHA and VA loans. To develop standards to guide the purchase of conventional loans from lenders across the country, Fannie Mae worked in cooperation with Freddie Mac to create a series of uniform conventional mortgage documents. Since both entities are quasi-government, public hearings were required before formal approval could be given. Consumer advocates participated in the hearings to help decide what should and should not be included in these important documents.

No single mortgage form could be used throughout the country because of the variations in state property laws. So the result of this work

has been a series of standardized mortgage instruments designed specifically to meet each state's requirements. Conforming mortgage instruments contain a section that covers universal standards and another section that covers state-specific requirements.

However, promissory notes are unilateral promises to pay and convey no property rights, so they contain fewer differences between the states' laws. This fact has allowed greater standardization of promissory note instruments, with one note serving a number of states as a "multi-state" document. Examples of a note and a mortgage instrument appear in the Appendix of this text.

Ongoing work to create uniform mortgage documents for residential loans has formed the basis for a standardized conventional loan known as a *conforming loan*. Besides uniform documents, which will be discussed in detail at the end of this chapter, a conforming loan must meet Fannie Mae/Freddie Mac standards for qualification of borrowers, preparation of an appraisal, and limits on the dollar amount of a loan. As a standardized conventional loan, the conforming loan has achieved wide acceptance. Since both agencies are always in the market to purchase loans, albeit at their own yield requirements, many primary-market lenders adhere to conforming loan standards to make sure their loans can be sold when money is needed.

While the preparation of mortgage instruments is a legal matter, real estate professionals use them in negotiations, and therefore the following section will provide an overview of important points regarding these instruments. The promissory note is almost always a separate instrument but is sometimes included as part of a mortgage document. The Uniform Commercial Code sets standards for drafting an enforceable and negotiable promissory note. In general, to be valid, a promissory note must contain the following basic provisions:

- It must name the parties to the promissory note—that is, the maker (borrower) and the payee (the lender)
- It must name the amount of the debt (**principal** borrowed)
- It must specify how and when the money is to be paid, including maturity date
- It must contain an acceleration clause
- It must contain a description of the payee's remedies if the money due is not repaid
- It must be signed by the maker

If, in foreclosure, the collateral securing the note (as pledged by the mortgage instrument) proves insufficient to cover the indebtedness, the holder of the note may obtain a **deficiency judgment**—an unsecured money judgment—against the debtor for the balance due. (State laws vary as to borrowers' and lenders' rights in a claim for deficiency judgment.) As discussed earlier, mortgagees attempting to obtain a deficiency judgment will generally follow the lien theory of mortgages requiring judiciary foreclosure procedures that usually allow deficiency judgments against the debtor. In the title theory states, mortgages typically allow nonjudicial foreclosure procedures but do not allow deficiency judgments. If the note is labeled “nonrecourse,” the borrower cannot be held personally liable.

Use of the wording “or order” or “or bearer” in defining the payee is important, as it is these words that make it possible for the note to be endorsed and transferred, thus becoming negotiable. Most mortgage promissory notes are negotiable, to allow transfer to secondary-market investors. If the note is negotiable, only one copy should be executed. If other copies are made, the note maker may initial them, but should not sign them. It is imperative to secondary-market investors that they receive both the properly executed promissory note and mortgage or deed of trust that has been filed showing the security interest of the holder of the promissory note, since one cannot foreclose on a property with a promissory note alone.

Mortgage Instrument

A conforming loan mortgage instrument is divided into two major sections: (1) uniform covenants that are standard across the country, and (2) non-uniform covenants that cover special requirements of state law. While some of the details vary, the underlying purposes of mortgage covenants are very similar. These will be discussed next.

Parties Involved

The mortgage instrument must identify the names of all parties involved who have an ownership interest in the property being mortgaged. These parties may not be the same as those obligated on the promissory note. Since the mortgage is a conveyance-type instrument, it is necessary to have all owners indicate agreement by signature. The rules of contract law apply to mortgages, so they must be in writing, and the parties must be

legally competent to contract. Whether the marital status of the parties involved needs to be stated depends upon state law. If the parties are married, both signatures may be required, as marital rights, homestead rights, and/or community property rights may be at stake.

Identification of Property

Identification of the property offered as collateral to secure the promissory note must be accurately described so as to distinguish it from any other property in the world. A street address is never acceptable because it can change over the years. Nor are boundary lines based on physical features—for example, “the big live oak by the river bend”—acceptable as long-term identification. Several methods are used to legally define real property. One is by “metes and bounds,” using a surveyor’s description of boundary lines from a fixed starting point, thence proceeding in specific compass directions and distances around the property back to the starting point. In urban areas, the most common method is by a “lot and block” description taken from a subdivision plat, which must be registered and approved by a local government authority. A third method, found mostly in western states, is by geodetic survey. By this method, large tracts of land were surveyed, marked by stakes in the ground, and designated by townships of 36 square miles that can be used to identify land. Legal description of real property is more fully explained in Chapter 10, “Property Analysis.”

An erroneous description of the property, even a typographical error, can render the mortgage instrument void, but does not necessarily invalidate the promissory note. If a loan has been funded and the promissory note properly signed, there is an obligation to repay whether or not the mortgage is valid. If the mortgage is not valid, a properly signed and funded note becomes an unsecured obligation.

Principal Amount Due

Most mortgage notes are paid on an installment plan wherein each payment includes all the interest due to that payment date, plus a portion of the principal due. Thus with each payment, the total amount owed is reduced. When mortgage notes are transferred, only the principal balance then due can be conveyed. Business practice places confidence in the seller of a note to deliver accurate information on the precise balance

due at the time of transfer. However, when a large commercial loan is transferred, some kind of legal assurance of the amount conveyed is usually required.

Estoppel

The term *estoppel* is sometimes applied to a mortgagee's information letter. This letter is a statement from the mortgage lender to the borrower giving information on the current status of that loan, including the amount of principal balance due at that time. Such information is normally obtained as part of the property listing process. An older practice, and one still used sometimes with large commercial loans, is to require an estoppel agreement when a note is transferred. The purpose of the agreement is an acknowledgment by both borrower and lender of the loan amount due at that time. In effect, it "stops" a subsequent purchaser of the note from claiming any greater amount. The legal doctrine of estoppel has a broader application in that it prevents a person from asserting rights that are inconsistent with a previous position.

Prepayment Penalty

If all or part of the principal balance of a loan is paid before it becomes due, there is a possible additional charge involved. The purpose of the **prepayment** penalty (some lenders call it a prepayment premium) is to allow the lender to recoup a portion of the interest that the lender had expected to earn when the loan was made. The following example serves to explain the lender's viewpoint.

Example

A loan of \$200,000 for 30 years at 6% interest is expected to earn the lender \$231,676 in interest over the life of the loan. (The monthly payment of \$1,199.10 multiplied by 360 payments equals \$431,676. The principal is \$200,000; the balance is interest.)

Lenders do not loan money for the purpose of recovering the principal. There is a contractual right to the interest and some claim to compensation for a forfeiture of this right.

On the other hand, the borrower views the repayment as placing cash in the hands of the lender that can easily be loaned to another and continue to earn interest plus additional origination fees. So there is no compensable loss to the lender.

In mortgage instruments today, there are a variety of compromises on these conflicting views. First, no prepayment charges are permitted on HUD/FHA, VA, or conforming loans. On other residential loans, the prepayment penalty might range from 1% to 3% of the loan amount that is prepaid. For instance, if the charge is 3% and the amount prepaid is \$20,000, the borrower would owe an additional \$600 at the time of prepayment. Another fairly common solution to the prepayment question, sometimes found in commercial loans, is to allow up to 20% of the original loan amount to be prepaid in any one year with no additional charge. Under this option, the borrower could repay the loan in full within five years at no extra cost. Prepayment requirements must be clearly specified in the residential real estate loan documents, and specifically disclosed on the Truth-in-Lending document the lender must give a potential borrower within three business days of taking a mortgage loan application.

Lock-In Provisions

Another kind of prepayment requirement found in some commercial loans is the "lock-in." Commercial loans do not fall under the same kind of regulatory protection for borrowers that can be found in residential loans, making it easier for lenders to set harsher terms. A lock-in is one example. What it does is lock in the interest charge for a certain minimum number of years. For example, a loan for an apartment project might require all interest to be paid for the first eight years of the loan term. Prepayment at any time during the first eight years would require the borrower to pay all interest otherwise due for that time period and most likely would make any prepayment too costly.

Mortgage Covenants

These are promises made by the mortgagor or borrower. By signing the mortgage or deed of trust, the borrower agrees to uphold certain promises that fall into two broad categories: positive covenants and negative covenants. Examples of a positive covenant might include a mortgagor's promise to keep the property covered by hazard insurance or to make monthly mortgage payments. An example of a negative covenant might

include a mortgagor's agreement to the restriction of his or her ability to rent the property for profit.

Generally, not complying with a mortgage covenant can result in foreclosure proceedings against the property mortgaged.

Acceleration Clause

The **acceleration clause** in a mortgage instrument, or promissory note, gives a lender the right to call the entire balance due, in full, in advance of its due date upon the occurrence of a default. The most common type of default is a failure to make timely payments, but there are other kinds of defaults that can trigger an acceleration clause, including destruction of the premises, placing an encumbrance on the property, or the unauthorized sale or assignment of the property. The acceleration clause is a very important part of an installment obligation because without it, the alternative could be to foreclose each month as the payments actually come due. The uniform mortgage language for Fannie Mae/Freddie Mac-conforming loans uses broad terminology to apply the acceleration clause in the Covenant 19 provision in both its mortgage security documents and deed of trust security instruments, and this clause is also incorporated by reference in Fannie Mae/Freddie Mac's common promissory note documents.

Right to Sell/Due-On-Sale Clause—Assumption

As a general rule, mortgaged property can be freely sold by the owner, or mortgagor, either with an **assumption** of the existing debt by the new buyer or, if that is not permitted, by paying off the balance due on the existing mortgage. The popularity of loan assumptions follows the rise or fall of interest rates; in a period of increasing rates, an older, lower-interest loan is attractive to a potential buyer. In 1982, the contract rate on mortgage loans as reported by regulated savings associations reached 15.01%. During the following 25 years, 30-year, fixed-rate, self-amortizing mortgage loan contract rates slowly declined to nearly 4%. Obviously, the assumption of older, higher-interest loans has not been so attractive. This trend may shift as the economy recovers over the next few years; interest rates are expected to go up as the demand for credit increases with the needs of an expanding economy and continuing demands by the states and federal government to finance deficits.

The last time interest rates saw a large rise, in the late 1970s, assumptions became very popular. Lenders took the position that any change in collateral ownership gave them the right to allow assumptions only at higher interest rates; borrowers countered that an increase in interest rates restricted their right to sell. The contention was that this amounted to an unreasonable restraint on the owner's right to sell. In legal terminology, this restraint on a sale is called a *restraint on alienation* (meaning the right to transfer an interest in real estate to another). Thus a right-to-sell clause in a mortgage is sometimes referred to as the **alienation clause**.

Most states prohibit any unreasonable restraint on alienation—a limitation that has been mostly concerned with discrimination. For example, a restrictive covenant in a property deed that forbids any sale to a woman would be classed as an unreasonable restraint on the owner's right to sell. The question of whether or not a lender's right to increase an interest rate on an assumption, or otherwise deny the right to sell, amounts to an unreasonable restraint was the subject of much controversy and many court battles during the early 1980s. In 1982, the U.S. Supreme Court decided that a federally chartered institution does have the right to enforce a due-on-sale provision rather than accept a loan assumption, thereby upholding the Garn Act, which allowed banks to enforce **due-on-sale** provisions for which the banking industry had lobbied hard. Since that time, the practice has been for the assumption of a conventional loan to be cleared with the lender before any title is conveyed.

Mortgage instruments now carry more specific language regarding the lender's right to change an interest rate, or call the loan due, in the event of an assumption effort. The uniform mortgage language for Fannie Mae/Freddie Mac-conforming loans uses broad terminology to apply its due-on-sale provision. Covenant 18, entitled "Transfer of the Property or a Beneficial Interest in Borrower," simply prohibits any such transfer of interest without prior written consent of the lender. Failure to comply can result in a call for immediate payment of the entire loan balance. Both FHA and VA have limitations on assumptions that vary by date of loan origination, an issue that will be explored in greater detail in Chapter 8.

Even though there have been some rational arguments on both sides of the assumption/due-on-sale question, there is no obligation on the part of any lender to allow a loan assumption today. However, there is a need to disclose this fact in the loan agreement. This fact is particularly important when a home seller helps finance the sale of a house. Home sellers

are not normally in the business of making loans, and they can include a more stringent clause simply forbidding any loan assumption; that is, if the buyer subsequently resells the house, the existing loan must be paid in full.

MORTGAGE VARIATIONS

The underlying purpose of the mortgage instrument is to provide a pledge of property as collateral to secure a promissory note. In order to properly serve the needs of lenders and borrowers, there are variations in how loans are used that create differences in the wording of mortgage instruments. These are not the same as the special differences that derive from how a mortgage is repaid, an issue that will be considered in the next chapter. The following section identifies the principal kinds of mortgages and describes their purposes and unique features.

Regular Mortgage

A regular mortgage is a two-party legal document used to secure the performance of an obligation. The borrower, or mortgagor, grants certain rights to the lender, or mortgagee, pledging property as collateral. The rights granted may be in the nature of a lien or a conditional grant of title. Foreclosure with a regular mortgage is usually handled through court action. The mortgage is a conveyance instrument that creates rights in real property and should be recorded.

Deed of Trust

A **deed of trust**, sometimes called a *trust deed*, is a loan in which title to property is conditionally conveyed to a third-party trustee as security for an obligation owed to the lender, who is called the *beneficiary*. The trustee can be an individual (usually an attorney), a trust company, or a title insurance company, as selected by the lender. The trustee in this instrument is normally granted the right to undertake foreclosure through its "power of sale" clause. A deed of trust (an example of which appears in the Appendix) is the security instrument used in title theory states, as discussed earlier in this chapter, and foreclosure proceedings can be implemented without benefit of court action. In the event of a default, the lender notifies the trustee to request that action be taken to protect