Chapter 3

Finance Instruments

Chapter Objectives

- Contrast a financing instrument with a security instrument
- Describe advantages and disadvantages of mortgages and trust deeds
- Identify typical mortgage clauses

Promissory Notes

- **Written Promise to Pay**
  - **Payee**: Person or institution lending money
  - **Payor**: Maker of the note who promises to repay funds
- **Content of Note**
  - Names of the parties
  - Amount of debt, including interest rate **(note rate)**
  - Signature of maker
- **Negotiable Instruments**
  - Freely transferable from one party to another
  - Lender/other creditor can obtain immediate cash by selling note

Promissory Notes - Types

1. **Straight Note/Interest-Only Note:** Calls for interest-only payments during term of note with a balloon payment at end of loan term; usually short-term loan
2. **Installment Note:** Calls for payments of principal and/or interest at designated intervals (balloon payment may be required)
3. **Partially Amortizing Installment Note/Installment Note with Balloon:** Calls for periodic payments of principal/interest during loan term with balloon payment at end of term to pay off balance due
4. **Fully Amortizing Installment Note:** Calls for regular payment of principal/interest calculated to pay off entire balance by end of loan term

3.1 Knowledge Check

What statement is TRUE as it relates to a note?

A. gives evidence of a debt
B. is a borrower’s promise to repay a debt
C. should be signed by the payee
D. should be signed by the payor

Security Instruments

- **Security Instrument with Promissory Note**
  - Requires debtor to **hypothecate** property as condition of loan
  - Serves as protection for creditor, motivation for debtor - make sure terms of note are fulfilled and note is repaid
  - When debt repaid, the note and security instrument are cancelled
- **Two Main Types**
  - Trust deed
  - Mortgage

Trust Deed and Mortgage

- **Trust Deed**
  - Instruments placing specific financial interest in title to real property into hands of disinterested third party as security for payment of note
  - Borrower has possession of and **equitable title** to property
  - When loan is paid, note/deed of trust are canceled and legal title/equitable title vested in borrower
  - Trustee can commence **non-judicial foreclosure action**
- **Mortgage**
  - Borrower conveys interest in property to lender as collateral for debt; creates a **voluntary lien** on property
  - Lender may commence a **judicial foreclosure action**

Lien Theory and Title Theory

- **Lien Theory**
  - Security instrument creates lien against property; must be repaid by debtor
  - Property serves as collateral
  - Judicial foreclosure may be required to obtain title and possession in case of default
- **Title Theory**
  - Security instrument gives actual title of property to lender while debt is outstanding; borrower retains only equitable title/possession of land
  - Once mortgage is repaid, legal title reverts to borrower
  - Judicial or non-judicial proceeding may be possible is case of default

Judicial Foreclosure Procedure

- **Acceleration Clause**
  - In case of default, allows lender to accelerate due date and demand balance be paid
  - Failure to pay balance, result in foreclosure action
- **Judicially-Ordered Foreclosure Sales Process**
  - The public is notified
  - The property is sold to the highest bidder
  - Any overages remaining are paid to the debtor
- **Deficiency Judgement**
  - Court order; debtor owes money to creditor due; collateral property does not bring enough at a foreclosure sale

Judicial Foreclosure Procedure

- **Redemption**
  - Debtor may be able to redeem property
  - **Equitable right of redemption**: redeem prior to confirmation of sale
  - **Statutory right of redemption**: redeem after final sale
  - **Deed in lieu of foreclosure:** convey before court action to avoid foreclosure on credit record

3.2 Apply your Knowledge

Match the mortgage term with the description.

1. Balloon Note	A. Additional payment at end of term
2. Beneficiary	B. Benefits from Deed of Trust
3. Trustee	C. Borrower
5. Judicial	D. Court Decision
7. Note	E. Evidence of debt
10. Trustee	F. Holds Title
9. Straight Note	G. Interest Only
4. Hypothecate	H. Pledges as Security
8. Security Instrument	I. Protects Lender
6. Non-Judicial	J. Trustee's Sale
3. Fully Amortizing	K. Zero balance due at end of term

Mortgage Lien Position

- **Lien Position**
  - Establishes order in which liens are paid off out of proceeds of foreclosure sale
- **First Mortgage**
  - First lien position; priority over all other mortgages
- **Second Mortgage**
  - Second lien position; lender in riskier position
- **Senior Mortgage**
  - Any mortgage in higher lien position
- **Junior Mortgage**
  - Any mortgage with lower lien position than another

Mortgage Lien Position

- **Subordination Agreement**
  - Public record that permits the second lien holder to be in the first lien position
  - **Examples**
    - Because of the high-risk nature of construction loans, construction lenders frequently refuse to lend money unless they can be assured of a first lien position
    - When a property owner has a junior mortgage, such as a home equity line of credit, and wants to refinance his first mortgage but keep the line of credit open

3.3 Knowledge Check

A ______agreement is a written agreement between lienholders on a property that changes the priority of mortgages, judgments, and other liens.

A. foreclosure
B. priority
C. subordination
D. superior

Financial Instrument Clauses

- **Acceleration Clause**
  - Gives lender right to declare entire loan balance immediately due because of borrower default or violation of other contract provisions
  - Most promissory notes, mortgages, trust deeds, and land contracts contain acceleration clauses
  - Upon default, lenders want to be able to make all payments due without having to file separate actions for each missed payment
  - Lenders must wait until payments are delinquent at least 120 days before enforcing acceleration clause

12 CFR § 1024.39 and 41

Financial Instrument Clauses

- **Alienation Clause**
  - Gives lender certain stated rights when there is transfer of ownership in the property (AKA due on sale clause)
  - May be triggered by:
    - Transfer of title
    - Transfer of significant interest in property
    - Abandonment of property
  - FHA/VA loans cannot technically have alienation clauses, but attempt to restrict transfer in other ways

Financial Instrument Clauses

- **Defeasance Clause**
  - States, in legal document, that in event a stated condition has been fulfilled, the legal document becomes void
  - Can appear in contracts or mortgages; more likely to be found in title theory states
- **Partial Release, Satisfaction, or Reconveyance Clause**
  - Obligates creditor to release part of property from lien and convey title back to debtor once certain provisions of note or mortgage have been satisfied; usually occurs after % of mortgage has been paid
  - Appears in many blanket mortgages and some construction mortgages

Financial Instrument Clauses

- **Prepayment Clause**
  - Gives the lender the right to charge the borrower a penalty for paying off the loan early
  - Seen in conventional loans; when refinancing
  - Prohibited in government (FHA, VA, or USDA/RHS) loans
- **Other Mortgage Covenants**
  - Covenant = Promise
  - Example: Property owner promising to keep property in good condition

Dodd-Frank Act § 1414

Chapter 3 Quiz

1. **A promissory note calling only for payment of interest during its term is a(n)**

   A. amortizing note.

   B. installment note.

   C. negotiated note.

   D. straight note.

Chapter 3 Quiz

2. A clause that permits the lender to call the outstanding balance due and payable should the property be sold by the borrower is a(n)

A. acceleration clause.

B. alienation clause.

C. balloon payment clause.

D. exculpatory clause.

Chapter 3 Quiz

3. Which document normally accompanies the mortgage?

A. abstract of title

B. contract of sale

C. deed

D. promissory note

Chapter 3 Quiz

4. To foreclose a mortgage as opposed to a trust deed, a creditor

A. files an attachment in the amount of the debt.

B. files a court action.

C. notifies the debtor of the default, waits ten days, publishes a notice of default in the paper, then claims a forfeiture.

D. notifies the trustee of default.

Chapter 3 Quiz

5. Which term describes the process by which a borrower pledges property as security for a loan without giving up possession of it?

A. defeasance

B. hypothecation

C. redemption

D. subordination

Chapter 3 Quiz

6. **What clause gives a lender the right to declare the entire loan balance due immediately because of borrower default or for violation of other contract provisions?**
   A. acceleration clause
   B. alienation clause
   C. defeasance clause
   D. prepayment clause

Chapter 3 Quiz

7. **The document that creates a lien against real property as security for the promise to repay a loan is called a(n)**
   A. equitable title.
   B. mortgage.
   C. promissory note.
   D. subordination note.

Chapter 3 Quiz

8. The borrower who pledges property to a lender as collateral for a debt is referred to as the

A. beneficiary.

B. mortgagee.

C. mortgagor.

D. trustee.