PRIVATE MONEY FINANCING ON OWNER OCCUPIED FAMILY RESIDENCES

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The need for the easy money loan will not be derailed with the demise of the sub prime market. Instead, real estate brokers and their clients, may find themselves turning the clock back at the platform of "creative financing" techniques. Thus, there exists the re-emergence (lest anyone thinks it ever went away) of private money financing on owner occupied single family homes (including 1 to 4 units).

Private money financing means non-institutional financing. In today's residential environment, that can mean any of the following: purchase money financing (i.e., when a seller of property carries back a note secured by a deed of trust on the residence sold), or a third-party second deed of trust loan (or sometimes third or fourth deed of trust loan), or the wrap around mortgage (sometimes simply referred to as the "wrap"), which is a form of purchase money financing by which terms the seller carries back a note and deed of trust which includes any existing secured loans as part of the total principal. A broker's commission in the form of a promissory note secured by a single family residence may also be considered a purchase money loan.

Real estate brokers or others considering private money financing techniques to either facilitate the sale of a home or as an alternative to refinancing, should proceed with the same caution as when crossing railroad tracks. California law for the unwary in this area may be the equivalent of being hit by a locomotive.

The following is important to any private money lending transaction:

- **A well-drafted Promissory Note** is essential. One must clearly state matters such as the date payments are due, how interest is calculated if payments are amortized (i.e., 30/360 or actual 360/60), maturity dates, clear definitions of events of default, late fees, default rate of interest, address for notices, where payments are to be made, and what date that a balloon payment will become due. An attorney’s fees provision is also essential as under California law one cannot collect attorney's fees when bringing a legal action to enforce the promissory note unless the promissory note specifically provides for it. Additionally, the form of note must have defined terms consistent with the deed of trust, and vice versa.

- **A well-drafted Deed of Trust** is also essential. Too often forms are used that are either outdated or the parties assume must be good since it is a preprinted form. There are as many bad forms as "bad borrowers". The well-drafted deed of trust includes numerous covenants on matters ranging from covenants of the borrower to maintain the property and the amount of insurance required to be carried, to
very clear rights of the lender, how proceeds from a foreclosure sale should be
distributed, and a provision for attorney's fees. Further, unique features of the
transaction may need to be examined in the context of the deed of trust, and
incorporated within its terms.

- **A UCC 1 Financing Statement** may be required if there are items of personal
property (or non-fixture items) intended to be secured with the home (e.g.,
appliances, movable spas and other outdoor amenities, or other items that are
not fixtures and make the residence "special"). A well-drafted deed of trust will
include fixture filing language, in which case the UCC-1 need only be filed with
the Secretary of State; however, if the deed of trust does not include fixture filing
language, then the UCC-1 needs to be both recorded in the office of the county
recorder where the property is located, and also filed with the office of the
Secretary of State. If the owner of the property lives in another state or is an
entity organized in another state, the UCC-1 needs to be filed in the office of the
Secretary of State where the owner of the property resides, or if an entity, the
state of formation.

- **A Guaranty** will not always be enforceable in a purchase money loan transaction
as set forth below, and therefore getting Uncle Joe or Aunt Mary to sign on the
dotted line does not add additional security. Plus a borrower can never guaranty
its own debt although some repeatedly try to get around California's anti-
deficiency laws discussed below, by attempting to have such a guaranty
executed. In a non-purchase money lending transaction, the guaranty must be
more than a statement that the guarantor is guarantying the obligation of the
other. The well-drafted guaranty includes numerous waivers of California statutes
which if not waived within the provisions of the guaranty, may preclude the lender
from enforcing the guaranty following a non-judicial foreclosure sale. Any
limitations of the guaranty (e.g., if the guarantor is not guarantying the full amount
of the loan) need to be carefully drafted, and the guaranty should include all
costs of collection expended in enforcing the promissory note and other loan
documents, as well as an attorney's fee provision.

- **A Lender's ALTA Policy of Title Insurance** is recommended. Too often the
mantra to "keep it simple" or "we do not need to over lawyer the deal" defies
common sense of obtaining title coverage. Contrary to conventional wisdom, the
volume of title litigation relating to single family residences far exceeds litigation
relating to title issues on commercial property. Prior to making the loan, the
lender should always inspect the property and try to understand if there are
encroachments immediately visible. While the cost of a survey may not be
warranted, if in doubt order it. Finally, upon obtaining the tile commitment and
prior to closing, one must make sure to read the exceptions to coverage, and
determine if there are any potential issues relating to outstanding monetary
obligations showing of record, easements or other matters. Always read and
review, or obtain counsel to assist in the review of the underlying documents
relating to the title exceptions. Endorsements should be obtained in connection
with all title exceptions.
Purchase money loans and other private party loans should be entered into with a clear eye for what is at the end of the tracks. The smart lender has considered in advance the problems it will encounter if there is a default on the loan, and it is necessary to enforce the loan documents signed by the borrower and guarantor.

In the case of the purchase money loan, there will be only one remedy: foreclosure. If after foreclosure the property is worth less than the amount owed (resulting in being able to collect less than the amount owed, and the uncollected amount constituting a "deficiency"), there will be no further right to proceed against the borrower. Yes, the borrower walks free. This protection is afforded the borrower pursuant to California's anti-deficiency legislation. In the event the lender obtained a guaranty to the purchase money loan, California Law is unsettled as to whether it will be enforceable against the guarantor in a purchase money loan transaction.

In the event of a non purchase money loan, if there has been a non-judicial foreclosure, and the property is worth less than the loan, the lender will be precluded from bringing any further action against the borrower to collect. The lender's right to seek a deficiency against the borrower on a non-purchase money loan only exists if it brings a judicial foreclosure. Unlike the non-judicial foreclosure, which is conducted by the trustee designated on the deed of trust and may be completed in less than 120 days, a judicial foreclosure first requires the filing of a lawsuit and may take six (6) months or more to complete, following which time the borrower has a one (1) year period to redeem the property by paying off the loan; and since the borrower has a one (1) year right of redemption, the ability to sell the property to a third party during the one (1) year redemption period is impaired. In most instances, the lender may proceed against the guarantor for a deficiency on a non-purchase money loan.

Purchase money lending and other private lending while seemingly a fast track solution to financial woes, is mired with issues, only some of which are discussed above. Proceed with caution and consider at all times whether successful engineering requires the use of qualified professionals.

DISCLAIMER: This article is intended to provide a general overview of lending issues. It is not intended nor should it be relied upon as legal advice. Each loan is fact specific and as such different principles of law may apply, counsel should be consulted. For additional information contact Gordon L. Gerson at GERSON LAW FIRM APC, ggerson@gersonlaw.com or call (858) 452-5400.