

From the Author of the Best-Selling Book, *Flipping Properties*

FINANCING
SECRETS
OF A
MILLIONAIRE
REAL ESTATE
INVESTOR

WILLIAM BRONCHICK



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C O N T E N T S

1. Introduction to Real Estate Financing 1

- Understanding the Time Value of Money 2
- The Concept of Leverage 2
- Owning Property “Free and Clear” 5
- How Financing Affects the Real Estate Market 6
- How Financing Affects Particular Transactions 7
- How Real Estate Investors Use Financing 8
- When Is Cash Better Than Financing? 9
- What to Expect from This Book 10
- Key Points 10

2. A Legal Primer on Real Estate Loans 11

- What Is a Mortgage? 11
 - Promissory Note in Detail 12
 - The Mortgage in Detail 14
 - The Deed of Trust 15
- The Public Recording System 15
- Priority of Liens 16
- What Is Foreclosure? 17
 - Judicial Foreclosure 17
 - Nonjudicial Foreclosure 18
 - Strict Foreclosure 19
- Key Points 19

3. Understanding the Mortgage Loan Market 21

- Institutional Lenders 21
- Primary versus Secondary Mortgage Markets 22
- Mortgage Bankers versus Mortgage Brokers 23
- Conventional versus Nonconventional Loans 25
 - Conforming Loans 25
 - Nonconforming Loans 28

| | |
|--------------------------------------|----|
| Government Loan Programs | 28 |
| Federal Housing Administration Loans | 29 |
| The Department of Veterans Affairs | 30 |
| State and Local Loan Programs | 31 |
| Commercial Lenders | 31 |
| Key Points | 32 |

4. Working with Lenders 33

| | |
|--|----|
| Interest Rate | 33 |
| Loan Amortization | 34 |
| 15-Year Amortization versus 30-Year Amortization | 36 |
| Balloon Mortgage | 37 |
| Reverse Amortization | 38 |
| Property Taxes and Insurance Escrows | 38 |
| Loan Costs | 39 |
| Origination Fee | 39 |
| Discount Points | 39 |
| Yield Spread Premiums: The Little Secret Your Lender Doesn't Want You to Know | 39 |
| Loan Junk Fees | 40 |
| "Standard" Loan Costs | 41 |
| Risk | 44 |
| Nothing Down | 45 |
| Loan Types | 46 |
| Choosing a Lender | 48 |
| Length of Time in Business | 49 |
| Company Size | 50 |
| Experience in Investment Properties | 50 |
| How to Present the Deal to a Lender | 51 |
| Your Credit Score | 52 |
| Your Provable Income | 56 |
| The Property | 56 |
| Loan-to-Value | 58 |
| The Down Payment | 59 |
| Income Potential and Resale Value of the Property | 60 |
| Financing Junker Properties | 60 |
| Refinancing—Worth It? | 61 |
| Filling Out a Loan Application | 61 |
| Key Points | 62 |

5. Creative Financing through Institutional Lenders 63

- Double Closing—Short-Term Financing without Cash 63
- Seasoning of Title 65
- The Middleman Technique 67
 - Case Study #1: Tag Team Investing 69
 - Case Study #2: Tag Team Investing 70
- Using Two Mortgages 71
- No Documentation and Nonincome Verification Loans 72
 - Develop a Loan Package 75
- Subordination and Substitution of Collateral 76
 - Case Study: Subordination and Substitution 77
- Using Additional Collateral 79
 - Blanket Mortgage 79
 - Using Bonds as Additional Collateral 80
- Key Points 82

6. Hard Money and Private Money 83

- Emergency Money 83
- Where to Find Hard-Money Lenders 84
- Borrowing from Friends and Relatives 85
- Using Lines of Credit 86
- Credit Cards 86
- Key Points 87

7. Partnerships and Equity Sharing 89

- Basic Equity-Sharing Arrangement 90
 - Scenario #1: Buyer with Credit and No Cash 90
 - Scenario #2: Buyer with Cash and No Credit 91
 - Your Credit Is Worth More Than Cash 91
 - Tax Code Compliance 92
 - Pitfalls 93
 - Alternatives to Equity Sharing 93
- Joint Ventures 94
 - Using Joint Venture Partnerships for Financing 94
 - Legal Issues 95
- Alternative Arrangement for Partnership 95
 - Case Study: Shared Equity Mortgage with Seller 96
- When Does a Partnership Not Make Sense? 97
- Key Points 98

8. The Lease Option 99

- Financing Alternative 100
- Lease—The Right to Possession 100
 - Sublease 100
 - Assignment 100
- More on Options, the “Right” to Buy 101
 - An Option Can Be Sold or Exercised 102
 - Alternative to Selling Your Option 102
- The Lease Option 103
 - The Lease Purchase 103
 - Lease Option of Your Personal Residence 104
 - The Sandwich Lease Option 106
 - Cash Flow 107
 - Equity Buildup 107
 - Straight Option without the Lease 108
 - Case Study: Sandwich Lease Option 109
 - Sale-Leaseback 110
 - Case Study: Sale-Leaseback 111
- Key Points 112

9. Owner Financing 113

- Advantages of Owner Financing 115
 - Easy Qualification 115
 - Cheaper Costs 116
 - Faster Closing 116
 - Less Risk 116
 - Future Discounting 117
- Assuming the Existing Loan 117
 - Assumable Mortgages 117
 - Assumable with Qualification 118
- Buying Subject to the Existing Loan 118
 - Risk versus Reward 119
 - Convincing the Seller 120
 - A Workaround for Down-Payment Requirements 121
- Installment Land Contract 122
 - Benefits of the Land Contract 124
 - Problems with the Land Contract 125
- Using a Purchase Money Note 125
 - Variation: Create Two Notes, Sell One 126
 - Another Variation: Sell the Income Stream 126

| | |
|--|-----|
| Wraparound Financing | 127 |
| The Basics of Wraparound Financing | 127 |
| Wraparound versus Second Mortgage | 130 |
| Mirror Wraparound | 132 |
| Wraparound Mortgage versus Land Contract | 133 |
| Key Points | 133 |

10. Epilogue 135

| | |
|--|-----|
| Appendix A Interest Payments Chart | 139 |
| Appendix B State-by-State Foreclosure Guide | 141 |
| Appendix C Sample Forms | 143 |
| Uniform Residential Loan Application | |
| [FNMA Form 1003] | 144 |
| Good Faith Estimate of Settlement Costs | 148 |
| Settlement Statement [HUD-1] | 149 |
| Note [Promissory–FNMA] | 151 |
| California Deed of Trust (Short Form) | 153 |
| Mortgage [Florida–FNMA] | 155 |
| Option to Purchase Real Estate [Buyer-Slanted] | 171 |
| Wrap Around Mortgage [or Deed of Trust] Rider | 173 |
| Installment Land Contract | 174 |
| Subordination Agreement | 176 |
| Glossary | 179 |
| Resources | 187 |
| Suggested Reading | 187 |
| Suggested Web Sites | 188 |
| Real Estate Financing Discussion Forums | 188 |
| Index | 189 |

Introduction to Real Estate Financing

Knowledge is power.

-Francis Bacon

In 1991, I made my first attempt at financing an investment property through creative means. With a lot of guts and a little knowledge, I made an offer that was accepted by the seller. I tendered \$1,000 as earnest money on the sales contract, then proceeded to try to make the deal work. I failed, lost my \$1,000, but I learned an important lesson—a little knowledge can be dangerous. I decided then to become a master at real estate finance.

Financing has traditionally been, and will always be, an integral part of the purchase and sale of real estate. Few people have the funds to purchase properties for all cash, and those that do rarely sink all of their money in one place. Even institutional and corporate buyers of real estate use borrowed money to buy real estate.

This book explains how to utilize real estate financing in the most effective and profitable way possible. Mostly, this book focuses on acquisition techniques for investors, but these techniques are also applicable to potential homeowners.

Understanding the Time Value of Money

In order to understand real estate financing, it is important that you understand the time value of money. Because of inflation, a dollar today is generally worth less in the future. Thus, while real estate values may increase, an all-cash purchase may not be economically feasible, because the investor's cash may be utilized in more effective ways.

The cost of borrowing money is expressed in interest payments, usually a percent of the loan amount. Interest payments can be calculated in a variety of ways, the most common of which is simple interest. Simple interest is calculated by multiplying the loan amount by the interest rate, then dividing it up into period (12 months, 15 years, etc).

☛ **Example:** A \$100,000 loan at 12% simple interest is \$12,000 per year, or \$1,000 per month. To calculate monthly simple-interest payments, take the loan amount (principal), multiply it by the interest rate, and then divide by 12. In this example, $\$100,000 \times .12 = \$12,000$ per year $\div 12 = \$1,000$ per month.

Mortgage loans are generally not paid in simple interest but rather by amortization schedules (discussed in Chapter 4), calculated by amortization tables (see Appendix A). *Amortization*, derived from the Latin word "amorta" (death), is to pay down or "kill" a debt. Amortized payments remain the same throughout the life of the loan but are broken down into interest and principal. The payments made near the beginning of the loan are mostly interest, while the payments near the end are mostly principal. Lenders increase their return and reduce their risk by having most of the profit (interest) built into the front of the loan.

The Concept of Leverage

Leverage is the process of using borrowed money to make a return on an investment. Let's say you bought a house using all of your cash for \$100,000. If the property were to increase in value 10 percent

The Federal Reserve and Interest Rates

The Federal Reserve (the Fed) is an independent entity created by an Act of Congress in 1913 to serve as the central bank of the United States. There are 12 regional banks that make up the Federal Reserve System. While the regional banks are corporations whose stock is owned by member banks, the shareholders have no influence over the Federal Reserve banks' policies.

Among other things, the function of the Fed is to try to regulate inflation and credit conditions in the U.S. economy. The Federal Reserve banks also supervise and regulate depository institutions.

So how does the Fed's policy affect interest rates on loans? To put it simply, by manipulating "supply and demand." The Fed changes the money supply by increasing or decreasing reserves in the banking system through the buying and selling of securities. The changes in the money supply, in turn, affect interest rates: the lower the supply of money, the higher the interest rate that is charged for loans between banks. The more it costs a bank to borrow money, the more they charge in interest to consumers to borrow that money. The preceding is a simplified explanation, because there are other factors in the world economy that affect interest rates and money supply. And, of course, there are also widely varying opinions by economists as to what factors drive the economy and interest rates.

over 12 months, it would now be worth \$110,000. Your return on investment would be 10 percent annually (of course, you would actually net less because you would incur costs in selling the property).

$$\text{Equity} = \text{Property value} - \text{Mortgage debt}$$

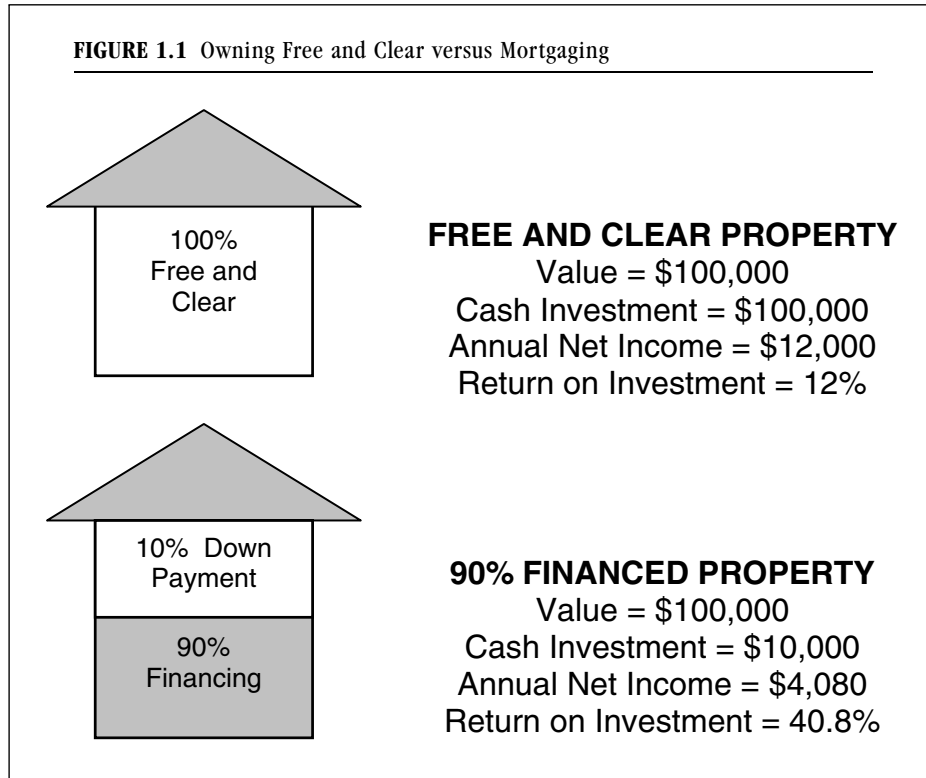
If you purchased a property using \$10,000 of your own cash and \$90,000 in borrowed money, a 10 percent increase in value would still result in \$10,000 of increased equity, but your return on cash is 100 percent (\$10,000 investment yielding \$20,000 in equity). Of course, the borrowed money isn't free; you would have to incur loan costs and interest payments in borrowing money. However, by renting the property in the meantime, you would offset the interest expense of the loan.

Calculating Return on Investment

Annual return on investment (ROI) is the interest rate you yield on your cash investment. It is calculated by taking the annual cash flow or equity increase and dividing it by the amount of cash invested.

Let's also look at the income versus expense ratios. If you purchased a property all cash for \$100,000 and collected \$1,000 per month in rent, your annual cash-on-cash return is 12 percent (simply divide the annual income, \$12,000, by the amount of cash invested, \$100,000).


If you borrowed \$90,000 and the payments on the loan were \$660 per month, your annual net income is \$4,080 (\$12,000 - [\$660 × 12]), but your annual cash-on-cash return is about 40 percent (annual cash of \$4,080 divided by \$10,000 invested).



So, if you purchased ten properties with 10 percent down and 90 percent financing, you could increase your overall profit by more than threefold. Of course, you would also increase your risk, which will be discussed in more detail in Chapter 4.

Owning Property “Free and Clear”

For some investors, the goal is to own properties “free and clear,” that is, with no mortgage debt. While this is a worthy goal, it does not necessarily make financial sense. See Figure 1.1.

 **Example:** Consider a \$100,000 property that brings in \$10,000 per year in net income (*net* means gross rents collected, less expenses, such as property taxes, maintenance, utilities, and hazard insurance). The \$100,000 in equity thus yields a 10 percent annual return on investment (\$10,000, the annual net cash flow, divided by \$100,000, the equity investment).

If the property were financed for 80 percent of its value (\$80,000) at 7.5 percent interest, the monthly payment would be approximately \$560 per month, or \$6,720 per year. Net rent of \$10,000 per year minus \$6,720 in debt payments equals \$3,280 per year in net cash flow. Divide the \$3,280 in annual cash flow by the \$20,000 in equity and you have a 16.4 percent return on investment. Furthermore, with \$80,000 more cash, you could buy four more properties. As you can see, financing, even when you don't necessarily "need" to do so, can be more profitable than investing all of your cash in one property.

How Financing Affects the Real Estate Market

Because financing plays a large part in real estate sales, it also affects values; the higher the interest rate, the larger your monthly payment. Conversely, the lower the interest rate, the lower the monthly payment. Thus, the lower the interest rate, the larger the mortgage loan you can afford to pay. Consequently, the larger the mortgage you can afford, the more the seller can ask for in the sales prices.

Also, people with less cash are usually more concerned with their payment than the total amount of the purchase price or loan amount. On the other hand, people with all cash are more concerned with price. Because most buyers borrow most of the purchase price, the prices of houses are affected by financing. Thus, when interest rates are low, housing prices tend to increase, because people can afford a higher monthly payment. Conversely, when interest rates are higher, people cannot afford as much a payment, generally driving real estate prices down.

Since the mid-1990s, the prices of real estate have dramatically increased in most parts of the country. The American economy has grown, the job growth during this period has been good, but most important, interest rates have been low.

How Financing Affects Particular Transactions

When valuing residential properties, real estate appraisers generally follow a series of standards set forth by professional associations (the most well-known is the Appraisal Institute). Sales of comparable properties are the general benchmark for value. Appraisers look not just at housing sale prices of comparable houses, but also at the financing associated with the sales of these houses. If the house was owner-financed (discussed in Chapter 9), the interest rate is generally higher than conventional rates and/or the price is inflated. The price is generally inflated because the seller's credit qualifications are looser than that of a bank, which means the buyer will not generally complain about the price.

Take a Cue from Other Industries

The explosion of the electronics market, the automobile market, and other large-ticket purchase markets is directly affected by financing. Just thumb through the Sunday newspapers and you will see headlines such as “no money down” or “no payments for one year.” These retailers have learned that financing moves a product because it makes it easier for people to justify the purchase. Likewise, the price of a house may be stretched a bit more when it translates to just a few dollars more per month in mortgage payments.

Appraisals on income properties are done in a variety of ways, one of which is the “income” approach. The *income approach* looks at the value of the property versus the rents the property can produce. While financing does not technically come into the equation, it does affect the property’s profitability to the investor. Thus, a property that can be financed at a lower interest rate will be more attractive to the investor if cash flow is a major concern.

Tax Impact of Financing

Down payments made on a property as an investor are not tax-deductible. In fact, a large down payment offers no tax advantage at all because the investor’s tax basis is based on the purchase price, not the amount he or she puts down. However, because mortgage interest is a deductible expense, the investor does better tax wise by saving his or her cash. Think about it: the higher the monthly mortgage payment, the less cash flow, the less taxable income each year. While positive cash flow is desirable, it does not necessarily mean that a property is more profitable because it has more cash flow. A larger down payment will obviously increase monthly cash flow, but it is not always the best use of your money.

How Real Estate Investors Use Financing

As discussed above, investors use mortgage loans to increase their leverage. The more money an investor can borrow, the more he or she can leverage the investment. Rarely do investors use all cash to purchase properties, and when they do, it is on a short-term basis. They usually refinance the property to get their cash back or sell the property for cash.

The challenge is that loans for investors are treated as high-risk by lenders when compared to noninvestor (owner-occupied properties) loans. Lenders often look at leveraged investments as risky and are less willing to loan money to investors. Lenders assume (often correctly) that the less of your own money you have invested, the more likely you will be to walk away from a bad property. In addition, fewer investor loan programs mean less competition in the industry, which leads to higher loan costs for the investor. The goal of the investor thus is to put forth as little cash as possible, pay the least amount in loan costs and interest, while keeping personal risk at a minimum. This is quite a challenge, and this book will reveal some of the secrets for accomplishing this task.

When Is Cash Better Than Financing?

Using all cash to purchase a property may be better than financing in two particular situations. The first situation is a short-term deal, that is, you intend to sell the house shortly after you buy it (known as “flipping”). When you have the cash to close quickly, you can generally get a tremendous discount on the price of a house. In this case, financing may delay the transaction long enough to lose an opportunity. Cash also allows you to purchase properties at a larger discount. You’ve heard the expression, “money talks, BS walks.” This is particularly true when making an offer to purchase a property through a real estate agent. The real estate agent is more likely to recommend to his or her client a purchase offer that is not contingent on the buyer obtaining bank financing.

The second case is one in which you can use your retirement account. You can use the cash in your IRA or SEP to purchase real estate, and the income from the property is tax-deferred. In order to do this, you need an aggressive self-directed IRA custodian (oddly enough, most IRA custodians view real estate as “risky” and the stock market as “safe”). Two such custodians are Mid Ohio Securities, <www.midoh.com>, or Entrust Administration, <www.entrustadmin.com>.

Understanding a Cash Offer versus Paying All Cash

If you make a “cash offer” on a property, it does not necessarily mean you are using all of your own cash. It means the seller is receiving all cash, as opposed to the seller financing some part of the purchase price (discussed more fully in Chapter 9).

What to Expect from This Book

This book will show you how to finance properties with as little cash as possible, while maintaining minimum risk and maximum profit.

The first few chapters describe the mortgage loan process, legal details, and the banking industry. Chapter 4 covers different types of lenders and loans, and the benefits of each. Chapter 5 covers how to creatively use institutional loan programs as an investor. Chapters 6, 7, 8, and 9 cover creative, noninstitutional financing.

As with any technique on real estate acquisition or finance, you should review the process with a local professional, including an attorney. Also, keep in mind that while most of these ideas are applicable nationwide, local practices, laws, rules, customs, and market conditions may require variations or adaptations for your particular use.

Key Points

- Interest rates affect property values.
- Financing affects the value of a property to an investor.
- Investors use financing to leverage their investments.

A Legal Primer on Real Estate Loans

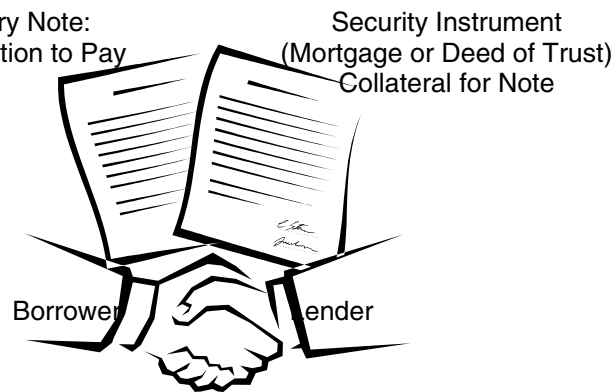
If there were no bad people there would be no good lawyers.

-Charles Dickens

Before we discuss lenders, loans, and loan terms, it is essential that you understand the legal fundamentals and paperwork involved with mortgage loans. By analogy, you cannot make a living buying and selling automobiles without a working knowledge of engines and car titles. Likewise, you need to understand how the paperwork fits into the real estate transaction. Without a working knowledge of the paperwork, you are at the mercy of those who have the knowledge. Furthermore, without the know-how your risk of a large mistake or missed opportunity increases tremendously.

What Is a Mortgage?

Most of us think of going to a bank to get a mortgage. Actually, you go to the bank to get a loan. Once you are approved for the loan, you sign a promissory note to the lender, which is a legal promise to

FIGURE 2.1 The Mortgage Transition

pay. You also give the lender (not get) a mortgage as security for repayment of the note. A *mortgage* (also called a “deed of trust” in some states) is a security agreement under which the borrower pledges his or her property as collateral for payment. The mortgage document is recorded in the county property records, creating a lien on the property in favor of the lender. See Figure 2.1.

If the underlying obligation (the promissory note) is paid off, the lender must release the collateral (the mortgage). The release will remove the mortgage lien from the property. If you search the public records of a particular property, you will see many recorded mortgages that have been placed and released over the years.

Promissory Note in Detail

A note is an IOU or promise to pay; it is a legal obligation. A promissory note (also known as a “note” or “mortgage note”) spells out the amount of the loan, the interest to be paid, how and when payments are made, and what happens if the borrower defaults. The note

may also contain disclosures and other provisions required by federal or state law.

A Mortgage Note Is a Negotiable Instrument

Like a check, a mortgage note can be assigned and collected by whoever holds the note. As discussed in Chapter 3, mortgage notes are often bought, sold, traded, and hypothecated (pledged as collateral).

Most lenders use a form of note that is approved by the Federal National Mortgage Association (FNMA, or Fannie Mae). A sample form of this note can be found in Appendix C. The note is signed (in legal terms, “executed”) by the borrower. The original note is held by the lender until the debt is paid in full, at which time the original note is returned to the borrower marked “paid in full.”

A Promissory Note Is a Personal Obligation

Because promissory notes are personal obligations, the history of payments will appear on your credit file, even if the debt is used for investment. If you fail to pay on the note, your credit will be adversely affected, and you risk a lawsuit from the lender. Some notes are nonrecourse, that is, the lender cannot sue you personally. Although not always possible, you should try to make sure most of your debt is nonrecourse.

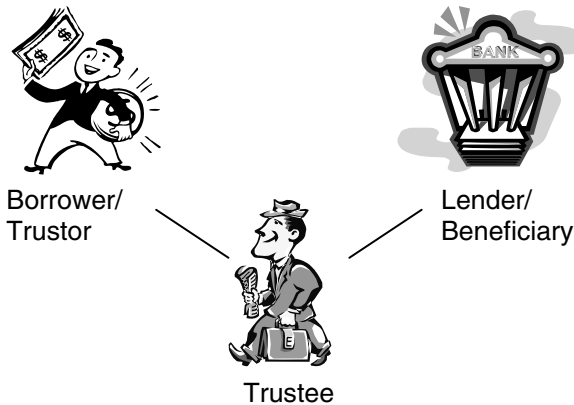
FIGURE 2.2 Parties to a MortgageBorrower/
MortgagorLender/
Mortgagee

The Mortgage in Detail

The security agreement executed by the borrower pledges the property as collateral for the note. Known by most as a “mortgage,” this document, when recorded (discussed below), creates a lien in favor of the lender. The mortgage agreement is generally a standardized form approved by FNMA. While the form of note is generally the same from state to state, the mortgage form differs slightly because the legal process of foreclosure (the lender’s right to proceed against the collateral) is different in each state. See Figure 2.2.

The mortgage document will state that upon default of the note, the lender can exercise its right to foreclose on the property. Foreclosure is the process of lenders exercising their legal right to proceed against the collateral for the loan (discussed later in this chapter). It also places other obligations upon the borrower, such as

- maintaining the property,
- paying property taxes, and
- keeping the property insured.

FIGURE 2.3 Parties to a Deed of Trust

The Deed of Trust

Some states (e.g., California) use a document called a “deed of trust” (AKA “trust deed”) rather than a mortgage. The *deed of trust* is a document in which the trustor (borrower) gives a deed to the neutral third party (trustee) to hold for the beneficiary (lender). A deed of trust is worded almost exactly the same as a mortgage, except for the names of the parties. Thus, the deed of trust and mortgage are essentially the same, other than the foreclosure process. See Figure 2.3.

The Public Recording System


The recording system gives constructive notice to the public of the transfer of an interest in property. Recording simply involves bringing the original document to the local county courthouse or county clerk’s office. The original document is copied onto a computer file or onto microfiche and is returned to the new owner. There is a filing fee of about \$6 to \$10 per page for recording the document.

In addition, the county, city, and/or state may assess a transfer tax based on either the value of the property or the mortgage amount.

A deed or other conveyance does not have to be recorded to be a valid transfer of an interest. For example, what happens if John gives title to Mary, then he gives it again to Fred, and Fred records first? What happens if John gives a mortgage to ABC Savings and Loan, but the mortgage is not filed for six months, and then John immediately borrows from another lender who records its mortgage first? Who wins and loses in these scenarios?

Most states follow a “race-notice” rule, meaning that the first person to record his document, wins, so long as

- he received title in good faith,
- he paid value, and
- he had no notice of a prior transfer.

 **Example:** John buys a home and, in so doing, borrows \$75,000 from ABC Savings Bank. John signs a promissory note and a mortgage pledging his home as collateral. Because ABC messes up the paperwork, the mortgage does not get recorded for 18 months. In the interim, John borrows \$12,000 from The Money Store, for which he gives a mortgage as collateral. The Money Store records its mortgage, unaware of John’s unrecorded first mortgage to ABC. The Money Store will now have a first mortgage on the property.

Priority of Liens

Liens, like deeds, are “first in time, first in line.” Thus, if a property is owned free and clear, a mortgage recorded will be a *first mortgage*. A mortgage recorded thereafter will be a *second mortgage* (sometimes called a *junior mortgage* because its lien position is behind the first mortgage). Likewise, any judgments or other liens recorded later are also junior liens. Holding a first mortgage is a desirable

position because a foreclosure on a mortgage can wipe out all liens that are recorded behind it (called “junior lien holders”). The process of foreclosure will be discussed in more detail later in this chapter.

At the closing of a typical real estate sale, the seller conveys a deed to the buyer. Most buyers obtain a loan from a conventional lender for most of the cash needed for the purchase price. As discussed earlier, the lender gives the buyer cash to pay the seller, and the buyer gives the lender a promissory note. The buyer also gives the lender a security instrument (mortgage or deed of trust) under which she pledges the property as collateral. When the transaction is complete, the buyer has the title recorded in her name and the lender has a lien recorded on the property.

What Is Foreclosure?

Foreclosure is the legal process of the mortgage holder taking the collateral for a promissory note in default. The process is slightly different from state to state, but there are basically two types of foreclosure: judicial and nonjudicial. In mortgage states, judicial foreclosure is used most often, whereas in deed of trust states, nonjudicial (called power of sale) foreclosure is used. Most states permit both types of proceedings, but it is common practice in most states to exclusively use one method or the other. A complete state-by-state list of foreclosure proceedings can be found in Appendix B.

Judicial Foreclosure

Judicial foreclosure is a lawsuit that the lender (mortgagee) brings against the borrower (mortgagor) to force the sale of the property. About one-third of the states use judicial foreclosure. Like all lawsuits, a judicial foreclosure starts with a summons (a legal notice of the lawsuit) served on the borrower and any other parties with inferior rights in the property. (Remember, all junior liens, including ten-

ancies, are wiped out by the foreclosure, so they all need to be given legal notice of the proceeding.)

If the borrower does not file an answer to the lawsuit, the lender gets a judgment by default. A person is then appointed by the court to compute the total amount due including interest and attorney's fees. The lender then must advertise a notice of sale in the newspaper for several weeks.

If the total amount due is not paid by the sale date, a public sale is held on the courthouse steps. The entire process can take as little as a few months to a year depending on your state and the volume of court cases in your county.

The sale is conducted like an auction, in that the property goes to the highest bidder. Unless there is significant equity in the property, the only bidder at the sale will be a representative of the lender. The lender can bid up to the amount it is owed, without having to actually come out of pocket with cash to purchase the property. Once the lender has ownership of the property, it will try to sell it through a real estate agent.

If the proceeds from the sale are insufficient to satisfy the amount owed to the lender, the lender may be entitled to a deficiency judgment against the borrower and anyone else who guaranteed the loan. Some states prohibit a lender from obtaining a deficiency judgment against a borrower (applies only to owner-occupied, not investor properties). In practice, few lenders seek a deficiency judgment against the borrower.

Nonjudicial Foreclosure

A majority of the states permit a lender to foreclose without a lawsuit, using what is commonly called a "power of sale." Upon default of the borrower, the lender simply files a notice of default and a notice of sale that is published in the newspaper. The entire process generally takes about 90 days.

What Is a Deficiency?

In order for a borrower to be held personally liable for a foreclosure deficiency, there must be recourse on the note. Most loans in the residential market are with recourse. If possible, particularly when dealing with seller-financed loans (see Chapter 9), have a corporate entity sign on the note in your place. A corporation or limited liability company (LLC) protects its business owners from personal liability for business obligations. Upon default, the lender's legal recourse will be against the property or the corporate entity, but not against you, the business owner.

Strict Foreclosure

Two states—New Hampshire and Connecticut—permit strict foreclosure, which does not require a sale. When the court proceeding is started, the borrower has a certain amount of time to pay what is owed. Once that date has passed, title reverts to the lender without the need for a sale.

Key Points

- A mortgage is actually two things—a note and a security instrument.
- Some states use a deed of trust as a security instrument.
- Liens are prioritized by recording date.
- Foreclosure processes differ from state to state.

Understanding the Mortgage Loan Market

Neither a borrower nor a lender be; for loan oft loses both itself and friend.

—William Shakespeare

The mortgage business is a complicated and ever-changing industry. It is important that you understand how the mortgage market works and how the lenders make their profit. In doing so, you will gain an appreciation of loan programs and why certain loans are offered by certain lenders.

There are several categories of lenders that are discussed in this chapter, and many lenders will fit in more than one category. In addition, some categories of lending are more of a lending “style” than a lender category; this concept will make more sense after you finish reading this chapter.

Institutional Lenders

The first broad category of distinction is institutional versus private. Institutional lenders include commercial banks, savings and

loans or thrifts, credit unions, mortgage banking companies, pension funds, and insurance companies. These lenders generally make loans based on the income and credit of the borrower, and they generally follow standard lending guidelines. Private lenders are individuals or small companies that do not have insured depositors and are generally not regulated by the federal government.

Primary versus Secondary Mortgage Markets

First, these markets should not be confused with first and second mortgages, which were discussed in Chapter 2. *Primary mortgage lenders* deal directly with the public. They *originate* loans, that is, they lend money directly to the borrower. Often referred to as the “retail” side of the business, lenders make a profit from loan processing fees, not from the interest paid on the loan.

Primary mortgage lenders generally lend money to consumers, then sell the mortgage notes (together in large packages, not one at a time) to investors on the *secondary mortgage market* to replenish their cash reserves.

Portfolio lenders don't sell their loans to the secondary market, but rather they keep the loans as part of their portfolio (some lenders sell part of their loans and keep others as part of their portfolio). As such, they don't necessarily need to conform their loans to guidelines established by the Federal National Mortgage Association (FNMA) or the Federal Home Loan Corporation (FHLMC). Small, local banks that portfolio their loans can be an investor's best friend, because they can bend the rules to suit that investor's needs.

Larger portfolio lenders can handle more loans, because they have more funds, but they are not as flexible as the small banks. Larger portfolio lenders can also give you an unlimited amount of loans, whereas FNMA/FHLMC lenders have limits on the number of loans they can give you (currently loans for nine properties, but these limits often change). The nation's larger portfolio lenders include World Savings and Washington Mutual.

Why Sell the Loan?

Lenders sell loans for a variety of reasons. First, they want to maximize their cash reserves. By law, banks must have a minimum reserve, so if they lend all of their available cash, they can't do any more loans. Second, they want to minimize their risk of interest rate fluctuations in the market.

The largest buyers on the secondary market are FNMA (or “Fannie Mae”), the Government National Mortgage Association (GNMA, or “Ginnie Mae”), and the FHLMC (or “Freddie Mac”). Private financial institutions such as banks, life insurance companies, private investors, and thrift associations also buy notes.

FNMA is a quasi-governmental agency (controlled by the government but owned by private shareholders) that buys pools of mortgage loans in exchange for mortgage-backed securities. GNMA is a division of the Department of Housing and Urban Development (HUD), a governmental agency. Because most loans are sold on the secondary mortgage market to FNMA, GNMA, or FHLMC, most primary mortgage lenders conform their loan documentation to these agencies' guidelines (known as a “conforming” loan). Although primary lenders sell the loans on the secondary mortgage market, many of the primary lenders will continue to collect payments and deal with the borrower, a process called *servicing*.

Mortgage Bankers versus Mortgage Brokers

Many consumers assume that “mortgage companies” are banks that lend their own money. In fact, a company that you deal with may be either a mortgage banker or a mortgage broker.

A *mortgage banker* is a direct lender; it lends you its own money, although it often sells the loan to the secondary market. Mortgage

Loan Servicing

Loan servicing is an immensely profitable business for mortgage banks and other lenders. Servicing involves collecting the loan payments, accounting for tax and insurance escrows, dealing with customer issues, and mailing notices to the customer and the Internal Revenue Service (IRS). The average fee charged for servicing is about $\frac{3}{8}$ percent of the loan amount. This may not sound like much, but try multiplying it by a billion dollars!

bankers (also known as “direct lenders”) sometimes retain servicing rights as well.

A *mortgage broker* is a middleman who does the loan shopping and analysis for the borrower and puts the lender and borrower together. Many of the lenders through which the broker finds loans do not deal directly with the public (hence the expression “wholesale lender”).

Using a mortgage banker can save the fees of a middleman and can make the loan process easier. A mortgage banker can give you direct loan approval, whereas a broker gives you information second-hand. However, many mortgage banks are limited in what they can offer, which is essentially their own product. In addition, if you present your loan application in a poor light, you’ve already made a bad impression. I am not suggesting you lie or mislead a lender, but understand that presenting a loan to a lender is like presenting your taxes to the IRS. There are many ways to do it, all of which are valid and legal. Using a mortgage broker allows you to present a loan application to a different lender in a different light (and you are a “fresh” face).

A mortgage broker charges a fee for his or her service but has access to a wide variety of loan programs. He or she also may have knowledge of how to present your loan application to different lenders for approval. Some mortgage bankers also broker loans. As an

investor, it is wise to have both a mortgage broker and a mortgage banker on your team.

Mortgage Brokering

Keep in mind that mortgage brokering is an unlicensed profession in many states. If there is no licensing agency to complain to in your state, make sure you have personal references before you do business with a mortgage broker.

Conventional versus Nonconventional Loans

Conventional financing, by definition, is not insured or guaranteed by the federal government (see discussion of government loans later in this chapter). Conventional loans are generally broken into two categories: conforming and nonconforming. A *conforming loan* is one that conforms or adheres to strict Fannie Mae/Freddie Mac loan underwriting guidelines.

Conforming Loans

Conforming loans are a low risk to the lender, so they offer the lowest interest rates. Conforming loans also have the strictest underwriting guidelines.

Conforming loans have the following three basic requirements:

1. *Borrower must have a minimum of debt.* Lenders look at the ratio of your monthly debt to income. Your regular monthly expenses (including mortgage payments, property taxes, insurance) should total no more than 25 percent to 28 percent of your gross monthly income (called “front-end ratio”). Further-

Underwriting

Underwriting is the task of applying guidelines that provide standards for determining whether or not a loan should be approved. Understand that loan approval is the final step in the loan application process before the money is handed over (known as “funding” a loan). Note that many lenders will give “preapproval” of a loan. Preapproval is really a half-baked commitment. Until a loan is approved in writing, the bank has no legal commitment to fund. And, in many cases, loan approval is often given with conditions attached that must be satisfied before closing.

- more, your monthly expenses plus other long-term debt payments (e.g., student loan, automobile, alimony, child support) should total no more than 36 percent of your gross monthly income (called “back-end ratio”). These ratios can sometimes be increased if the borrower has excellent credit or puts up a larger down payment.
2. *Good credit rating.* You must be current on payments. Lenders will also require a certain minimum credit score (discussed in Chapter 4).
 3. *Funds to close.* You must have the requisite down payment (generally 20 percent of the purchase price, although lenders often bend this rule), proof of where it came from, and a few months of cash reserves in the bank.

FHA-insured loans (discussed later in this chapter) allow higher LTVs but are more limited in scope and are not generally available to investors (discussed later in this chapter).

What Is the Loan-to-Value (LTV) Ratio?

Loan-to-value ratio is the percentage of the value of the property the lender is willing to lend. For example, if the property is worth \$100,000, an 80 percent LTV loan will be for \$80,000. Note that LTV is not the same as loan-to-purchase price, because the purchase price may be more or less than the appraised value (discussed in more detail in Chapter 5).

Private mortgage insurance. Private mortgage insurance (PMI) requirements apply only to first mortgage loans; thus, you can get around PMI requirements by borrowing a first and second mortgage loan. So long as the first mortgage loan is less than 80 percent loan-to-value, PMI is not required. However, the second mortgage loan may have a high interest rate, so that the blending of the interest rate on the first and second mortgage loans exceeds what you would be paying with a first mortgage and PMI. Use a calculator to figure out which is more profitable for you (the formula for interest rate blending is discussed in Chapter 5).

One way around the large down payment is to purchase PMI. Also known as “mortgage guaranty insurance,” PMI will cover the lender’s additional risk for a high loan-to-value ratio (LTV) program. The insurer will reimburse the lender for its additional risk of the high LTV.

PMI should not be confused with mortgage life insurance, which pays the borrower’s loan balance in full when he or she dies (not recommended—regular term life insurance is a better deal for the money).

Nonconforming Loans

Nonconforming loans have no set guidelines and vary widely from lender to lender. In fact, lenders often change their own nonconforming guidelines from month to month.

Nonconforming loans are also known as “subprime” loans, because the target customer (borrower) has credit and/or income verification that is less than perfect. The subprime loans are often rated according to the creditworthiness of the borrower—“A,” “B,” “C,” or “D.”

An “A” credit borrower has had few or no credit problems within the past two years, with the exception of a late payment or two with a good explanation. A “C” credit borrower may have a history of several late payments and a bankruptcy.

The subprime loan business has grown enormously over the past ten years, particularly in the refinance business and with investor loans. Every lender has its own criteria for subprime loans, so it is impossible to list every loan program available on the market. Suffice it to say, the guidelines for subprime loans are much more lax than they are for conforming loans.

Government Loan Programs

The federal government and state government sponsor loan programs to encourage home ownership. Most of the loan programs are geared towards low-income neighborhoods and first-time homebuyers. If you are dealing in low-income properties, you should be aware of these guidelines if you intend to sell properties to these target homebuyers. Also, some of these programs are geared to investors as well.

Confusion of Terms

Some mortgage professionals will use the expression “conventional” to mean “conforming,” and vice-versa. So, when a mortgage broker says that “you’ll have to go with a nonconforming loan,” the loan documentation may still have to substantially conform with FNMA guidelines. In fact, even loans that do not conform with FNMA or conventional standards are underwritten on FNMA “paper” (the actual note, mortgage, and other related documents). Lenders do this with the intention of eventually selling the paper, even if it may begin as a portfolio loan.

Federal Housing Administration Loans

HUD is the U.S. Department of Housing and Urban Development, an executive branch of the federal government. The Federal Housing Administration (FHA) is an arm of HUD that administers loan programs. HUD does not lend money but rather insures lenders that make high LTV loans. Because high LTV loans are risky for lenders, the FHA-insured loan programs cover the additional risk. Not all lenders can make FHA-insured loans; they must be approved by HUD.

The most common FHA loan program is the 203(b) program, designed for first-time homebuyers. This program allows an owner-occupant to put just 3 percent down and borrow 97 percent loan-to-value. This program is for owner-occupied (noninvestor) properties, but investors should be familiar with the program because they may wish to sell a property to a buyer who may use the program.

The two most common HUD loans available for investors are the Title 1 Loan and the 203(k) loan.

Title 1 loan. The Title 1 loan insures loans of up to \$25,000 for light to moderate rehab of single-family properties, or \$12,000 per unit for a maximum of \$60,000 on multifamily properties. The interest rates on these loans are generally market rate, although local participation by state or municipal agencies may reduce the rate (see below).

An interesting note on Title 1 loans is that it is not limited to owners of the property. A lessee or equitable owner under an installment land contract (discussed in Chapter 9) may qualify for the loan.

FHA 203(k) loan. The 203(k) program is for an investor who wants to live in the home while rehabbing it. It allows the investor-occupant to borrow money for the purchase or refinance of a home as well as for the rehab costs. It is an excellent alternative to the traditional route for these investors, which is to buy a property with a temporary (“bridge”) loan, fix the property, then refinance it (many lenders won’t offer attractive, long-term financing on rehab properties).

The 203(k) loan can be for up to the value of the property plus anticipated improvement costs, or 110 percent of the value of the property, whichever is less. The rehab cost must be at least \$5,000, but there is no limit to the size of the rehab (although it cannot be used for new construction, that is, the basic foundation of the property must be used, even if the building is razed). The program can be used for condominiums, provided that the condo project is otherwise FHA qualified. Cooperative apartments, popular in New York and California, are not eligible.

The Department of Veterans Affairs

The Department of Veterans Affairs (VA) guarantees certain loan programs for eligible veterans. As an occupant, an eligible veteran can borrow up to 100 percent of the purchase price of the property. When a borrower with a VA-guaranteed loan cannot meet the payments, the lender forecloses on the home. The lender next looks to the VA to cover the loss for its guarantee, and the VA takes ownership of the home. The VA then offers the property for sale to the public.

Condominium Financing Pitfalls

Condominiums can be difficult to finance in general, as compared to single-family homes. In general, stay away from units in developments that have a large concentration of investor-owners. Condo developments that have a 50 percent or more concentration of nonoccupant owners are very difficult to finance through institutional lenders.

State and Local Loan Programs

Many states and localities sponsor programs to help first-time homebuyers qualify for mortgage loans. The programs are aimed at improving low-income neighborhoods by increasing the number of owners versus renters in the area. Most of these programs are for owner-occupants, not investors, but it may also help to know about these programs when you are selling homes.

Some state and local programs work in conjunction with HUD programs, such as Title 1 loans. Contact your state or city department of housing for more information on locally sponsored loan programs. A list of links to state programs can be found at <www.hsh.com/pamphlets/state_hfas.html>.

Commercial Lenders

Most of the discussion so far has been about financing of single-family homes and small multifamily residential homes. What about large multifamily projects and commercial projects, such as shopping centers, strip malls, and office buildings? Many of the same concepts do apply, except for the financing guidelines.

Commercial lenders generally do not have industry-wide loan criteria. Instead, each lender has its own criteria and will review loans on a project-by-project basis. Lenders will look at the experience of

the investor as well as the income and expenses of the particular collateral. In other words, commercial lenders are more concerned with whether the property will generate enough income to pay the loan, not whether the borrower has good credit (although a borrower with poor credit will generally have a hard time getting any type of loan from an institutional lender). A commercial appraisal is required, which is more detailed and expensive than a residential appraisal. A commercial loan will require the borrower to have a substantial reserve of cash to handle vacancies.

Commercial loans also can be made for residential buildings of five units or more, but there is a minimum loan amount required by each lender (generally a \$300,000 to \$500,000, depending on the property values in your marketplace). Oddly enough, multimillion dollar loans are often made without recourse to the borrower. In other words, if the project fails, the borrower (often a corporate entity) is not liable for the debt. The lender's sole recourse is to foreclose against the property. For this reason, the lender is more concerned with the property than the borrower.

Key Points

- Most lenders sell their loans to the secondary market.
- Loans come in three basic categories: conforming, nonconforming, and government.
- The government does not lend money, but rather it guarantees loans.
- Commercial lenders look to the property rather than the borrower.

Working with Lenders

Except for the con men borrowing money they shouldn't get and the widows who have to visit with the handsome young men in the trust department, no sane person ever enjoyed visiting a bank.

—Martin Meyer

Now that you understand how loans and the mortgage market works, you can begin to understand how to approach financing. In Chapter 3, we discussed a variety of loan *programs* that differ based on the lender, the type of property, and the borrower. We will now turn to loan *types* that are generally available in most of the loan programs discussed thus far and the advantages and disadvantages of each. Before doing so, let's explore some of the relevant issues we need to consider when borrowing money.

Interest Rate

The cost of borrowing money, that is, the interest rate, is one of the most important factors. As discussed in Chapter 1, interest rates affect monthly payments, which in turn affect how much you can

afford to pay for a property. It may also affect cash flow, which affects your decision to hold or sell property.

Loan Amortization

There are many different ways a loan can be structured as far as interest payments go. The most common ways are simple interest and amortized.

As discussed in Chapter 1, a simple interest loan is calculated by multiplying the loan balance by the interest rate. So, for example, a \$100,000 loan at 12 percent interest would be \$12,000 per year, or \$1,000 per month. The payments here, of course, represent interest-only, so the principal amount of the loan does not change.

An amortized loan is slightly more involved. The actual mathematical formula is beyond a book like this, so we've provided a sample interest rate table in Appendix A. However, you can find a thousand Internet Web sites that will do the calculations instantly online (try mine at <www.legalwiz.com>—click on “calculators”). The amortization method breaks down payments over a number of years, with the payment remaining constant each month. However, the interest is calculated on the remaining balance, so the amount of each monthly payment that accounts for principal and interest changes. For the most part, the more payments you make, the more you decrease the amount of principal owed (the amount of the loan still left to pay). See Figure 4.1.

The loan *term* or duration is important to figuring your payment. By custom, most loans are amortized over 30 years or 360 monthly payments. The second most common loan term is 15 years. The payments on a 15-year amortization are higher each month, but you pay the loan off faster and thus pay less interest in the long run.

FIGURE 4.1 Amortization of \$100,000 Loan at 8% Interest Over 30 Years

| Payment # | Date | Payment | Interest | Principal | Loan Balance |
|-----------|------------|---------|----------|-----------|--------------|
| 1 | 02-01-2003 | 733.76 | 666.67 | 67.09 | 99,932.91 |
| 2 | 03-01-2003 | 733.76 | 666.22 | 67.54 | 99,865.37 |
| 3 | 04-01-2003 | 733.76 | 665.77 | 67.99 | 99,797.38 |
| 4 | 05-01-2003 | 733.76 | 665.32 | 68.44 | 99,728.94 |
| 5 | 06-01-2003 | 733.76 | 664.86 | 68.90 | 99,660.04 |
| 6 | 07-01-2003 | 733.76 | 664.40 | 69.36 | 99,590.68 |
| 7 | 08-01-2003 | 733.76 | 663.94 | 69.82 | 99,520.86 |
| 8 | 09-01-2003 | 733.76 | 663.47 | 70.29 | 99,450.57 |
| 9 | 10-01-2003 | 733.76 | 663.00 | 70.76 | 99,379.81 |
| 10 | 11-01-2003 | 733.76 | 662.53 | 71.23 | 99,308.58 |
| 11 | 12-01-2003 | 733.76 | 662.06 | 71.70 | 99,236.88 |
| 12 | 01-01-2004 | 733.76 | 661.58 | 72.18 | 99,164.70 |
| 13 | 02-01-2004 | 733.76 | 661.10 | 72.66 | 99,092.04 |
| 14 | 03-01-2004 | 733.76 | 660.61 | 73.15 | 99,018.89 |
| 15 | 04-01-2004 | 733.76 | 660.13 | 73.63 | 98,945.26 |
| 16 | 05-01-2004 | 733.76 | 659.64 | 74.12 | 98,871.14 |
| 17 | 06-01-2004 | 733.76 | 659.14 | 74.62 | 98,796.52 |
| 18 | 07-01-2004 | 733.76 | 658.64 | 75.12 | 98,721.40 |
| 19 | 08-01-2004 | 733.76 | 658.14 | 75.62 | 98,645.78 |
| 20 | 09-01-2004 | 733.76 | 657.64 | 76.12 | 98,569.66 |
| 21 | 10-01-2004 | 733.76 | 657.13 | 76.63 | 98,493.03 |
| 22 | 11-01-2004 | 733.76 | 656.62 | 77.14 | 98,415.89 |
| 23 | 12-01-2004 | 733.76 | 656.11 | 77.65 | 98,338.24 |
| 24 | 01-01-2005 | 733.76 | 655.59 | 78.17 | 98,260.07 |
| 25 | 02-01-2005 | 733.76 | 655.07 | 78.69 | 98,181.18 |
| 26 | 03-01-2005 | 733.76 | 654.54 | 79.22 | 98,102.16 |
| 27 | 04-01-2005 | 733.76 | 654.01 | 79.75 | 98,022.41 |
| 28 | 05-01-2005 | 733.76 | 653.48 | 80.28 | 97,942.13 |
| 29 | 06-01-2005 | 733.76 | 652.95 | 80.81 | 97,861.32 |
| 30 | 07-01-2005 | 733.76 | 652.41 | 81.35 | 97,779.97 |
| 31 | 08-01-2005 | 733.76 | 651.87 | 81.89 | 97,698.08 |
| 32 | 09-01-2005 | 733.76 | 651.32 | 82.44 | 97,615.64 |
| 33 | 10-01-2005 | 733.76 | 650.77 | 82.99 | 97,532.65 |
| 34 | 11-01-2005 | 733.76 | 650.22 | 83.54 | 97,449.11 |
| 35 | 12-01-2005 | 733.76 | 649.66 | 84.10 | 97,365.01 |
| 36 | 01-01-2006 | 733.76 | 649.10 | 84.66 | 97,280.35 |
| 37 | 02-01-2006 | 733.76 | 648.54 | 85.22 | 97,195.13 |
| 38 | 03-01-2006 | 733.76 | 647.97 | 85.79 | 97,109.34 |
| 39 | 04-01-2006 | 733.76 | 647.40 | 86.36 | 97,022.98 |
| 40 | 05-01-2006 | 733.76 | 646.82 | 86.94 | 96,936.04 |
| 41 | 06-01-2006 | 733.76 | 646.24 | 87.52 | 96,848.52 |
| 42 | 07-01-2006 | 733.76 | 645.66 | 88.10 | 96,760.42 |
| 43 | 08-01-2006 | 733.76 | 645.07 | 88.69 | 96,671.73 |
| 44 | 09-01-2006 | 733.76 | 644.48 | 89.28 | 96,582.45 |
| 45 | 10-01-2006 | 733.76 | 643.88 | 89.88 | 96,492.57 |
| 46 | 11-01-2006 | 733.76 | 643.28 | 90.48 | 96,402.09 |
| <hr/> | | | | | |
| 349 | 02-01-2032 | 733.76 | 56.28 | 677.48 | 7,764.01 |
| 350 | 03-01-2032 | 733.76 | 51.76 | 682.00 | 7,082.01 |
| 351 | 04-01-2032 | 733.76 | 47.21 | 686.55 | 6,395.46 |
| 352 | 05-01-2032 | 733.76 | 42.64 | 691.12 | 5,704.34 |
| 353 | 06-01-2032 | 733.76 | 38.03 | 695.73 | 5,008.61 |
| 354 | 07-01-2032 | 733.76 | 33.39 | 700.37 | 4,308.24 |
| 355 | 08-01-2032 | 733.76 | 28.72 | 705.04 | 3,603.20 |
| 356 | 09-01-2032 | 733.76 | 24.02 | 709.74 | 2,893.46 |
| 357 | 10-01-2032 | 733.76 | 19.29 | 714.47 | 2,178.99 |
| 358 | 11-01-2032 | 733.76 | 14.53 | 719.23 | 1,459.76 |
| 359 | 12-01-2032 | 733.76 | 9.73 | 724.03 | 735.73 |


15-Year Amortization versus 30-Year Amortization

In general, 15-year loans tend to have a slightly lower interest rate. In addition, you reach your financial goal of “free and clear” faster. However, there are three downsides to the 15-year loan. The first is that you are obligated to a higher payment that reduces your cash flow. Second, the higher monthly obligation appears on your credit report, which affects your debt ratios and thus your ability to borrow more money (discussed later in this chapter). Third, your monthly payment is less interest and more principal. While this may sound like a good thing, it doesn’t give you the same tax benefits; interest payments are deductible, principal payments are not.

Three Negatives to a 15-Year Loan

1. Higher monthly payments
2. Increased debt ratios
3. Less of a tax deduction

Unless the interest rate on the 15-year note is significantly lower, opt for the 30-year note. You can accomplish the faster principal pay down by making extra interest payments to the lender.

 **Example:** On a \$100,000 loan amortized at 8% over 30 years, your payment is \$733.76. If you make an additional principal payment each month of \$100, the loan would be fully amortized in just over 20 years, saving you \$62,468.87 in interest.

You can use a financial calculator to calculate how much extra you need to pay each month to reduce the loan term (again, try mine at www.legalwiz.com—click on “calculators”). And, of course,

when times are hard and the property is vacant, you aren't obligated to make the higher payment.

Biweekly Mortgage Payment Programs

An entire multilevel marketing business has been made out of the selling people the idea of a biweekly mortgage program. Basically, if you pay your loan every two weeks rather than monthly, you make two extra payments per year. With the additional payments going towards principal, the debt amortizes faster. Before plunking down several hundred dollars to a third party to do this for you, ask your lender. Many lenders will set up a direct deposit program from your bank account for biweekly payments.

Balloon Mortgage

A *balloon* is a premature end to a loan's life. For example, a loan could call for interest-only payments for three years, then be due in full at the end of three years. Or, a loan could be amortized over 30 years, with the principal balance remaining due in five years. When the loan balloon payment becomes due, the borrower must pay the full amount or face foreclosure.

A balloon provision can be risky for the borrower, but if used with common sense, it may work effectively by satisfying the lender's needs. Balloon notes are often used by builders as a short-term financing tool. These types of loans are also known as "bridge" or "mezzanine" financing.

Reverse Amortization

Regular amortization means as you make payments the loan balance decreases. Reverse amortization means the more you pay, the more you owe. How is that possible? Simple—by making a lower payment each month than would be possible for the stated interest rate. A reverse amortization loan increases your cash flow but also increases your risk because you will owe more in the future. If you bought the property below market, a reverse amortization loan may make sense, especially if real estate prices are rising rapidly (another option may be a variable rate loan, discussed later in this chapter).

Reverse Amortization Loans for the Elderly

Many mortgage banks are advertising reverse amortization loans to elderly homeowners as a way to reduce their monthly payments. These loan programs are not intended for investors as described above.

Property Taxes and Insurance Escrows

In addition to monthly principal and interest payments on your loan, you'll have to figure on paying property taxes and hazard insurance. Many lenders won't trust you to make these payments on your own, especially if you are borrowing at a high loan-to-value (80 percent LTV or higher). Lenders estimate the annual payments for taxes and insurance, then collect these payments from you monthly into a reserve account (called an "escrow" or "impound account"). The lender then makes the disbursements directly to the county tax collector and your insurance company on an annual basis. Thus, the total amount collected each month consists of principal and interest payments on the note, plus taxes and insurance—hence the acronym PITI.

Loan Costs

Origination Fee

The cost of a loan is as important as the interest rate. Lenders and mortgage brokers charge various fees for giving you a loan (and you thought they just made money on the interest rates!). Traditionally, the most expensive part of the loan package is the loan origination fee. The fee is expressed in *points*, that is, a percentage of the loan amount: 1 point = 1 percent. So, for example, if a lender charges a “1 point origination fee” on a \$100,000 loan, you would pay 1 percent, or \$1,000, as a fee.

Discount Points

Another built-in profit center is the charging of “discount points.” The lender will offer you a lower interest rate for the payment of money up front. Thus, if you want your interest rate to be lower, you can “buy down” the rate by paying $\frac{1}{2}$ point (percent) or more of the loan up front. Buying down the rate only makes sense if you plan on keeping the loan for a long time; otherwise buying down the interest rate is a waste of money.

Borrowers nowadays are smarter and try to beat the banks at their own game by refusing to pay points. Banks even advertise “no cost” loans, that is, loans with no discount points or origination fees.

Yield Spread Premiums: The Little Secret Your Lender Doesn't Want You to Know

The lower the interest rate, the better off you are, or are you? Lenders advertise “wholesale” interest rates on a daily basis to mortgage brokers, who then advertise rates to their customers. This wholesale interest rate can be marked up on the retail side by the mortgage broker.

☛ **Example:** Say, for example, your mortgage broker offers you an interest rate of 7.25% on a \$200,000, 30-year fixed loan. The monthly payment on this loan would be \$1,364.35, which is acceptable to you. However, the wholesale rate offered by the lender may be 7.00%, which is \$1,330.60 per month. This difference may not seem like much, but over 30 years, it amounts to about \$12,000 in additional interest paid. The mortgage broker receives a “bonus” back from the lender for the additional interest earned. This bonus is called a yield spread premium (YSP) because it represents the additional yield earned by the lender for the higher interest rate.

Are Yield Spread Premiums Legal?

At this time, YSPs are legal as long as they are disclosed on the loan documents. Although it is not technically a fee to the borrower, YSPs are not illegal “kickbacks” to the mortgage broker either. You will, however, see the fee noted on the HUD-1 closing statement as POC (paid outside of closing).

Loan Junk Fees

Even without points and at par (no markup on the interest rate), there is no such thing as a no-cost loan. Lenders sneak in their profit by disguising other fees, such as the following:

- Administrative Review
- Underwriting Charge
- Documentation Fee

These charges are given fancy names but are really just ways for the lender to make more profit. Lenders also pad their actual fees, such as the cost of obtaining credit reports, courier charges, and other “miscellaneous fees” (one lender admitted to me that he pays less than \$15 for a credit report yet charges the borrower \$85!). Understand that lenders are in business to make money, so if a loan sounds too good to be true, it probably is—look carefully at their fees and charges.

Good Faith Estimate

By law, a lender is required to give you a list of the loan fees up front when you apply for the loan. Unscrupulous lenders are notorious for adding in last-minute charges and fees that you won't discover until closing. Of course, you are free to back out at that point, but who wants to lose a good real estate deal? Lenders know this reality, so make sure you get as much as you can in writing before closing the loan.

“Standard” Loan Costs

While every lender has its own fees and points it charges, there are certain costs you can expect to pay with every loan transaction. These fees should be listed in the lender's good faith estimate as well as on the second page of the closing statement. The closing statement is prepared at closing by the escrow agent on a form known as a HUD-1, in compliance with the Real Estate Settlement Procedures Act (RESPA), a federal law. A sample of this form can be found in Appendix C. All of the following charges appear on page two of the form:

- *Title insurance policy.* While a lender secures its loan with a security instrument recorded against the property, it wants a guarantee that its lien is in first position (or, in the case of a

second mortgage, second position). A lender's policy of title insurance guarantees to the lender it is in first position (or, in the case of a second mortgage, second position). This policy costs anywhere from a few hundred dollars to a thousand dollars, depending on the amount of the loan and when the last time a title insurance policy was issued on the property; the more recently another policy was issued, the cheaper the policy. Also, if you are purchasing an owner's title insurance policy in conjunction with the lender's policy (very common), the fee for the lender's policy is substantially reduced.

- *Prepaid interest.* While this is not a "fee," it is a cost of financing you pay up front. Because interest is paid for the use of money the month before, you need to figure on paying prorated interest. For example, let's assume your monthly payment on the mortgage note will be \$1,000. If you close your loan on the 15th of the month, your first payment won't be due for 45 days. The lender will collect 15 days of interest at closing for the use of the money that month, which is \$500.
- *Application fee.* While standard among some lenders, this fee is really a "junk" fee. Nobody should charge you for asking you to do business with them. Lenders often waive this fee if they fund your loan.
- *Document recording fees.* Because the mortgage or deed of trust will be recorded at the county, there are fees charged. The usual range is about \$5 to \$10 per page, and the typical FNMA Mortgage or deed of trust is anywhere from 12 to 20 pages. In addition, some states and localities (e.g., New York) charge an additional tax on mortgage transactions based on the amount of the loan.
- *Reserves.* If the lender is escrowing property taxes and insurance, it will generally collect a few months extra up front. While technically not a cost, it is cash out of your pocket.

- *Closing fee.* The lender, company, attorney, or escrow company that closes the loan charges a fee for doing so. Closing a loan involves preparing a closing statement, accounting for the monies, and passing around the papers. The closer actually sits down with the borrower and explains the documents and, in most cases, takes a notary's acknowledgment of the borrower (a mortgage or deed of trust must be executed before a notary in order for it to be accepted for recording in public records; the promissory note is not recorded but held by the lender until it is paid in full). The closer also makes sure the documents find their way back to the lender or the county for recording.
- *Appraisal.* Virtually all loans require an appraisal to verify value. An appraisal will cost you between \$300 and \$500, and even more if the subject property is a multiunit or commercial building. Appraisers often charge additional fees for a "rent survey," which is a sampling of rent payments of similar properties. The lender will want this information to verify that the property can sustain the income you projected.
- *Credit report.* Lenders charge a fee for running your credit report. The lender may charge as much as \$85 for a full credit report. Vendors often run short-form credit reports, which are much cheaper. The lender may run a short-form version first to get a quick look at your credit, then a full report at a later time (called a "three bureau merge" because it contains information from the three major credit bureaus).
- *Survey.* A lender may require that a survey be done of the property. A *survey* is a drawing that shows where the property lies in relation to the nearest streets or landmarks. It will also show where the buildings and improvements on the property sit in relation to the boundaries. If a recent survey was performed, it may not be necessary to do a new survey. Rather, the lender may ask for a survey update from the same surveyor or another surveyor. In some parts of the country, an "Improvement Location Certificate" is used; it is essentially a drive-by survey.

- *Document preparation fees.* Some lenders will charge you an attorney's fee for document preparation. Larger lenders have in-house attorneys and paralegals. Smaller lenders hire outside service companies to prepare the loan documents. The reason documents are not always done "in house" is because of the complexities of compliance with lending regulations. Document preparation companies pay lawyers to research the laws and draft documents for compliance. Based on the information provided by the lender, the document preparation company prepares the forms for the lender. The fee for this service is generally a few hundred dollars, which is passed on to the borrower.

Now that you know how lenders make their money, you can negotiate your loan with confidence. Virtually every fee a lender asks for can be negotiated. However, don't expect the lender to waive every fee, charge no points, and get no back-end fees (yield spread premiums). The lender has to make a profit to be willing to do business with you. Profit is also important to you as an investor, but so is the availability of the money you borrow. If you want a lender that is willing to work hard for you, make sure you are willing to pay reasonable compensation. Pinching pennies with your lender will not get it excited about pushing your loan through the process faster. However, knowing what fees are negotiable will allow you to get a loan at a fair interest rate and pay a reasonable fee to get it.

Risk

In addition to profit and cash flow, one of the major factors you should consider in borrowing money is risk. While maximum leverage is important to the investor, it is also higher risk to the investor. The more money you borrow, the more risk you could potentially incur. That is, while you have less investment to lose, you may be personally liable for the debt you have incurred.

With larger commercial projects, the lender's main concern is the financial viability of the project itself. In that case, the borrower does not necessarily have to sign personally on the promissory note. The lender's sole legal recourse is to foreclose the property.

With smaller residential loans, the investor/borrower signs personally on the note and is thus liable personally for the obligation. While the lender can foreclose the property, there may be a deficiency owed that is the personal obligation of the borrower. In the late 1980s, many leveraged investors learned this lesson the hard way when they were forced to file for bankruptcy protection. A smart investor finances properties with a cash cushion, positive (or at least breakeven) cash flow, and at a reasonable loan-to-value ratio.

Nothing Down

While "nothing-down" financing is viable, it does not necessarily mean a 100 percent loan-to-value. For example, buying a \$150,000 property for \$150,000 with all borrowed money is not a bad deal if the property is worth \$200,000. That's a 75 percent LTV. Buying a property for close to 100 percent of its value and financing it 100 percent with personal recourse is very risky. If you don't have the means to support the payments while the property is vacant, you may be in for trouble. Like any business, real estate is about maintaining cash flow.

So, in considering your loan, factor in the following issues:

- Are you near the top of an inflated market?
- Is the local economy's outlook good or bad?
- If purchasing, are you buying below market?
- How long do you intend to hold the property and for what purposes?
- Are prices likely to drop before you sell it?
- Will you be able to refinance the property in the future?

- Are you personally obligated on the note, or is the debt nonrecourse (or signed for by your corporate entity)?

All of these factors are relevant to risk and to whether you want to leverage yourself without a backup plan.

Loan Types

In Chapter 3, we discussed broad categories of loans, such as conventional versus government loans, conforming versus nonconforming loans, brokered loans versus portfolio loans, etc. These distinctions are really lending “styles” more than loan types. Virtually every lender or loan category involves variation of the loan term and interest rate. The loan term is the length of time by which the loan is amortized. The loan term is fixed, whereas the interest rate can vary throughout the term of the loan. Each loan type (fixed versus variable interest rate, 15-year versus 30-year) has a place for the borrower/investor, and we will explore the benefits and detriments of each.

The most common type of real estate loan is a fixed-rate, 30-year amortization. A fixed-rate loan is desirable because it provides certainty. It hedges your bet against higher interest rates by allowing you to lock in a low interest rate. If interest rates fall, you can always refinance at a lower rate at a later time.

With interest rates uncertain in the future, many lenders are offering variable-rate financing. Known as an adjustable-rate mortgage (ARM), there are dozens of variations to suit the lender’s profit motives and borrower’s needs.

ARMs have two limits, or caps, on the rate increase. One cap regulates the limit on interest rate increases over the life of the loan; the other limits the amount the interest rate can be increased at a time. For example, if the initial rate is 6 percent, it may have a lifetime cap of 11 percent and a one-time cap of 2 percent. The adjustments are made monthly, every six months, once a year, or once every few years, depending on the “index” on which the ARM is based. An

index is an outside source that can be determined by formulas, such as the following:

- LIBOR (London Interbank Offered Rate)—based on the interest rate at which international banks lend and borrow funds in the London Interbank market.
- COFI (Cost of Funds Index)—based on the 11th District’s Federal Home Loan Bank of San Francisco. These loans often adjust on a monthly basis, which can make bookkeeping a real headache!
- T-bills Index—based on average rates the Federal government pays on U.S. treasury bills. Also known as the Treasury Constant Maturity, or TCM.
- CD Index (certificate of deposit)—based on average rates banks are paying on six-month CDs.

The index you choose will affect how long your rate is fixed for and the chances that your interest rate will increase. Which one is best? Because that depends on what is going on in the national and world economy, you have to review your short-term and long-term goals with your lender before choosing an index.

ARMs are very common in the subprime market and with portfolio lenders, but they can be very risky because of the uncertainty of future interest rates. However, like a balloon mortgage, an ARM can be used effectively with a little common sense. If you plan to sell or refinance the property within a few years, then an ARM may make sense.

Hybrid ARM

Ask your lender about a hybrid ARM, that is, an ARM that is fixed for a period of three, five, or even seven years. After that time, the rate will adjust, usually once (hence the expression “3/1 ARM” or “5/1 ARM”). The initial rates on these loans are not as good as a six-month ARM but will give you more flexibility and certainty (generally, the longer the rate is fixed for, the higher interest rate you’ll pay). Also, watch for prepayment penalties that are often built into ARM loans.

For more information on ARM loans, you can download the official consumer pamphlet prepared by the Federal Reserve Board and the Office of Thrift Supervision at my Web site, <www.legalwiz.com/arm>.

Choosing a Lender

Choosing a lender that you want to work with involves several factors, not the least of which is an open mind. You need a lender that can bend the rules a little when you need it and get the job done on a deadline. You need a lender that is large enough to have pull, but small enough to give you personal attention. And, most of all, you need a lender that can deliver what it promises.

Prepayment Penalties

Lenders are smart investors, too. If interest rates are falling, lenders don't want you to pay off a higher interest rate loan. They discourage you from refinancing by adding a prepayment penalty (PPP) clause to your loan. The PPP provision states that if you pay the loan in full within a certain time period (usually within one year to three years), you must pay a penalty. The common penalty ranges from 1 percent to 6 percent of the original loan balance. Make sure that your loan does not have a PPP if you plan on refinancing or selling the property in the next few years.

Length of Time in Business

Because the mortgage brokering business is not highly regulated in most states, there are a lot of fly-by-night operations. Bad news travels faster than good news in business, so bad mortgage brokers don't last too long. Look for a company that has been in business for a few years. Check out the company's history with your local better business bureau. If mortgage brokers are licensed with your state, check to see if any complaints or investigations were made against them.

Also, ask for referrals from other investors and real estate agents. Many mortgage brokers will bait you with "too good to be true" loan programs that most investors won't qualify for. Once they have you hooked, it may be too late to switch brokers, and now you are forced to take whatever loan they can find for you. It's not that all of these mortgage brokers are crooks; it's often the case that the broker is just not knowledgeable about the particular loan programs they offer. In many cases, the particular lender they were dealing with was the culprit. Many wholesale lenders offer programs to mortgage brokers,

then when the loan comes through, the underwriter changes its mind or asks for more documentation. In some cases, it is the old bait and switch; in other cases, it is simply a miscommunication between the wholesale lender and the mortgage broker. Thus, it is important that you ask the mortgage broker if it has dealt with the particular lender or loan program in the past.

Company Size

A company that is too big can be problematic because of high employee turnaround. Also, the proverbial “buck” gets passed around a lot. If you are dealing with a mortgage broker, it is often a one-person operation. Dealing with a one-man operation may be good in terms of communication if he or she is a go-getter. On the other hand, the individual may be hard to get a hold of, because he or she is answering the phone all day.

A small to midsized company is a good bet. You will be able to get the boss on the phone, but he or she will have a good support staff to handle the minor details. Also, a midsized company may have access to more wholesale lenders than a one-person company.

Experience in Investment Properties

It is important to deal with a mortgage broker or banker that has experience with investor loans. Owner-occupant loans are entirely different than investor loans. And, it is important that the broker or lender you are dealing with has a number of different programs. It is often the case that you find out a particular loan program won't work, in which case you need to switch lenders (or loan programs) in a heartbeat to meet a funding deadline.

Six Questions to Ask Your Lender

1. How many regular investor clients do you have?
2. Do you get any back-end fees from the lender?
3. What percentage of your loans don't get funded (completed)?
4. What kind of special nonconforming loan programs do you have for investors?
5. What income and credit requirements do I need?
6. What documentation will I need to supply you with?

How to Present the Deal to a Lender

For the most part, lenders follow guidelines established by FNMA and Freddie Mac, as well as their own lending guidelines. If you are looking for the best interest rate, then you must be able to conform to FNMA guidelines, which include a high credit score, provable income, and verifiable assets.

If you are not going with a conforming loan, then there are the following basic guidelines a lender will look at:

- Your credit score
- Your provable income
- The property itself
- Your down payment

Your Credit Score

Much of the institutional loan industry is driven by credit. While having spotless credit is not a necessity, it is certainly a good asset, if used wisely.

Your credit history is maintained primarily by three large companies, known as the credit bureaus: Equifax, TransUnion, and Experian (formerly TRW). Your credit report has “headers” that contain information about your addresses (every one they can find), phone numbers (even the unlisted ones), employer, Social Security number, aliases, and date of birth. This information is usually reported by banks and credit card companies that report to the credit bureaus (be careful about giving your unlisted address or phone number to your credit card company—it may end up on your credit file). Some information comes from public records, such as court filings and property records.

Your credit report also contains a history of nearly every charge card, loan, or other extension of credit that you ever had. It will show the type of loan (e.g., installment loan or revolving credit), the maximum you can borrow on the account, a history of payments, and the amount you currently owe. It will also show information from public records, such as judgments, IRS liens, and bankruptcy filings. Some debts are reported by collection agencies, such as unpaid phone, utility, and cable TV bills. Your credit report will also show every company that pulled your credit report within the past two years (called an “inquiry”).

How long does information stay on my credit report? In theory, information stays on your credit report indefinitely. However, federal law—the Fair Credit Reporting Act (FCRA)—requires that any negative remarks be removed upon request after seven years (except for bankruptcy filing, which may remain for ten years). If you don’t ask, however, negative information won’t always go away.

How do I get negative information removed from my credit report? You may find some information on your report that is just plain wrong. Accounts that are not yours, judgments against people with similar names, and duplicate items are very common. Some items are more subtle, such as the fact that a debt is listed as still unpaid when in fact it was discharged in your bankruptcy. Ask the credit bureau in writing to reinvestigate the information. Under federal law, the bureau must reinvestigate and report back within 30 days. In some states, the law requires a shorter time period. If the bureau does not report back within the requisite time period, the item must be removed.

Communicating with Credit Bureaus

Send your letter by certified mail, return receipt requested. If you do not get results within the time period specified by your state law or the FCRA, you can write a sterner letter threatening to sue under state or federal law. You can also try to contact the creditor directly. Keep in mind that a creditor may also be liable for reporting wrong information. Before jumping into court, try contacting your regional Federal Trade Commission office and your state Attorney General's Consumer Fraud Department.

If you have "bad" items on your credit report, such as late payments, charge-offs, judgments, or a bankruptcy, the credit bureaus can legally report this information. However, if the information is stated in an incorrect or misleading format, you can still ask the bureaus to reinvestigate the information. Sometimes you will get lucky and the bureau does not report back within the required time period. In this event, the information must be removed.

Disputing Items on Your Credit Report

Do not be too specific with your request. For example, if a bureau reports that you had a judgment against you and it was paid, do not volunteer that information (a record of a judgment rendered and paid off is still worse than no judgment in the first place). Simply state that the information is incomplete and request that it be reinvestigated. In some cases, it is less work for the credit bureau to remove the item than to recheck it.

What things affect my credit? Credit reports are based on a computer model, called a FICO score, developed by Fair Isaac, and Co. (FICO, www.fairisaac.com). Although the FICO formula is not generally known to the public, certain things tend to improve your score, such as the following:

- Installment loans (e.g., home mortgage, automobile) that are paid on time
- A few open credit lines with low balances
- A history of living at the same address
- Owning a home

Beyond the obvious late payments, judgments, and bankruptcy, there are certain subtle things that lower your score, such as the following:

- Too many revolving credit card accounts
- Too many inquiries
- High balances on credit cards
- Too many recently-opened accounts

How can I improve my credit? A good credit score is generally above 660. Some loans are so stringent that they require a FICO score above 700. If your score is above 700, you have excellent credit. The bad news is, if you keep borrowing, your score will fall, even if you are current on all payments. So, in short, use your credit wisely. You can check your own FICO score at <www.fairisaac.com>.

If you do not have late payments but want to improve your credit score, you should

- stay away from multiple department store cards—too many open accounts;
- bring a copy of your credit report when shopping for a loan—car dealers may run your credit a dozen times in one day of shopping, leaving damaging “inquiries.”
- separate your credit file from your spouse’s and remove each other’s names from your credit cards; if you have authorization to use your spouse’s card, it ends up on your credit file, too.

Can I get a loan with bad credit? Whether you can get a loan with poor credit depends on the type of loan. Unsecured loans, such as credit cards and bank signature loans, usually require a good credit history. Secured loans, such as home mortgages and car loans, are a bit more flexible. Lenders are more aggressive and will take larger risks when the loan is secured by collateral. The lender may require a larger down payment and charge a higher interest rate for the risk of lending to an individual with poor credit.

“I Don’t Like Credit Cards—Should I Pay Them Off and Cancel Them?”

Never pay off completely or cancel a credit card! A person with no credit at all is worse off than a person with a bad credit history. You may think that credit cards are evil, but you may not be able to get a phone, a job, or even a utility account without a credit score. A person with an empty credit file looks somewhere between “suspicious” and “scary” to a company inquiring about your credit. Have a credit card or two, and use them once or twice a year, even if it is just to pay to fill up your gas tank.

Your Provable Income

FNMA loan regulations require proof of requisite income to support the loan payments. Proof of income requires strict documentation, such as

- two years of W-2 forms,
- past two pay stubs, and
- two years of tax returns.

If you are self-employed, or at least a 25 percent owner of a business, you need to show that you have been in business at least two years. Proof of self-employment requires copies of tax returns showing the business income.

The Property

An understated point thus far is the property itself. Part of the lender's risk analysis is the property they are collateralizing with the loan. The lender has to keep in the back of its mind the worst-case scenario: a borrower's default and ensuing foreclosure. In other words, the lender asks itself, "Would I want to own this property?"

The appraisal. The first thing a lender will do is order an appraisal. Some lenders have in-house staff, but most use independent contractors. Because the appraiser charges his or her fee whether or not the loan is approved, the lender generally collects the appraisal fee (about \$350) from the borrower up front.

There are three generally accepted approaches to appraising property: the market data approach, the cost approach, and the income approach.

Market data approach. The market data approach is the most commonly used formula for single-family homes, condominiums, and small apartments. Basically, a licensed appraiser looks at the three most "similar" houses in the vicinity that have sold recently. He or she then compares square footage and other attributes. The number of bedrooms and baths, age of the property, improvements, physical condition, and the presence of a garage will affect the price, but square footage is usually the most important factor. As you might expect, there are exceptions to this rule. For example, the style of house, its location, and proximity to main roads, and whether it has a view or beach access will greatly affect the value. For the most part, however, if you leave these issues aside, square footage, number of bedrooms and baths, and physical condition are the most relevant factors. Keep in mind that bedrooms and baths on the main level add more value than bedrooms and baths in a basement or attic.

The income approach. With income properties, an appraiser will also use the income approach method, particularly if comparable properties are not available for comparison. The income approach is

basically a mathematical formula based on certain presumptions in the marketplace (based, of course, on opinion). The formula is as follows:

$$\text{Value} = \text{Net operating income} \div \text{Capitalization rate}$$

Net operating income is the potential (not actual) rents the property will command, less average vacancy allowance and operating expenses. Operating expenses include property management, insurance, property taxes, utilities, maintenance, and the like, but not mortgage loan payments.

Capitalization rate is a little more subjective and difficult to calculate. Capitalization, or “cap” rate, is the rate of return a particular investor would expect to receive if he or she purchased a similar property at a similar price. The cap rate is derived from looking at similar properties and the net operating income associated with them. Obviously, estimating cap rate is not an exact science but a trained guess.

Gross rent multiplier. For single-family rentals, duplexes, and other small projects, an appraiser may use the “gross rent multiplier” to help determine value. This formula basically looks at similar properties and their rental incomes. By dividing the sales prices of similar properties by the monthly rent received, the appraiser can come up with a rough formula to compare with the subject property.

Loan-to-Value

Loan-to-value (LTV) is an important criterion in determining the lender’s risk. In maximizing leverage, the investor wants to invest as little cash as possible. However, the lender’s point of view is that the more equity in the property, the less of a loss it would take if it had to foreclose.

FNMA-conforming loan guidelines generally require an investor to put 20 percent cash down on a purchase, which means an 80 percent LTV. Nonconforming loans may permit as little as 5 percent down for investors, depending on the financial strength of the borrower. Thus, an investor with excellent credit and provable source of income

Loan-to-Value versus Loan-to-Purchase Price

Loan-to-value is determined by the amount of the loan compared to the appraised value of the property. If the investor is buying a property for less than the appraised value, then the lender's LTV criteria should change, correct? Actually, not—most lenders' LTV criteria are based on the appraised value or purchase price, whichever is less. Based on various studies done by lenders, the statistical chance of a borrower's default decreases if the borrower has more of his or her own money invested.

may be able to borrow as much as 95 percent of the purchase price of an investment property. On the other hand, an investor with mediocre credit and who is self-employed for a short period of time may be required to put 20 percent down. There are a hundred variations, depending on the particular lender's underwriting criteria.

The Down Payment

You need to show at least two months of bank statements to the lender to prove that you have the requisite down payment on hand. If the down payment money suddenly "appeared" in your account, you need to show where it came from. If it was a gift, for example, from a relative, you'll need a letter from that relative stating so. Basically, the lender wants to make sure you didn't borrow the money for the down payment (although some lenders will permit you to borrow the down payment from your home equity line of credit, discussed in Chapter 6). If your credit report shows recently high balances or a lot of recent inquiries from credit card companies, this may be a red flag for the lender. In short, don't expect to borrow the down payment from a credit card or other unsecured line and think the lender won't notice.

Income Potential and Resale Value of the Property

The particular property being financed is relevant to the lender's risk. If the property is a single-family home in a "bread and butter" neighborhood, the lender's risk is reduced. Because middle-class homes in established neighborhoods are easy to sell, a lender feels secure using them as collateral. However, if the property is in a neighborhood where sales are not brisk, the lender's risk is increased. Also, if the property is very old or nonconforming with the neighborhood (e.g., one bedroom or very small), then the lender will be tighter with their underwriting guidelines. On the other hand, the stronger the local economy, the more likely a lender will be to waive the strictest of their loan guidelines.

Financing Junker Properties

One of the major headaches you will run into as an investor is trying to finance fixer-upper properties. Many banks shy away from these loans because a subpar property doesn't meet the strict FNMA lending guidelines. Also, lenders based their LTV and down payment requirements on the purchase price, not the appraisal. Thus, you are penalized as an investor for getting a good deal.

☛ **Example:** A property is worth \$100,000 in good shape and needs \$15,000 in repairs. The investor negotiates a purchase price of \$70,000. The lender offers 80% LTV financing, which should be \$80,000, right? Wrong! The lender offers 80% of the purchase price or appraised value, whichever is *less*. So, the lender would expect the borrower to come up with 20% of \$70,000, or \$14,000, offering \$56,000 in financing.

Dealing with junker properties requires a lender that understands what it is you do. A small, locally owned bank that portfolios its loans will be your best bet. The lender may even lend you the fix-up money for the deal. An appraisal will be done of the property, noting its current value and its value after repairs are complete. The lender will lend

you the money for the purchase, holding the repair money in escrow. When the repairs are completed, the lender will inspect the property, then authorize the release of the funds in escrow.

Refinancing—Worth It?

A corollary to financing properties is the concept of refinancing. When and how often should you refinance your investment properties? Should you take advantage of falling interest rates?

The rule of thumb is that you should not refinance your loan unless it is a variable rate or your new rate is 2 percent lower than your existing rate (that is, 2 points lower—not 2 percent of your current rate—such as 8 percent down to 6 percent). However, this rule of thumb is just that—a guideline. There are costs involved in getting a loan, and it takes several years of payments at the lower rate to recoup your investment. Also, keep in mind that if your existing loan has been amortized for several years, you are starting to pay less interest and more principal on your current loan; refinancing means starting all over again.

The bottom line is to use common sense and a calculator—figure out whether the interest savings is worth the extra cost (and potentially the risk) of refinancing.

Filling Out a Loan Application

You should be familiar with FNMA Form 1003, a standard loan application form used by most mortgage brokers and direct lenders to gather information about your finances. You should also have one filled out on your computer that you can provide to your lender (you can download a fillable Form 1003 on my Web site at <www.legalwiz.com/1003.htm>. You should always fill out a Form 1003 truthfully and honestly, but, like income tax returns, there are many “gray areas” when it comes to stating your income, debt, and assets. If you have any doubt, have your mortgage broker review it before submitting it to the lender.

Cash Out Refinancing

Many investors refinance every few years as property values increase, using the extra cash to buy more properties, as suggested in Robert Allen's best-selling book, *Nothing Down for the '90s*. While this process does increase your leverage, it also increases your risk. There is nothing inherently wrong with taking out cash in a refinance, so long as the cash is used wisely. Spending the money as profit is not a smart use. Paying off credit cards with that money isn't always a smart use of cash either because you are taking unsecured debt and substituting it with secured debt. While it may seem like the monthly payments are lower, the expense of the refinance hardly makes it worthwhile. And if you end up with a high LTV and/or negative cash flow on the property and housing prices fall, you are in for a world of financial hurt.

Key Points

- Lenders make their profit in a variety of ways—the key is understanding how they do it, and paying the minimum you need to get a good loan at a fair price.
- Choose a mortgage company that has the requisite experience and can handle your business.
- Understand the basic loan criteria before you apply for a loan.
- Refinance only when the numbers make sense.

Creative Financing through Institutional Lenders

The power of thought—the magic of the mind!

—Lord Byron

While having a good mortgage broker or lender on your side is very valuable, you still need to have a few tricks in your back pocket to make things work. One of the main challenges for the investor is to buy properties with little or no cash, yet still have a low enough payment to avoid negative cash flow. This chapter will discuss some of the ways to do so.

Double Closing—Short-Term Financing without Cash

If your intention is to buy a property and turn it around quickly for a cash profit, it is almost a sin to pay loan costs. Known as a *flip*, the investor wants to make \$5,000 to \$10,000 turning a property that he or she buys at a bargain price. This process can be accomplished without traditional bank financing, much less a down payment.

If a particular seller and buyer cannot be present at the same time, a closing can be consummated *in escrow* (an incomplete transaction, waiting for certain conditions to be met, such as the funding of a loan). Thus, the seller can sign a deed and place it into escrow with the closing agent. When the buyer completes his or her loan transaction, the deed is delivered and the funds are disbursed. In many cases, you can buy and sell the property to a third party in a back-to-back *double closing* (also called *double escrow* in some states). You do not need any of your own cash to purchase the property from the owner before reselling it to another investor/buyer in a double closing.

The seven-step double-closing process works as follows:

1. Party A signs a purchase agreement with party B at a below-market price.
2. Party B signs a purchase agreement with party C, offering the property at market price.
3. The only party coming to the table with cash is party C. Assuming party C is borrowing money from a lender to fund the transaction, party C's bank will wire the funds into the bank account of the closing agent.
4. Party A signs a deed to party B. This deed is *not delivered* but deposited in escrow with the closing agent. Party B signs a deed to party C, which is deposited in escrow with the closing agent.
5. Party C signs the bank loan documents, at which point the loan is funded and the transaction is complete.
6. The closing agent delivers funds to party A for the purchase price and the difference to party B.
7. The closing agent records the two deeds one after another at the county land records office.

As you can see, no cash was required by party B to close the transaction. Party B's funds came from the proceeds of the sale from party B to party C. If the second sale does not happen, the first transaction, which is closed in escrow, cannot be completed. At that point, the deal is dead.

If you are doing a double closing, you are acting as both buyer and seller. A double closing is actually two separate transactions. If you do not want party C to meet party A, the double closing can be completed in two phases rather than all at once. Obviously, you cannot give the seller funds until your buyer gives you funds. Thus, one of the two transactions must be closed in escrow until the other is complete. Often, this escrow closing may last an hour. The bottom line is you cannot close with the owner if your third-party buyer does not deliver funds to you.

If you are interested in more information about the flipping process, pick up a copy of my book, *Flipping Properties* (Dearborn Trade, 2001).

Seasoning of Title

In recent years, some lenders have been placing "seasoning" (time of ownership) requirements on loan transactions. Some lenders are afraid to fund the second part of a double closing because of the possibility that the buyer's purchase price is inflated. The lenders are acting mostly out of irrational fear because of a recent barrage of real estate scams reported in the newspapers.

Property flipping scams. There has been a lot of negative press lately about double closings. Scores of people have been indicted under what the press has called "property flipping schemes." Some lenders, real estate agents, and title companies will tell you that double closings are illegal. In fact, they are nothing of the sort.

The illegal property-flipping schemes work as follows. Unscrupulous investors buy cheap, run-down properties in mostly low-

income neighborhoods. After they do shoddy renovations to the properties, they sell them to unsophisticated buyers at an inflated price. In most cases, the investor, appraiser, and mortgage broker conspire by submitting fraudulent loan documents and a bogus appraisal. The end result is a buyer who has paid too much for a house and cannot afford the loan. Because many of these loans are FHA-insured, the U.S. Senate has held hearings to investigate this practice.

Despite the negative press, neither flipping nor double closings are illegal. The activities described above simply amount to loan fraud, nothing more. As a result, some lenders have placed seasoning requirements on the seller's ownership. If the seller has not owned the property for at least 12 months, the lender will assume that the deal is fishy and refuse to fund the buyer's loan. There really is no solution to this issue other than to deal with other lenders that don't have the seasoning hangup. Make sure you stay in control of the loan process and steer your buyers to a mortgage company that doesn't have a problem with double closings.

Two possible solutions. If the buyer has found a lender that is really stuck on the seasoning issue, you have two options: (1) assign your contract to the end-buyer or (2) have the original owner buy you out of the deal.

If you assign your contract to your end-buyer, he or she will close directly with the owner. However, the end-buyer may not have enough cash to pay you the difference between your purchase price with the owner and his or her purchase price with you. You need to trust that the parties involved will pay you at closing from the seller's proceeds!

The safer way to solve the problem is to approach the owner and ask him or her to buy you out of the deal. *Buying you out* means that the owner is going to pay you to cancel the sales agreement with you so that he or she can enter into a purchase contract directly with your end-buyer. Ideally, it would be best if the owner paid you in cash before he or she closed with your end-buyer. If the owner wants to wait until the end-buyer closes the sale with him or her to pay you the cash, put the agreement in writing in the form of a promissory note,

secured by a mortgage on the property. Thus, at closing, you will be paid off as a lien holder.

The Middleman Technique

Many foolish investors and unscrupulous mortgage brokers have been known to “overappraise” a property, effectively financing a property for 100 percent of its value. The mortgage broker then passes the buyer’s down payment back to the buyer under the table so that the deal is done with nothing down. Not only is this practice illegal, it is foolish, unless the property can be rented for more than the loan payment.

Again, there is nothing special about buying a property with no money down unless it is profitable to do so. If you can purchase the property at a substantially below-market price *and* with no money down, you then have a good deal. This is buying 100 percent loan to purchase, not 100 percent loan to value.


The problem with buying a property at a below-market price is that conventional lenders tend to penalize you with their loan regulations. As discussed earlier, FNMA-conforming loan guidelines usually require that an investor put up 20 percent of his or her own cash as a down payment. The 20 percent rule applies even if the purchase price is half of the property’s appraised value. A common, but illegal, practice is for the buyer to put up the down payment and for the seller to give it back to the buyer after closing. People may get away with it all the time, but this practice is loan fraud.

The middleman technique is a legal way to get around the 20 percent down rule. The process requires the following three important factors:

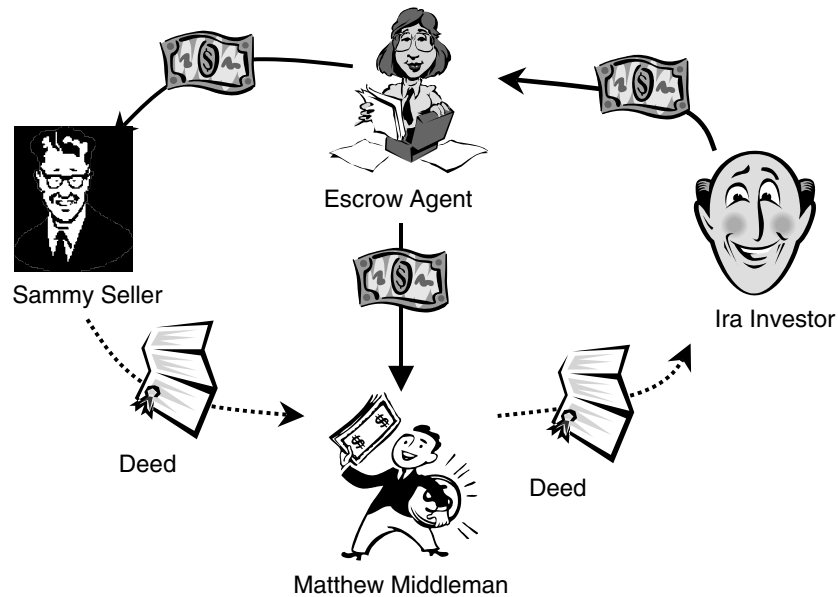
1. A middleman buyer
2. A negotiated purchase price that is 10 percent to 20 percent below market value

3. A lender that does not require evidence of a cash down payment

Use a middleman partner to buy the house from the owner at a discount and sell it to you for its full appraised value. Do a double closing at which time the middleman buys the property and simultaneously sells to you. The reason for the middleman buyer is to increase the purchase price, because most lenders base their LTV on the lesser of the purchase price or the appraised value. Thus, even if you negotiate a 20 percent discount in the purchase price, the maximum loan you can get is based on the purchase price, not the appraised value.

 **Example:** Sammy Seller has a property worth \$100,000 and is willing to accept \$80,000 for an all-cash sale. Matthew Middleman signs a purchase contract to buy it from Sammy for \$80,000. Matthew Middleman then signs a contract to sell the same property to Ira Investor for \$100,000. The terms of the contract are \$80,000 cash and a note for \$20,000, due in ten years. Ira applies for a loan with First National Bank for 80 percent of the purchase price, or \$80,000. At a double closing, Sammy signs a deed to Matthew, which is held in escrow. Matthew signs a deed to Ira, which is also held in escrow. First National Bank funds the loan by wiring the money into the account of the escrow agent. The closing agent writes Sammy a check for \$80,000. Ira signs a note to Matthew for \$20,000. The closing agent records the two deeds back-to-back. Sammy gets his \$80,000. Ira gets his property for only a few thousand dollars down (his loan costs). Matthew gets a note from Ira for \$20,000. See Figure 5.1.

Epilogue: A month or two after closing, Matthew and Ira become partners when Ira deeds a one-half interest in the property to Matthew in exchange for complete satisfaction of the note.

FIGURE 5.1 Middleman Double-Closing Technique

Warning: Keep in mind that you should disclose to the lender up front that you are not putting up any cash in the deal. Do not, I repeat, do not pay the seller cash at closing and take it back under the table in exchange for a note. This practice is loan fraud, punishable by up to 30 years in federal prison. See 18 U.S.C. Sec. 1014.

Case Study #1: Tag Team Investing

I stumbled across a property that was bank-owned and offered by auction to the public. Like many foreclosures, the property was in need of repair (approximately \$10,000 worth, in this case). The mar-

ket value of the property in its existing condition was about \$180,000. The bank was willing to accept a bid of \$134,000, which was 74 percent of its value.

I brought in a middleman to submit the bid of \$134,000 to the bank. The terms of the offer were all cash, which the lender would receive, as explained in a moment.

The middleman then signed a contract to sell the property to me for \$180,000. The terms of the sale from the middleman to me were \$9,000 cash and a \$27,000 promissory note (no payments, interest only, due in five years). The \$27,000 note was to be secured by a second mortgage on the property, because I intended to borrow 80 percent of the purchase price (\$144,000) and secure the new loan with a new first mortgage on the property.

After the double closing, I owned the property subject to a new first mortgage of \$144,000 to an institutional lender and a second mortgage of \$27,000 to the middleman investor. The bank that owned the property received their \$134,000 in cash, and the middleman investor walked away with about \$9,000 in cash. I was out of pocket about \$11,000, which was the down payment (\$9,000), plus closing costs (\$2,000).

I later sold the property for \$185,000, at which time the middleman investor agreed to accept a 50 percent discount on the \$27,000 note. I used proceeds from the sale to pay the middleman. In the meantime, the payments on the \$144,000 first mortgage note were less than I was able to rent the property for.

Case Study #2: Tag Team Investing

A client of mine (we'll call him Chuck) used the middleman method to buy a \$1.6 million house with no money down. The property was banked-owned as the result of a foreclosure. Chuck set up a simple living trust for himself with his buddy as trustee. The trust signed a contract (executed by Chuck's buddy, the trustee) to buy the house from the bank for \$950,000. Chuck then signed a contract to buy the house from the trust for \$1.6 million, the property's appraised

value. Chuck gave the trust \$400,000 cash and borrowed \$1.2 million from an institutional lender. Because Chuck was the beneficiary of the trust, he received the proceeds of the sale (his \$400,000 down payment, plus the \$250,000 loan proceeds), netting nearly \$250,000 cash in his pocket. Needless to say, he has yet to reach into his pocket for a monthly payment on his new loan!

Walk the Fine Line Carefully

In Chuck's example, the lender never asked (nor did Chuck misrepresent) the relationship between the trust and himself. However, if the lender does ask about the relationship between you and the middleman, be truthful. Don't mislead or misrepresent anything to the lender you are borrowing from. It's one thing to be creative with a lender; it's another thing to lie.

Using Two Mortgages

In the Case Studies above, we got around the 20 percent down payment financing requirement by using a seller-carryback loan (discussed in more detail in Chapter 9). This type of loan is known as an 80-15-5 loan; you borrow a first mortgage loan for 80 percent of the purchase price, ask the seller to accept a note for 15 percent of the purchase price, and put down the balance of 5 percent in cash. There are many variations to this formula, such as 80-10-10 (80 percent first mortgage, 10 percent second mortgage, 10 percent down).

In Case Study #2, the seller accepted a note and second mortgage for part of the purchase price. The 10 percent (or more) can also be borrowed from a third party, such as an institutional lender. The ad-

Tax Consequences to the Middleman

You may be wondering, “If the middleman sells the property to you at a profit, isn’t this taxable income?” Yes and no. Although it looks like a profit is made, there is no real gain. The middleman, in Chuck’s case, was a trust of which Chuck was the taxable owner, so there was no gain. In Case Study #1, the middleman’s profit was a note, which is an installment sale. Installment sale income is taxed when the gain is actually received, not when the note is executed. In that particular case, no gain was received until the note was paid in full (in my case, it was only paid 50 percent, which was taxable income to the middleman).

vantage of using two loans as opposed to one 90 percent or 95 percent LTV loan, is that the underwriting requirements are easier on the 80 percent LTV first mortgage loan (and you avoid the PMI requirement, discussed in Chapter 3). Generally speaking, nonconforming lenders aren’t as concerned with the source of the down payment or whether the borrower offers cash or a note (or other financing) for the balance of the purchase price. So long as the primary lender is in a first mortgage lien position at 80 percent LTV or less, they are fine with the seller accepting a note or the borrower obtaining some of the difference in the form of a second mortgage loan.

No Documentation and Nonincome Verification Loans

Conforming loans generally require strict proof of income, assets, and other debts. If, for example, you cannot prove income to a lender, whether it is because you are self-employed for a short time or

Get Out the Calculator

Using a first and second mortgage in lieu of one larger loan may not make sense until you do the numbers. Surely, a second mortgage loan as described here will carry a higher interest rate because of the lender's increased risk of being in second position. Make sure the "blended" interest rate between the first and second mortgages does not exceed what you otherwise would be paying with a larger, single first mortgage loan. Also, keep in mind that a larger first mortgage loan may also mean you are paying private mortgage insurance, so that must be factored into the monthly payment.

How to Calculate a Blended Interest Rate

Multiply each interest rate times the amount it relates to the total debt, then add them together. For example, if you have an \$80,000 first mortgage loan at 8%, and a \$20,000 second mortgage loan at 10%, the blended rate is $(8\% \times .8) + (10\% \times .2) = 8.4\%$.

can't otherwise prove income, there are nonincome verification (NIV) loans.

NIV loans (also known as "stated income" loans) require less documentation than traditional loans. Lenders often advertise these programs as "no doc" loans, meaning the borrower does not have to come up with any documentation other than a credit report and a loan application.

Some loans are called “no ratio” loans, in that you don’t have to justify your total debt (mortgages plus other continuing obligations, such as car loans and student loans) compared to your income.

Few, if any loans are true “no documentation” loans. Most of these offered programs are bait and switch tactics: The lender says they don’t need documentation, but when the loan is being processed, the lender will ask for more and more documentation. Often, the lender will see some red flags that trigger the additional inquiry.

The best defense to these tactics is a good offense; speak to your lender or mortgage broker up front. Identify documentation issues up front, educate the lender about your finances, and be truthful. The more a lender suspects you are hiding something, the more documentation the lender will ask for.

Here is a real-world example: Carteret Mortgage, <www.nva-mortgage.com>, lists the following general guidelines for one of its no-ratio mortgage loans:

- Minimum middle credit score must be 640.
- Five credit accounts are required; three may be from alternative sources—utility, auto insurance, etc.
- Bankruptcy and foreclosures must be discharged for three years with reestablished credit.
- Two years’ employment with same employer.
- Two months’ PITI reserves are required with an LTV less than 80 percent. Six months’ reserves are required otherwise.
- 10 percent minimum down payment is required from your own funds. No gifts.

You should ask for this kind of information up front from your mortgage broker or lender. The more information you know about what a lender needs, the more information you can provide.

Watch What You Say on NIV Loans

Just because you don't have to provide documentation of your income to the lender, it doesn't mean you have a license to lie. Most lenders will make you sign an authorization to release federal income tax returns. They may not check now, but if your loan goes into default, they may obtain copies of your tax returns. If the income you report on your loan application is way out of sync with your tax returns, you may be answering to loan fraud charges.

Develop a Loan Package

You should present a loan package of your own to any new lender. This package should include the following:

- Your completed FNMA Form 1003 loan application (See Appendix C.)
- A recent copy of your credit report, with written explanations of negative information
- A copy of the purchase contract for the subject property
- A copy of the down payment check and documented proof of where it came from
- Copies of recent tax returns, pay stubs, and W-2s (if applicable)
- Recent appraisal of the property if you have one, or a market analysis prepared by a real estate agent
- Copies of existing leases or information of rental value of similar properties

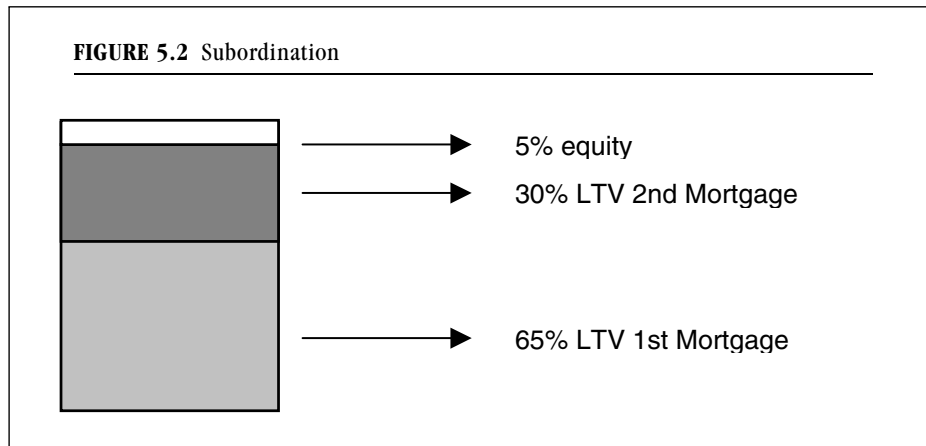
- Copies of recent bank statements, retirement plan accounts, and brokerage accounts
- Any other relevant financial information concerning assets or liabilities.
- References from other bankers, lenders, or prominent members of your community, such as a judge, politician, or bank president

The more information you provide up front, the less surprises the lender runs into, and hence the less likely it will be suspicious and ask for more documentation.

Subordination and Substitution of Collateral

Subordination is asking someone who holds a mortgage (or deed of trust) on your property to agree to make his or her lien *subordinate*, or second in line, to another lien. For example, suppose you own a property worth \$100,000 that has a first mortgage to ABC Savings Bank for \$65,000. If you want to borrow \$30,000 from First National Bank secured by a second mortgage, you would have to pay a much higher interest rate because First National's mortgage would be subordinate, or second, to the lien in favor of ABC Savings Bank. See Figure 5.2. A second lien position is riskier than a first lien position, so the interest rate is generally higher to compensate the lender for its increased risk. If you could convince ABC Savings Bank to move its lien to second position, First National would now be a first mortgage holder and thus give you a better interest rate.

Keep in mind that you can use subordination to draw cash on properties you already own. If you* purchased a property with seller financing, simply ask the former owner to subordinate his or her mortgage to a new first. This may require you to give the seller some incentive, such as additional cash or paydown of the principal. Either way, subordination is an excellent way to finance a purchase or draw money out of existing properties.



Substitution of collateral is a method of moving a lien from one property, or collateral, to another. The substituted property does not necessarily have to be real estate. You can use a car or boat title as the substitute collateral. Better yet, get the mortgage holder to release the mortgage with no substitute collateral! To get someone to take a note without collateral, you need to offer a substantial cash down payment. Think about this: If the note you give the seller is not secured by the property, you can refinance or sell the real estate without paying off the note.

Case Study: Subordination and Substitution

A property owner (we'll call her Mrs. Seller) called me to discuss selling her house. After some negotiations, we agreed to purchase the property for \$63,000 as follows:

- \$35,000 cash at closing of title
- Promissory note and second mortgage (subordinate to a new first) for \$28,000, payable in installments of \$350 per month, no interest

She owned the house free and clear, so why would she do such a thing? The answer is, to have her needs met. After some discussion, she told me that she was sick of the upkeep of the property and wanted a brand-new doublewide mobile home. The \$35,000 cash was for the new home, and the \$350 per month would pay her mobile home lot rent (just so you know that I didn't "steal" the property from some little old lady!).

I went to a hard-money lender (discussed in Chapter 6) and borrowed \$37,500 at 12 percent interest (only \$35,000 went to the seller; the extra cash was for the points on the loan). I closed escrow, placing a new first mortgage in favor of the hard-money lender, and a second mortgage (subordinate to the first) in favor of the seller for \$28,000. My total monthly payments were \$725 per month, and I rented the property to a nice family for \$800 per month.

A few years later, I wanted to sell the property, so I called Mrs. Seller and asked if she would be willing to take a discount on the amount we still owed her, which was approximately \$20,000 (remember the original amount was \$28,000). She said that she liked the monthly payments and didn't want me to pay her off! With that, she agreed to accept \$10,000, release the mortgage from the property, and allow us to continue making payments on the \$10,000 balance of the unsecured promissory note. Not only did we profit from the sale of the property, we also walked away from closing with an extra \$10,000 cash in our pockets! The extra cash was due to the fact that we only paid her \$10,000 towards the balance of the \$20,000 debt still remaining. We continued to make monthly payments on the note, but because the security (mortgage) was released from the property, we received the cash from the proceeds of the sale.

As you can see, subordination and substitution of collateral are two powerful tools to make you more money in real estate.

Zero-Interest Financing: The Exception to the “Cash Flow Is King” Rule

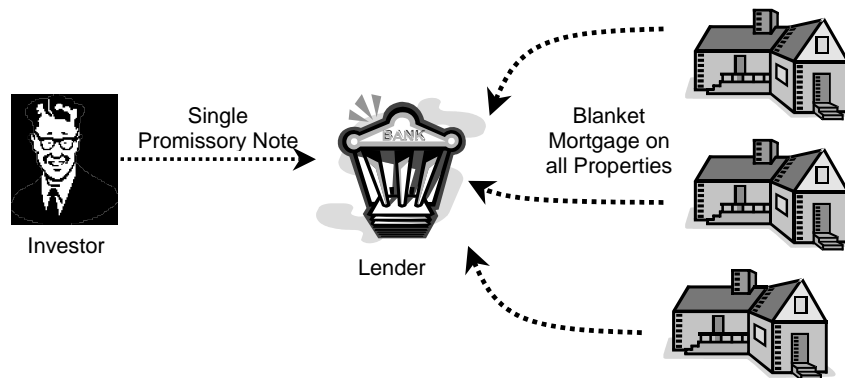
In Mrs. Seller’s case, the payments on the high-interest-rate first mortgage plus the owner-carry second mortgage were only slightly less than the market rent for the property. However, because the payments on the owner-carry second were for zero interest, the equity pay-down far exceeded the value of the cash flow. Zero-interest financing is one of the rare instances where monthly cash flow is not the investor’s first concern.

Using Additional Collateral

If the lender you are dealing with feels uncomfortable with the collateral or your LTV requirements, offer additional security for the loan. There are several ways to securitize a loan, other than with a lien on the subject property.

Blanket Mortgage

A blanket mortgage is a lien that covers multiple properties. Developers often use a blanket mortgage that covers several lots. When each lot is developed and sold, the lien is released from that lot. A blanket mortgage (or deed of trust) is just like a regular lien, except that it names several properties as collateral. When recorded in county records, the lien is now placed on each property named in the security instrument. See Figure 5.3.

FIGURE 5.3 Blanket Mortgage

If you have other property with equity, even raw land, you can offer this property as additional security for the loan. Be cautious, however, with offering your personal residence as security; failure to make payments can make you homeless!


Using Bonds as Additional Collateral

A bond, like a note, is a debt instrument. In return for the loan, the investor is paid in full at a future date. Bonds generally pay interest at fixed periods, unless they are zero-coupon bonds. The cash value of a bond at any given time is based on the maturity date and its present value, which in turn is based on whether investors are speculating interest rates will rise or fall in the future. As interest rates fall, bond prices rise, and vice-versa. And, logically, the later the maturity date, the less the present value of the bond.

Municipal and government bonds are virtually the same as cash; they can be traded, sold, and hypothecated (used as collateral). U.S. Treasury bonds are safe, secure investments from a risk standpoint.

From an investment standpoint, they are a fair to good bet, depending on interest rates and market inflation.

Most laypeople think of bonds as being a secure investment. Of course, institutional lenders are generally too savvy to accept the face value of a bond as collateral. However, when dealing with a private motivated seller, an owner-carry offer that is cross-collateralized with U.S. Treasury bonds sounds appealing. When making an offer to a seller with owner financing, offer the face value of the bond as collateral. Although the present value may be less, the very idea of a bond as additional collateral sounds safe. Furthermore, bonds can be used in lieu of a down payment.

 **Example:** Sonny Seller owns a house free and clear and is asking \$100,000 for his house. Brian Buyer offers Sonny \$110,000 as follows: \$30,000 in U.S. Treasury bonds and an \$80,000 note secured by a mortgage on the property. The \$30,000 in bonds, if they matured in 30 years, can be bought for a fraction of their face value, depending on the market interest rates. In the seller's mind, he's receiving more than the asking price, but the buyer is paying much less than the asking price (sometimes sellers are stuck on asking price just because they are ashamed to tell their neighbors they took less!).

For an excellent reference on using bonds as collateral for real estate financing, I recommend *Formulas for Wealth* by Richard Powelson, Ph.D. (Skyward Publishing, 2001). For more information on bonds, try www.savingsbonds.gov.

Key Points

- Avoid loan costs on flips—use the double closing.
- Use the middleman technique to overcome lender down payment requirements.
- Don't let lack of income hold you back—use NIV loans.
- Think beyond the property for collateral: substitute, subordinate, and cross-collateralize.

Hard Money and Private Money

A loan shark is simply a thief without a Wall Street office.

—Lyndon H. LaRouche, Jr.

An often overlooked and very valuable source of funding is private money. Small companies and individual investors called “hard-money lenders” are an excellent resource for quick cash. Private lenders are often known as hard-money lenders because they charge very high interest rates. I have personally borrowed at 18 percent with 8 points as an origination fee! These rates may sound outrageous at first blush, but it is the availability of the money not the cost that matters.

Emergency Money

I recently won with the high bid on a condominium auctioned by the Department of Veterans Affairs (VA). I made the bid in the name of a corporation rather than my individual name. I was assured by my mortgage broker that the lender that had my loan application would

permit me to finance the purchase in a corporation. At the 11th hour, the lender changed its mind, requiring me to close in my individual name. I asked the VA for permission to amend the purchase contract to name me, rather than my corporation. The VA refused, and I now had less than five days to close or lose the deal. Because my winning purchase bid was an excellent price, I opted for using hard money to purchase the property. I paid 14 percent interest for a few months, then refinanced the property at a good interest rate. All in all, the high cost of the hard-money loan was worth it and saved me in a pinch.

Hard-money lending criteria are based on the collateral (the property) rather than the financial strength of the borrower. For this reason, hard-money lenders are often referred to as “equity” lenders. A hard-money lender looks at a loan, thinking, “Would I want to own this property for the amount of money I lend this person?” Hard-money lenders generally go no higher than a 75 percent loan-to-value. The good news, however, is that many hard-money lenders will base their loan on appraised value, not purchase price. So, if you negotiate a very good purchase price, you may end up with an 85 percent loan-to-purchase ratio.

Hard-money lenders can be expensive but also easy to deal with if you are in a hurry for the money. In many cases, the availability of the money is more important than the cost of borrowing it.

Where to Find Hard-Money Lenders

Hard-money lenders are fairly easy to find, once you know where to look. The first place is your local newspaper, under “money to loan.” The ads will usually look something like this:

**Stop Foreclosure! Real Estate Loans.
Fast and Easy. No Credit Required.
48-Hour Funding. Call Fred 555-1134.**

Many hard-money lenders advertise on the Internet. Try a Yahoo! search of the Internet for hard-money lender Web sites. Not all hard-money lenders call themselves that; some use the title “equity based lender.” It is best to find one that is located within your state. A referral from another local real estate investor is helpful, too. For a referral to a local real estate investors club in your city, try the National Real Estate Investors Association at <www.nationalreia.com>.

Borrowing from Friends and Relatives

Friends and relatives seem like obvious choices for borrowing money, but they may be as skeptical as an institutional lender. They may try to boss you around and nag you about when you expect to repay the money you borrowed. They may also want to be part of the daily decision-making process, which would interfere with your business. And, of course, they may be emotional about their money, whereas institutional lenders don't take money matters personally.

Borrower Beware! Soliciting money from private investors can be a dangerous practice. Federal securities laws may apply to public solicitations of money as a “public offering.” In addition, state securities regulations (known as “Blue Sky Laws”) may also apply. Simply running a blind ad in the paper stating, “Private Money Wanted for Real Estate Purchase – 12% Return” may result in a call from your state Attorney General's Office. If you are approaching a friend, relative, or individual investor to borrow money secured by a specific property, then you are probably OK; borrowing money for a “pool” of funds becomes trickier. Also, when you deal with strangers, multiple parties, or the public at large, you should seek the advice of a local attorney knowledgeable about state and federal securities regulations.

Using Lines of Credit

A home equity line of credit (HELOC) can be an excellent financing tool, if it is used properly. A HELOC is basically like a credit card secured by a mortgage or deed of trust on your property. In most cases, it will be a second lien. You only pay interest on the amounts you borrow on the HELOC. You can access the HELOC by writing checks provided by the lender.

HELOCs are being advertised on television as a way to consolidate debt, but they can be used much more effectively by investors. When you need cash in a hurry for a short period of time, a HELOC can be very useful. For example, if a seller tells you to give him “\$75,000 cash on Friday and I’ll sell you my house for a song,” you need to act in a hurry. Another example of cash in a hurry is a foreclosure auction, which, in many states, requires payment at the end of the day of the auction. When you need cash in a hurry, there’s no time to go to the bank.

While the HELOC may be a high-interest-rate loan, it is a temporary financing source that can be repaid when you refinance the property. *Do not use your HELOC as a down payment or any other long-term financing source—it will generally get you into financial trouble.* Furthermore, an institutional lender may not lend you the balance if you borrowed the funds for the down payment.

Warning: Failure to pay your HELOC means you lose your home! Use your HELOC wisely and only if it means losing a steal of a deal if you don’t!

Credit Cards

You may already have more available credit than you realize. Credit cards and other existing revolving debt accounts can be quite useful in real estate investing. Most major credit cards allow you to take cash advances or write checks to borrow on the account. The transaction fees and interest rates are fairly high, but you can access this money on 24 hours’ notice. Also, because credit card loans are

Deducting HELOC Interest

There are limits on the deductions you can take on your personal tax return for interest paid on your HELOC. Generally speaking, you can only deduct that portion of interest on debt that does not exceed the value of your home and is less than \$100,000. But, if you do your real estate investments as a corporate entity, you can always loan the money to that entity and have the entity take the deduction as a business interest expense. This transaction must, of course, be reported on your personal return and must be an “arms-length” transaction (i.e., documented in writing and within the realm of a normal business transaction). Consult with your tax advisor before proceeding with this strategy.

unsecured, there are no other loan costs normally associated with a real estate transaction, such as title insurance, appraisals, pest inspections, surveys, etc.

Often, you will be better off paying 18 percent interest or more on a credit line for three to six months than paying 9 percent interest on institutional loans that have up-front costs that would take you years to recoup. Again, use credit cards carefully and only as a temporary solution if the deal calls for it.

Key Points

- Hard money is an excellent short-term financing tool.
- HELOCs and credit cards are excellent sources for fast cash.

Partnerships and Equity Sharing

The guy with the experience approaches the guy with the money. When the deal is complete, the guy with the experience has the money, and the guy who had the money has experience.

—Anonymous

If you are low on cash or have cash and are low on time, a partnership or equity-sharing arrangement may be for you. Using partners to finance real estate transactions is the classic form of using other people's money (OPM). Experienced investors are always willing to put up money to be a partner in a profitable real estate transaction. As with many businesses, talent is more important than cash. If you can find a good real estate deal, the money will often find its way to you!

Partnership arrangements work in a variety of circumstances. The most common scenario involves one party living in the property while the other does not. Another scenario may involve all of the parties living in the property. These arrangements are common among family members. Parents often lend their children money for a down payment on a house, with a promise of repayment at a later date. If

the repayment of the debt is with interest and/or relates to the future appreciation of the property, we have a basic equity-sharing arrangement.

Another common financing arrangement between multiple parties is a partnership wherein none of the parties live in the property. This chapter will discuss the basic partnership investment. Larger investments through limited partnerships and other corporate entities in a “pool” of money are known as “syndications.” These investments are generally classified as securities, so compliance with state and federal regulations is complex. Thus, syndications are generally not recommended for financing smaller projects because the legal fees for compliance with securities laws will far exceed the benefit of raising capital through multiple investors.

Basic Equity-Sharing Arrangement

The common equity-sharing arrangement involves one party living in the property and the other putting up cash and/or financing. Both the occupant and the nonoccupant enjoy tax benefits and share the profit, as described later in this chapter. First-time homebuyers make the best resident partners while family members, sellers, and real estate investors fill the nonresident partner role.

Scenario #1: Buyer with Credit and No Cash

A lot of potential homebuyers have the income to qualify for a mortgage loan, but only with a substantial down payment. With a small down payment, the monthly loan payments may be too high. A potential homebuyer could borrow the money for the down payment, but nobody but a fool (or a parent) would lend \$25,000 or more unsecured. Furthermore, loan regulations generally do not permit the use of borrowed money as a down payment.

An equity-sharing partner could put up the money in exchange for an interest in the property. The resident partner would obtain the loan, live in the property, make the monthly loan payments, and maintain the property. The nonresident partner who puts up the down-payment money is free from management headaches and negative cash flow. After a number of years (typically five to seven), the property is sold, the mortgage loan balance is paid in full, and the profits are split between the parties. Obviously, the strategy works best in a rising real estate market.

Scenario #2: Buyer with Cash and No Credit

The second equity-sharing scenario would be a buyer with cash but an inability to qualify for institutional financing. The resident partner would put up the down payment, the nonresident partner would obtain the loan. After a number of years, the property is sold, the mortgage loan balance is paid in full, and the profits are split between the parties.

Your Credit Is Worth More Than Cash

Just because you put up credit and no cash does not mean you aren't at risk. Cash is easy to come by, but good credit takes years to build, and only months to ruin. As I write this book, an investor friend of mine (we'll call him Brian) recalls his first deal. Brian was a neophyte investor who was approached by an experienced investor with the following proposal: "You put up your credit to get the loan; I'll put up the cash for the down payment." Brian bought the property with the investor in this manner, but Brian did not manage the property. Brian received a call from the lender a year later and was informed that the mortgage loan had not been paid in several months. Brian was unable to locate his partner who had apparently collected the rents and skipped town.

The moral of this story: Use your credit wisely—cash can be recouped in a few months, but credit blemishes can take years to fix.

Tax Code Compliance

Equity sharing arrangements are governed by Section 280A of the Internal Revenue Code (IRC). Labeled a Shared Equity Financing Agreement (SEFA), IRC Section 280A permits the nonresident partner investment property tax benefits (namely depreciation). In addition, the resident partner can take advantage of the benefits of owning a principal residence (namely, the mortgage interest deduction).

The nonresident partner is essentially treated for tax purposes as a landlord, taking depreciation for his or her ownership interest to the extent he or she receives rent. So, for example, if fair market rent for the property is \$1,000 per month and the resident/nonresident equity split is 60/40, then the resident must pay \$400 in rent to the nonresident partner if the nonresident wants to take the depreciation deduction. In turn, the nonresident partner returns the rent to property expenses for which the resident partner is responsible (in this way, the cash contribution by the resident partner is not increased—it is just shifted to conform with the tax code). If the resident does not pay rent, but rather makes all of the mortgage interest payments directly to the lender, then the investor receives no tax benefits, leaving them all to the resident. The agreement can be made in a number of ways, depending on the needs of the parties and their needs for the tax deductions.

The parties must have a co-ownership agreement that complies with IRC Section 280A in order to reap the benefits of this mixed use tax plan. If the relationship is deemed a “partnership” by the IRS, then the rules of IRC Section 280A are not applicable. A highly recommended book that covers the tax implication in detail is *The New Home Buying Strategy* by Marilyn Sullivan, Esq., <www.msullivan.com>.

Depreciation Is Often an Overrated Deduction

With breakeven or even slightly positive cash flow, the depreciation deduction creates a “paper loss” for the investor. The loss can be used to offset the investor’s other income. Keep two things in mind. First, the deduction is not always available to the investor, depending on his other income. Second, the depreciation taken on a rental property is recaptured (realized as a gain) when the property is sold. In short, don’t always assume that you need the depreciation deduction—always review the issues with a professional tax advisor before proceeding.

Pitfalls

A joint ownership arrangement can be problematic if the resident does not maintain the property or make the mortgage, insurance, or property tax payments. Furthermore, if the property does not go up in value, the nonresident party who put up the credit or cash may not realize any profits. Like any real estate investment, the shared equity arrangement should be approached with profit and not just financing in mind. In other words, make sure you buy the property at a good price and/or in the right neighborhood at the right time.

Alternatives to Equity Sharing

For the nonresident investor, there are several alternatives to the equity-sharing arrangement. The first is the lease option, which is discussed in more detail in the Chapter 8. The second is a joint venture.

Joint Ventures

A *joint venture* is a limited-purpose general partnership. A general partnership is formed when two or more people engage in a business with the intention of sharing profits and losses. A partnership need not necessarily be in writing, although it is generally a good idea. A joint venture is a general partnership that is limited in scope. Thus, if two individuals agree to buy a particular property with the intention of making a profit, the two individuals are not necessarily in business to buy properties; the scope of the partnership is limited to that one venture.

Under the federal tax code, a joint venture participation in a rental property does not necessarily create a partnership. So, while two individuals may co-own a rental property, they do not necessarily have to file a partnership return. However, if two or more individuals engage in multiple rental property investments, this may trigger reporting for federal tax purposes. For more information on partnership tax reporting, read IRS Publication 541 (get a free download at <www.irs.gov>).

Using Joint Venture Partnerships for Financing

Joint venture partnerships can be an excellent way to finance a real estate transaction, and they can be handled in a variety of ways. The most common is where one partner puts up cash and the other puts up his or her interest in the deal and/or his services in managing the property. The joint venture agreement will spell out how the money is contributed and how it is disbursed. Title to the property is generally held in the name of the joint venture, although title can be taken in the name of one or both of the partners. Using a partner to finance deals can be very effective on a deal-by-deal transaction.

Sometimes a joint venture partnership looks more like a general partnership because it is not specific to any one particular property. For example, an investor, or group of investors, may “pool” money

together for the purchase of properties at a foreclosure auction. This type of arrangement should be approached with extreme caution because it looks more like a general partnership than a joint venture. It also may cross over into securities regulations, particularly if you are the one soliciting money from other investors.

Legal Issues

Owning real estate jointly with other parties is an effective financing tool, but it can also be a liability. Under the Uniform Partnership Act, the law holds all partners liable for each other's actions. Thus, if you are a "silent" partner, you could be held liable as the "deep pocket." Consider setting up a limited liability company (LLC) or limited partnership for joint venture projects. The owners of an LLC are shielded from liability for activities of the company and the activities of each other. Limited partners (but not general partners) of a limited partnership are similarly shielded from personal liability.

For more information on LLCs and limited partnerships, visit my Web site at <www.legalwiz.com/LLC>.

Alternative Arrangement for Partnership

Rather than having a partnership own the property, partners can realize the same profit goals by using a note and security instrument. One partner will hold title to the property and sign a note to the other partner for the amount of the other partner's cash investment. The note is secured by a mortgage on the property. A second note and mortgage is also executed, which will be a shared equity mortgage. A *shared equity mortgage* has a payoff that is based on a formula that relates to the increase in value of the property.

Shared equity mortgages (AKA shared appreciation mortgages or participation mortgages) were popular when interest rates were so high that commercial borrowers could not maintain positive cash

flow. The lender thus dropped the interest rate in return for a share of the future profits in the borrower's property. Today, shared equity mortgages are not as popular, but they are still an effective tool for financing properties with people who are open-minded.

Tax Issue for the Lender

Normally, an investor must pay profits when he or she sells investment property for a gain. An owner (or co-owner) of real estate can defer paying taxes on this gain by exchanging under Section 1031 of the Internal Revenue Code. Because the partner holding the shared appreciation mortgage is not an owner of the real estate, he or she is not able to take advantage of a Section 1031 exchange (for more information on tax-deferred exchanging, go to <www.1031x.com>).

Case Study: Shared Equity Mortgage with Seller

A viable option for seller financing is to make the seller your partner with a shared appreciation mortgage. In this case, the seller/lender shares in the future appreciation of the property. A seller may be willing to accept little or nothing down in exchange for principal and interest payments, lack of management, and future appreciation. Essentially, the note and mortgage documents read the same as a standard note and mortgage, except that the payoff amount increases over time in proportion to the value of the property. The shared appreciation can be written a number of ways and need not necessarily be a 50/50 split of future appreciation.

Is a Shared Equity Mortgage a Partnership?

When using shared equity mortgages, there is a fine line between a lender/borrower and a partner/partner relationship. There could be adverse tax and legal consequences if a court or the IRS were to recharacterize a lender/borrower relationship to that of a legal partnership. The key legal distinction is the sharing of losses by the lender in the transaction. Because a partnership involves the agreed sharing of profits and losses, removing the lender's risk of loss will help avoid the recharacterization. As with any complicated transaction, you should hire the services of a competent attorney to draft or review the paperwork.

When Does a Partnership Not Make Sense?

Real estate partnerships, like any business partnership, should be approached with profit in mind. Buying property jointly with a friend makes no sense just because you want to limit your exposure to half the loss. Likewise buying property with a partner should be avoided if the partner's share of the profit is less than you could pay for a loan. Even at 18 percent interest and with 10 points origination fee, you might still end up with more profit by borrowing hard money. Use your common sense and a calculator, not your emotions and fears.

An equity partner should be used when conventional, hard-money, seller-carryback, and creative financing means are out of the question. In my experience, if you need a partner to finance the deal, it may not be all that good a deal; if you buy at the right price, borrowing the necessary money is easy. However, there is one exception to this rule: If your partner has a great deal more experience than you,

giving up part of the profit for a good education may be worthwhile. And, suffice it to say, make sure you know who you are partnering with by checking out his or her background and references.

Key Points

- Equity sharing and joint ventures can be effective financing alternatives.
- Approach general partnerships with extreme caution.
- Consider alternatives to partnerships whenever possible.

The Lease Option

The road less traveled is that way for a reason.

-Fortune Cookie

The lease-option strategy is a great way to leverage your real estate investments because it requires very little cash. The lease-option method is more of a financing alternative than a financing strategy because you don't own the property.

The basic lease-option strategy involves two legal documents, a lease agreement and an option. A lease gives you the right to possess the property, or, as an investor, to have someone else occupy it. If you can obtain a lease on a property at below market rent, you can profit by subleasing it at market rent.

An *option* is the right to buy a property. It is a unilateral or one-way agreement wherein the seller obligates himself or herself to sell you the property, but you are not obligated to buy it. By obtaining the right to buy, you control the property. You can market the property and sell it for a profit. The longer you can control the property in an appreciating market, the more value you create for yourself. By combining a lease and an option, you create a lease option.

Financing Alternative

The two primary objectives of the real estate investor are cash flow and appreciation. You don't need to own a property to create cash flow or benefit from appreciation. Because a lease entitles you to possession, it allows you to create cash flow. An option gives you the right to buy at a set price, allowing you to benefit from future appreciation.

Lease—The Right to Possession

Under a lease agreement, the lessor (landlord) gives the lessee (tenant) the right to possess and enjoy the property, one of the most important benefits of real estate ownership. The lessee is usually not responsible for property taxes and major repairs. Once you have the right to obtain possession of property, you can profit by subletting or assigning your right to possession.

Sublease

A *sublease* is a lease by a tenant to another person, a subtenant, of a part of the premises held by the tenant under a lease. The sublease can be for part of the premises or part of the time period. For example, if the tenant has a three-year lease agreement with the landlord, the tenant can sublease the rental unit for two years, or sublease part of the unit for three years.

Assignment

An *assignment* is a transfer to another of the whole of any property or any estate or right therein. As with a sublease, the master tenant

is not relieved from liability for obligations under the lease. However, the assignee of a lease is in contract with the landlord, and thus the landlord can collect from the assignee *or* the master tenant for nonpayment of rent.

Assignment and subletting are always permissible without an express provision in the lease forbidding the tenant from doing so. As a tenant/investor, it is imperative that there are no antiassignment or antisubletting clauses in your lease with the owner of the property.

More on Options, the “Right” to Buy

A real estate sales contract is a *bilateral*, or two-way, agreement. The seller agrees to sell, and the purchaser agrees to buy. Compare this agreement with an option; an option is a *unilateral* contract in which the seller is obligated to sell, but the purchaser is not obligated to buy. On the other hand, if the purchaser on a bilateral contract refuses to buy, he or she can be held liable for damages.

A bilateral contract with contingency is similar to an option. Many contracts contain contingencies, which, if not met, result in the termination of the contract. Essentially, a bilateral contract with a contingency in favor of the purchaser turns a bilateral contract into an option in that it gives the purchaser an “out” if he or she decides not to purchase the property. Though the two are not legally the same, an option and a bilateral purchase contract with a contingency yield the same practical result.

The receiver of the option (*optionee*) typically pays the giver of the option (*optionor*) some nonrefundable option consideration, that is, money or other value for the right to buy. If the option is exercised, the relationship between the optionor and optionee becomes a binding, bilateral agreement between seller and buyer. In most cases, the option consideration is credited towards the purchase price of the property. If the option is not exercised, the optionee forfeits the option money.

As seen in the following examples, an option can be used to gain control of a property without actually owning it:

- A speculator who is aware of a proposed development can obtain options on farmland and then sell the options to developers.
- To take advantage of appreciation in a hot real estate market, an investor can use a long-term option to purchase property.
- To induce timely rental payments, a landlord can offer the tenant an option to purchase.

There are literally hundreds of ways that an option can be structured, and every detail is open for negotiation between the optionor (seller) and optionee (buyer).

An Option Can Be Sold or Exercised

An option, like a real estate purchase agreement, is a personal right that is assignable. If you were able to obtain an option to purchase at favorable terms, you could sell your option. The assignee of the option would then stand in your shoes, having the same right to exercise the option to purchase the property. As with a lease, an option is freely assignable absent an express provision in the option agreement to the contrary.

Alternative to Selling Your Option

Rather than sell your option to purchase, you may wish to exercise the option yourself, then sell the property to a third-party buyer in a double closing, as described in Chapter 5.

Famous Option Story

The most infamous option financing story is how the United Nations found its way to New York City. In the mid-1940s, William Zeckendorf, a now infamous developer, took options on multiple waterfront lots on the east side of Manhattan. At the time, the properties were primarily being used for slaughterhouses. Zeckendorf's option price for the lots was \$6.5 million. With the help of the Rockefeller family, the United Nations purchased the property from Zeckendorf for \$8.5 million.

The Lease Option

A lease option is really two transactions: a lease and an option to purchase. Under a lease, a tenant may have the option to buy the property. The option itself can be structured in various ways. For example, the option may be that of a right of first refusal in the event the landlord intends to sell the property. The option may also be an exclusive option for the tenant to buy at a certain price. When combined with a lease, a purchase option may also include rent credits, that is, an agreement that part of the monthly rent payments will be applied to reduce the purchase price of the property. There are literally hundreds of ways that an option or lease option can be structured, and every detail is open for negotiation between the landlord and tenant.

The Lease Purchase

The lease purchase, like a lease option, is two transactions: a lease and a purchase agreement. A regular purchase contract is a bind-

ing bilateral agreement; the seller agrees to sell and the buyer agrees to buy. An option binds the seller to sell, but the buyer is not bound to buy. If the buyer on a bilateral contract fails to buy, he or she is in breach of contract. However, a properly drafted agreement will limit the seller's legal remedy to simply keeping the buyer's earnest money (called a "liquidated damages clause"). Thus, as a practical matter, the result is the same as if the buyer gave nonrefundable option money and failed to exercise his or her option.

In practice, lease purchase and lease option are just buzzwords that mean the same thing. Except as noted, we will use the two terms throughout this book interchangeably.

Lease Option of Your Personal Residence

Pride of ownership is what makes so many Americans obsessed with the idea of owning a home. Once you get over this idea, you will see that you can often rent more home than you can buy.

Why buy when you can rent? We've all seen the ads used by real estate agents: "Why rent when you can buy?" Consider the other side of the coin: "Why buy when you can rent?" In most parts of the country, a typical \$100,000 house will rent for about \$1,000 per month. Assuming a reasonable down payment and interest rate, the monthly mortgage payments would be less than \$1,000 per month. In this case, it makes sense to own the home. However, more expensive homes don't rent as well as cheaper homes. A typical \$500,000 home does not rent for \$5,000 per month. The more expensive the home, the cheaper it becomes to rent compared to buy. If you are concerned about the proverbial "throwing away rent," consider a lease option of your next home.

Case study: lease option builds equity. A student of mine from the Phoenix area (we'll call her Sharon) was interested in purchasing a home to live in, but she didn't have much cash. She was at her new

job just a short time and could not qualify for a conventional or an FHA low-down-payment loan. Sharon found a seller with a nice property, with little equity but with a low-interest-rate loan. Sharon leased the property from the owner for three years for \$1,200 per month, with an option to buy at \$162,000. The agreement provided that the seller give her a 25 percent (\$300) credit towards the purchase price for each rent payment made. Sharon put up just \$500 as a security deposit that would be credited toward the purchase price when she exercised her option to purchase.

After 18 months, the property had appreciated \$17,000 in value to \$179,000. In addition, Sharon's "equity" had increased \$5,400 because of the \$300 per month rent credit. Thus, Sharon's equity position was almost \$23,000:

| | |
|-----------|------------------|
| \$162,000 | Option price |
| - 5,400 | Rent credit |
| - 500 | Security deposit |
| \$156,100 | "Strike price" |
| | |
| \$179,000 | Market value |
| -156,100 | Strike price |
| \$ 22,900 | "Equity" |

Sharon exercised her option to purchase the property and sold it to a third party, pocketing the cash difference.

A few points are worth noting here: First, had Sharon purchased the home 18 months earlier, she would have been required by the lender to put up several thousand dollars for a down payment and loan costs. Because Sharon intended to live in the property for just a few years, she maximized her profit by using a lease option to control the property for 18 months, rather than a mortgage loan.

Second, Sharon's risk is limited to her \$500 investment. If Sharon had bought the property with conventional financing and property values had declined over the 18-month period, Sharon would have been stuck with the property. As you can see, using options to lever-

age real estate is an effective alternative to bank financing when future real estate values are uncertain.

Lease Option REFI

Rather than sell the property, Sharon in our Case Study could have obtained a loan to buy the property. In doing so, most lenders would consider the transaction a purchase and lend basing their LTV on the option strike price (\$156,100), not the appraised value (\$179,000). A small number of lenders will treat the transaction as a refinance (REFI), in which case the LTV is based on the appraised value. So, a 90 percent LTV refinance would allow a lender to give Sharon $.9 \times \$179,000 = \$161,000$, which would cover the strike price and the loan costs. Because a lease option REFI is not an ordinary transaction, be patient if you are looking for a lender that will fund in this manner; it will take a lot of phone calls!

The Sandwich Lease Option

The sandwich lease option is an old technique used by real estate entrepreneurs to create cash, cash flow, and equity buildup with literally no money, credit, or bank loans.

Let me give you a typical example of how a sandwich lease option works. A seller (soon to be *landlord*) is transferred out of town and rents his property. A year later, the tenant vacates (after skipping a few months rent) and leaves a big mess. The owner wants to sell the property for \$110,000. It is the middle of the winter, the house is vacant, and the real estate market is a bit slow.

The house needs new paint and carpet and therefore looks ugly. The \$850 per month mortgage payment is a burden to the owner. He decides to lease it on a month-to-month basis but cannot find a tenant because nobody wants to lease a house for sale when he or she may have to leave within a few months. The owner is a perfect candidate for a lease option.

The potential buyer (AKA tenant) filed for bankruptcy two years ago. He just moved to town. Although he has stable income, he cannot yet qualify for a loan. In addition, he still has to sell his old house to raise some cash for the down payment. He doesn't really want a straight rental, yet he is not ready to buy today. The tenant is a perfect candidate for the other end of a lease option. See Figure 8.1.

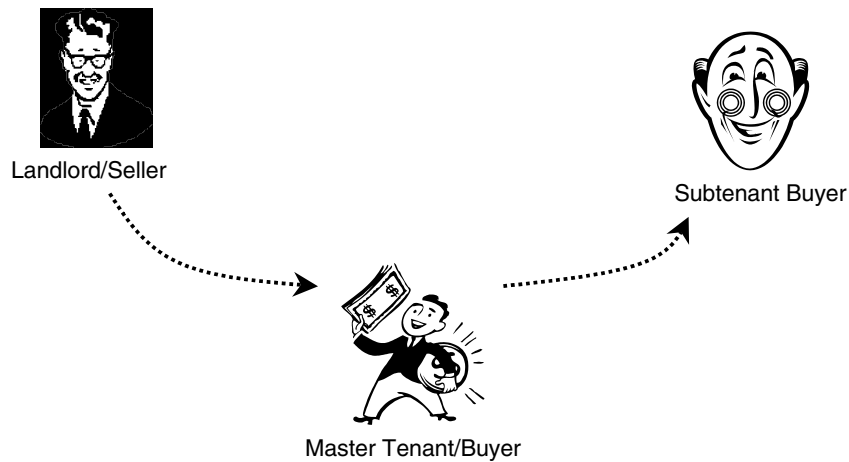
Cash Flow

So how do we, as real estate investors, fit in? Find the owner who fits the picture and sign up a lease-option agreement wherein you are the tenant/buyer. You are not going to live in the property but are still considered a "master tenant." The lease-option agreement will give you the right to sublet the property. If the price you pay is lower than market rent, you can create cash flow by subletting the property to another tenant. Depending on the deal, this can create several hundred dollars per month of cash flow – not bad for a property you don't even own!

Equity Buildup

After a year or two, you may have accumulated some equity in one of the following ways:

- Appreciation of the property due to inflation
- Increase in value from improvements on the property

FIGURE 8.1 Sandwich Lease Option

- Increase in equity from rent credits offered by the landlord/seller

Once your *equity*, the difference between the market value and your option strike price, reaches around 10 percent, you can obtain lender financing and buy the property. Or, you can offer the property for sale to another investor. Better yet, offer the property for sale to the tenant. In many cases, a tenant/buyer is willing to pay more than the property is worth! When the tenant is ready to exercise his option, you exercise your option from the owner and sell it to the tenant in a back-to-back double closing for a profit.

Straight Option without the Lease

A purchase option can be used without a lease to gain control of a property and create a profit. Once you have obtained an option, you can either sell (assign) your option for immediate profit or exercise

your option to purchase and simultaneously sell it to a third-party buyer. If you are speculating that a particular area is ripe for development, you can use an option as a long-term investment technique.

An option is a leveraged, low-risk investment; you can obtain an option with 1 percent or less of the purchase price in cash. Again, using options in lieu of conventional financing is cheaper and less risky when you are dealing with a real estate market that has an uncertain future.

Case Study: Sandwich Lease Option

I was referred to a woman who had a house she needed to sell in a hurry because she had a job transfer. She had tried to sell the property with a real estate agent, but, at the last minute, the buyer could not qualify for a new loan.

The house was a small two-bedroom ranch that was worth approximately \$45,000. The balance of the existing loan was approximately \$38,000, with monthly payments of \$380 per month (including taxes and insurance escrows). Although the average rents in the neighborhood were about \$575, she was not interested in becoming a long-distance landlord.

I offered to lease the property for \$380 per month, with an option to purchase at \$38,000 (the balance owed on her mortgage loan). I had the right to sublet, but I explained to her that my payments to her were not contingent on occupancy. This alleviated her fear of having to deal with the property if it became vacant.

I subletted the property for market rent, which was \$575. After about two years, the market value of the property had risen to \$75,000, so I exercised my option to buy at \$38,000. Based on a \$75,000 appraisal, I had no problem obtaining solid, institutional financing for the property. In fact, I even pulled out \$4,000 from the refinance to make capital improvements to the property. My payments went up, but so did the rents, based on the improvements and increase in value of the neighborhood.

For more information on using lease options, take a look at my home study package, “Big Profits with Lease options,” at <www.legalwiz.com>.

Sale-Leaseback

The sale-leaseback is a financing technique that has been used in the United States since the 1940s. The transaction, in its most basic form, involves the sale of a property to an investor who holds title and leases the property back to the former owner. The lease is typically a long-term net lease with the seller/tenant having the option of repurchasing at a later time. The seller/tenant reaps the benefit of favorable 100 percent “financing” and still retains the use of the property.

The buyer/landlord receives the tax benefit of depreciation and a guaranteed long-term rental. To do this with nothing down, simply sign a contract to purchase the property from the seller, then another contract to sell it to an investor. In a double closing, you purchase the property from the seller and resell it to the investor, who then leases it back to you, giving you an option to repurchase. You can then rent it out for cash flow or sublease it with an option to a tenant/buyer as described previously in this chapter.

The sale-leaseback has its drawbacks. If either party to a sale-leaseback is audited, the IRS may recharacterize the sale-leaseback as a disguised financing arrangement. This will result in an immediate recapture of the buyer/landlord’s depreciation of the property and imputed interest on the seller/tenant’s rental payments. The seller/tenant will lose the deduction for his or her rental payments because the payments will be reclassified as principal repayment of a loan.

The United States Supreme Court, in the landmark case of *Frank Lyon Co. v. United States*, stated the factors to be considered for re-characterization are

- the economic substance of the transaction based upon the potential risks and gains of the parties, and

- whether there was a purpose other than tax avoidance for the transaction.

While the above standards set forth by the court are not crystal clear, following are a few guidelines that we can follow to avoid recharacterization:

- Make certain that the purchase price of the property is for fair market value.
- Make certain the lease payments are for fair market rent, and that the lease arrangement is typical of the area and the intended use.
- Have reasons (other than tax avoidance) for the transaction and state those reasons in the preamble of your agreement.
- If the seller/tenant has an option to repurchase, make certain that it is based upon fair market value and not on a declining basis with unusually large rent credits (i.e., make sure it doesn't look like a loan payoff).
- Make certain that the buyer/landlord has the rights of any typical landlord in a comparable lease arrangement (including the right to have the property back at the end of the lease!).

Make certain that there is nothing in the sale-leaseback arrangement that prevents the buyer/landlord from selling, mortgaging, or assigning his or her interest or benefiting from future appreciation of the property.

Case Study: Sale-Leaseback

A client of mine (we'll call him Chris) used a sale-leaseback to profit in a win/win arrangement with a builder. The builder had finished developing the first phase of a new housing project. The builder's lender wanted to make sure a majority of the houses from

the first phase were complete before extending the builder more credit to build the second phase.

Chris offered to purchase the model homes the builder used to show to prospective purchasers. Chris and the builder entered into a sale-leaseback agreement, wherein Chris bought the properties at 80 percent of fair market value, then leased the properties back to the builder to use as model homes. Because the builder was able to show his lender that three of the homes in the first phase of the subdivision were sold, the builder was allowed to borrow more money for the next phase of the development. By the time the third phase of the development was complete, the builder no longer needed the model homes. The property values had increased, and Chris sold the homes for a substantial profit.

Key Points

- The lease option is an excellent, high-leverage financing alternative.
- The sandwich lease option is a cash flow generator.
- The sale-leaseback is another excellent financing alternative.

Owner Financing

If you'd like to know the value of money, go and try to borrow some.

—Benjamin Franklin

Owner financing is one of the best sources of capital for your real estate purchases. In an ideal world, every real estate purchase you made would be with owner financing. Low risk, an endless supply of funding, and great terms—what more could you ask for?

First, let's start with a definition of owner financing. An *owner-financed transaction* is one in which the seller accepts anything less than all cash at the closing. Let's step back and define an all-cash closing. An *all-cash closing* does not necessarily mean the buyer walks into closing with a briefcase full of money; all cash means the seller gets all cash (actually, the seller may use most of the cash to pay off the existing mortgage loan, so he or she walks away with some cash). If the seller accepts any part of the purchase price in the form of payments after the closing date, then it is an owner-carry sale. An *owner-carry sale* may involve the seller financing, or "carrying," the entire purchase price.

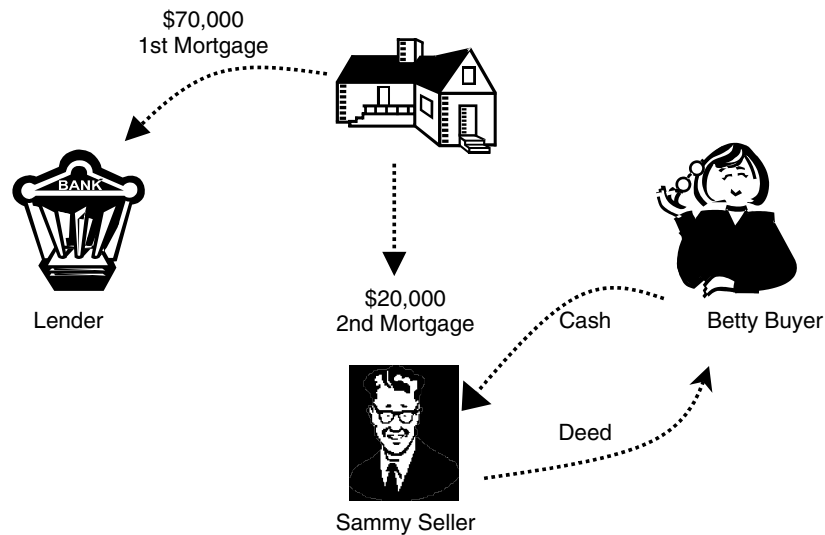
☛ **Example:** Sally Seller owns her home free and clear, that is, she owes nothing to the bank and there are no mortgage liens on the property. Sally agrees to sell her property to Barney Buyer for \$100,000; the terms are 5% down and owner-financing for \$95,000, or 95%, of the purchase price. At closing, Barney tenders \$5,000 in cash and signs a note for \$95,000. Sally executes and delivers a deed to Barney. The note is secured by a mortgage or deed of trust that is recorded against the property as a lien in favor of Sally.

The preceding example is a rare case because most sellers owe some money to a lender. In addition, most sellers want the maximum amount of cash from the sale and are not necessarily willing to accept as little as 5 percent down. As such, the seller may be willing to accept a partial owner-carry sale.

☛ **Example:** Sammy Seller owns a property worth \$100,000 that is encumbered by a mortgage of \$70,000. Sammy agrees to sell the property to Betty Buyer for \$100,000. Because there is \$30,000 in equity (\$100,000 value minus \$70,000 loan), Betty offers to pay \$10,000 down and \$20,000 in monthly installments with interest. The balance of the \$70,000 due under the purchase price is borrowed from a third-party lender. At closing, Betty borrows \$70,000 from the third-party lender, which is tendered to Sammy, who uses the cash to pay off his existing mortgage loan. Betty executes a mortgage or deed of trust to the third party lender, who has a new first lien position on the property.

Betty tenders \$10,000 in cash and a note for \$20,000 to Sammy. Betty also executes a mortgage or deed of trust to Sammy, who has a second lien position on the property. See Figure 9.1.

FIGURE 9.1 Owner-Carry Financing Example



Advantages of Owner Financing

As discussed next, there are many advantages of owner financing over conventional financing for the buyer/investor.

Easy Qualification

Owner financing is more attractive than conventional financing because it does not require traditional lender income and credit approval. If you have poor credit or lack of provable income, the traditional route of institutional financing may not work. Few conventional lenders offer low, fixed-interest-rate loans to people with a poor credit rating. In addition, lenders may be leery about extending too much credit to you if you own a lot of properties. And, when you

do own a number of properties, you may not be able to qualify for the best loan programs that offer the lowest interest rates. Thus, it makes sense to save your credit and only borrow from traditional sources when absolutely necessary.

Cheaper Costs

One of the biggest benefits for the buyer is not having to pay the costs associated with conventional loans. Points, origination fees, underwriting charges, appraisal, credit reports, and the plethora of other “junk” fees charged by conventional lenders can amount to thousands of dollars at closing. An owner-financed transaction eliminates most of these costs, allowing you to offer a seller more cash down (and thus a higher chance of having your offer accepted).

Faster Closing

An owner-financed transaction can close in a matter of days. Because there is no lender approval, survey, appraisal, and other delay factors, you can close very quickly.

Less Risk

With the exception of large commercial loans, an institutional lender will insist on your personal signature for the loan. Thus, if you make late payments or default on the loan, your credit rating is affected. In addition, you may be held personally liable for any deficiency judgment after a foreclosure sale.

In most cases, you can get away with a nonrecourse loan with a seller-carry deal. This can be done in two ways. First, you can use the following language in the note and security instrument: “Upon default of the note, the lender’s sole recourse is against the collateral secured hereby, and there shall be no personal recourse against the borrower.” Another way to limit your liability is to buy properties in the name of

a corporate entity, such as a limited liability company (LLC). For more information about LLCs, visit my Web site at <www.legalwiz.com/llc>.

Future Discounting

An owner-financed deal may also be an opportunity to profit in the future. Most owner-financed deals are not the first choice for the seller, but rather a compromise. Sellers most often want all of their equity cashed out at closing, yet settle for owner financing because of a slow housing market or a particular need to sell quickly. The seller's desire for cash does not generally diminish in the future, so a seller may be willing to accept a discount on the balance due on the note. So, if you are planning to sell the property or refinance the seller-carry note in the future, always ask the seller if he or she will accept a discount in the amount that is owed for an early payoff.

Assuming the Existing Loan

Let's go back to the Sammy Seller/Betty Buyer example. In that scenario, the seller owned a \$100,000 property with an existing mortgage lien of \$70,000. The seller had \$30,000 in equity and was willing to accept \$10,000 of it at closing and the balance in future payments. The seller also needed \$70,000 cash to pay off his existing first mortgage lien. Rather than Betty Buyer applying and paying the costs for a new first mortgage, it would make sense for Betty to assume the existing \$70,000 loan.

Assumable Mortgages

Some mortgages are assumable, that is, they can be taken over by a new borrower. Many people are familiar with the concept of an assumable mortgage, but few really understand the details. To *assume* an obligation means to agree to be legally obligated for it. A mortgage note can be assumed by anyone, that is, anyone can agree to make payments for someone else.

The concept of an assumable mortgage has to do with the security instrument (mortgage or deed of trust), not the note. Most security instruments contain a “due on sale” or “acceleration” clause. The due on sale clause allows the lender to call in the balance of the note if the property is transferred. A security instrument without an acceleration clause is referred to as an “assumable” loan. Thus, the expression “assumable loan” is really a misleading designation; the issue is not whether the note is assumable, it is whether the mortgage contains a due-on-sale provision. FHA-insured mortgages originated before December 1989 and VA-guaranteed mortgages originated before August 1988 contain no due-on-sale provision.

Assumable with Qualification

A mortgage without a due-on-sale clause is known as a “freely-assumable” loan because the buyer does not need any income or credit qualification to take over the property. With some loans, a lender may waive the due-on-sale option. The lender will usually do so if the buyer submits a credit application to the existing lender. These types of loans are known as “qualifying assumables.” Assuming these loans generally require the same credit and qualification as a new loan, but you avoid the fees associated with a new loan. In addition, the loan may be amortized for a few years, which means you pay less interest in the long run.

Buying Subject to the Existing Loan

If you take ownership to a property without paying off or formally assuming the existing loan, you are taking title “subject to” the existing loan. In most cases, the mortgage or deed of trust securing the existing loan contains a due-on-sale restriction, allowing the lender to call the balance owed immediately due and payable. If you intend to own the property for only a short period of time, the due-on-sale issue is, at least to you, wholly irrelevant. You will have sold the property

long before the lender discovers the transfer and decides to accelerate the loan.

If you plan to keep the property for the long run, then the due-on-sale clause may be an issue because the lender could, in theory, accelerate the loan within 30 days. At that point, you would have to either assume the loan or pay it off. If you don't pay it off, the lender could initiate foreclosure proceedings and you would lose the house. You would not be personally liable to the lender because you did not sign the original note. However, if you promised the former owner to make the payments, he or she could have legal recourse against you for defaulting on his or her payments.

Risk versus Reward

Buying a property subject to the existing loan is a risk versus reward gamble. The reward is that you avoid loan costs, personal liability for the note, and conserve your cash. You can also take advantage of favorable interest rates because an owner-occupied loan is likely to have a lower interest rate than if you originated an investor loan. You can also get away with a lower down payment.

The legal risk was addressed above, but what is the practical risk? That is, what is the real risk of the lender calling in the loan? Nowadays, the risk is pretty slim. Lenders began inserting due-on-sale clauses in their mortgages in the 1970s when interest rates rose dramatically. Homebuyers were assuming existing loans rather than borrowing new money from banks because the interest rates on existing loans were lower. The banks used the due-on-sale clause as a way to kill their own worst competition. If people had to pay off their loans when they sold properties, the banks could finance the buyers at the current dramatically higher interest rates.

So long as the interest rate on the existing loan is within a few percentage points of market rates, the lender is not likely to accelerate a performing loan. The reason is simply profit: It costs money in legal fees, and the lender would rather get paid than have another defaulted loan on its books.

However, if interest rates did rise dramatically, a lender might enforce the due-on-sale clause at a later time, forcing you to pay off the loan. If you plan to hold the property for the long term, you should consider a backup plan for this contingency, such as having the ability to refinance or sell the property. If there was enough equity in the property, you could always bring in a partner to put up the cash or refinance the property.

Is This Legal?

Many people are under the mistaken impression that transferring title to a property secured by a due-on-sale mortgage is illegal. This is because most lay people confuse civil liability with criminal liability. To be illegal, you must be in violation of a criminal law, code, or statute. There is no federal or state law that makes it a crime to violate a due-on-sale clause or conceal it from a lender. If the lender discovers the transfer, it may, at its option, call the loan due and payable. If it cannot be paid, the lender has the option of commencing foreclosure proceedings. You should also disclose the due-on-sale issue clearly in writing, particularly if you are a real estate agent or are dealing with parties not represented by an attorney.

Convincing the Seller

You won't find too many sellers willing to hand over their property without paying off the existing loan, unless the property has no equity and/or is in foreclosure. Thus, the issue for the seller is: "How do I know you'll make the payments?" The seller wants finality; he wants his loan paid off completely and removed from his credit report.

Simply tell the seller your intentions: You are going to pay off his loan within a year or two by selling or refinancing the property. In the meantime, you will continue making his payments. If this is not good enough, simply insert a clause into the purchase contract as follows:

Purchaser agrees to satisfy Seller's loan with _____
_____ bank loan # _____ on or before _____,
20___, and further agrees to make timely monthly payments
required by said lender, including tax and insurance escrows
as they become due.

The payoff date should be at least one year, preferably one, two, or three. Of course, the seller's legal recourse is to sue if you don't perform given that he has no recourse against the property. If he is savvy enough (or concerned enough) to understand his legal position, offer him a second mortgage on the property. This mortgage is for a nominal amount, such as \$10, but states that your failure to make payment on his underlying mortgage places you in default of the second mortgage. Thus, if you failed to make payments, he would have the right to foreclose against the property to get title back.

Another way to make him feel more secure would be to set up a third-party escrow with a collection company. This company would collect payments from you each month, send them to the lender and send a copy to the seller. A more practical way to accomplish the same task would be to set up a bank account with a direct deposit to the lender. The bank would send the seller duplicate copies of the bank statements each month. There are also several automated services on the Internet that will do it for you, such as <www.paytrust.com>. Your own bank may also have direct deposit and other automated banking services.

A Workaround for Down Payment Requirements

Buying subject to the existing mortgage loan is a nice short-term strategy to work around lender down payment requirements. For purchase money loans, lending guidelines require a certain down pay-

ment by the borrower. For refinance loans, however, the guidelines are strictly loan to value.

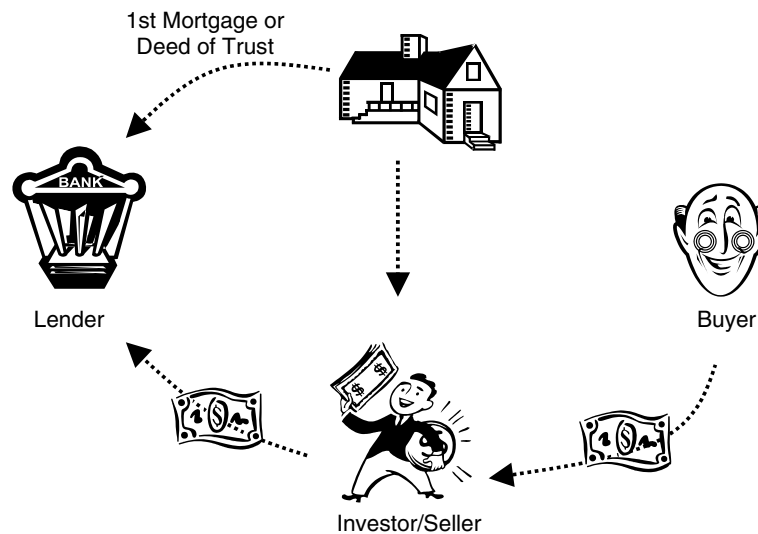
☛ **Example:** Selina Seller has a property worth \$100,000 that she agrees to sell to Bunny Buyer for \$80,000. Lending guidelines for ABC Savings Bank state that the loan may not exceed an 80% LTV. So, in theory, Bunny could borrow \$80,000, the entire purchase price. However, ABC's lending guidelines limit the loan to 80% of the purchase price or appraisal, whichever is less. Thus, Bunny needs to put \$16,000 down (20% of \$80,000), and ABC will lend her \$64,000 (80% of \$80,000). Furthermore, Bunny will probably pay about \$5,000 in costs to get the loan from ABC.

If Selina has a \$75,000 existing first mortgage loan, Bunny could give her \$5,000 in cash and buy the property subject to the existing loan. A year later, Bunny could refinance the existing loan. The refinance guidelines for ABC Savings Bank are an 80% LTV for investors. Because Bunny has owned the property for a year, ABC will offer her 80% of its appraised value, which is \$80,000 (80% × \$100,000). The \$80,000 would cover the payoff of the existing \$75,000 mortgage, plus the closing costs. So, in the long run, Bunny has less cash out of pocket. The chances that the lender would find out about, much less enforce, the due-on-sale clause on Selina's loan within 12 months are slim to none.

Installment Land Contract

If a seller is not willing to hand over the deed, you can purchase using an installment land contract (ILC). The *installment land contract* is an agreement by which the buyer makes payments under an agreement of sale in installment payments. The transaction is also known by the expressions, "contract for deed," "bond for deed," and "agreement for deed." The seller holds title as security until the balance is paid. In many respects, the land contract is identical to a mortgage, in that the buyer takes possession of the property, maintains it,

FIGURE 9.2 Land Contract Transaction



and pays taxes and insurance. However, title remains in the seller's name until the balance of the debt is paid.

A land contract usually contains a forfeiture provision, under which a defaulting buyer may be dealt with similarly to a defaulting tenant. Though recent court decisions and some state statutes have refused to enforce this provision, the seller having title makes the buyer feel psychologically disadvantaged. If you have title to the property, the old adage that possession is nine-tenths of the law works heavily in your favor.

Under a land contract, legal title remains in the seller's name until the purchase price is satisfied. The seller has a real property interest, but holds title essentially as security. The land contract creates an equitable conversion of the seller's interest to the buyer when the document is signed. The buyer has equitable title and, for all intents and purposes, is the owner of the property. When the buyer satisfies the indebtedness, the legal title passes and the buyer's equitable and legal title merge. See Figure 9.2.

The legal/equitable distinction is difficult for many people to understand, so here is a more common example. Suppose that you purchase an automobile from a dealer using a bank loan. The lender holds title until you pay off the loan. You are the equitable owner; that is, you have the right to drive the car. The bank holds legal title, but the bank's officer cannot drive your car without your permission.

Benefits of the Land Contract

The main problem with transferring title subject to the existing mortgage is the possibility of the lender finding out about the sale. A land contract transaction, like a lease, is not likely to come to the attention of the holder of the underlying mortgage. The anonymity factor is what makes the installment land contract appealing for all parties involved. And, even if the lender does discover the transaction, it may not consider a land contract a violation of the due-on-sale requirements (although most court decisions have ruled that a land contract is a "transfer" that triggers the due-on-sale).

VA Loan Exception

The land contract does not trigger the due-on-sale clause on VA-guaranteed loans. According to the VA loan guarantee regulations, a transaction that does not involve the seller transferring title to the buyer is not a "sale." Thus, you can use the land contract to "assume" VA loans that are not really assumable! Keep in mind that while a land contract may not trigger the due-on-sale on a VA-guaranteed loan, it does not give the borrower his VA entitlement back until the underlying VA-guaranteed loan is paid off.

Problems with the Land Contract

The basic challenge with using a land contract is the uncertainty of the parties' legal rights. A few states have specific enumerated rules for taking back a property in default of a land contract. For example, Texas law requires a specific notice to the defaulting buyer and a statutory period for the buyer to make up back payments. After that time, the seller can declare the contract in default and evict the buyer like a tenant. Illinois, Pennsylvania, North Dakota, and Ohio also have similar statutes.

In most states, however, the parties' rights are not clearly defined. Some courts treat the transaction as a purchase agreement, while others treat it as a mortgage transaction, requiring the seller (AKA lender) to commence a foreclosure proceeding. Make sure that you have an attorney carefully draft the agreement in your favor, depending on whether you are buying or selling.

Using a Purchase Money Note

As you are now aware, most lenders sell their loans on the secondary market soon after the loans are made. The secondary market players, like FNMA, will not buy an individual note from a private individual. However, there is an entire market of small, private investors that do buy mortgage notes one at a time.

Lending regulations are extremely complex and ever-changing, so I do not recommend you jump into the lending business. However, when the occasion presents itself, you can act as a lender by creating a note, then selling it simultaneously at closing to a third party.

When dealing with yield and discount concepts, keep the process simple: Find out what note buyers are looking for, then create a note to fit their criteria. A host of note buyers and a list of their buying criteria can be found on the Internet at <www.notenetwork.com> and <www.americannote.com>. The purchase price for the note will

depend on a number of factors, such as the value of the property, your creditworthiness, and whether it is rental property. At closing, you sign a note to the seller that is turned into cash when the note buyer purchases it from the seller. This may require closing in escrow while waiting for the funds from the note buyer.

Keep in mind that the note buyer will have fairly stringent loan-to-value criteria and will want to purchase the note at a discount off the face amount. For example, if the property is worth \$100,000, the note buyer may require that the maximum loan to value ratio is 90 percent, which means the note will be for \$90,000. In addition, the note buyer may only pay 90 percent of the face amount of the note, which is \$81,000. If the seller is only looking to net \$81,000, the transaction will work for everyone. One of the benefits of using a note to purchase property is that you avoid paying conventional loan costs, such as underwriting, points, and document preparation. You also need not worry about being penalized by traditional lending criteria for buying a property at a discounted price.

Variation: Create Two Notes, Sell One

Another way to skin the proverbial cat is to create two notes secured by two mortgages on the property. Sell the note and mortgage at closing for cash, giving the seller the cash proceeds. Make payments to the note buyer on the mortgage and to the seller on the second mortgage.

Another Variation: Sell the Income Stream

Note buyers don't just buy entire notes, they also buy partials. *Partials* are parts of the income stream, that is, a portion of the total payments due on the note. For example, a \$100,000 note at 9 percent will pay down about \$12,000 in principal in the first ten years. The total principal and interest payments on the loan over the first ten years, however, will be over \$96,000! Suppose that you found some-

one willing to pay \$20,000 for these \$96,000 worth of payments (a yield of almost 16 percent). Thus, at closing the seller gets \$20,000 plus the remaining 240 payments on the mortgage, the balance of which will be \$88,000 in ten years.


Your sales pitch is that the seller will receive \$108,000 for the purchase price, when in fact he or she is asking only \$100,000! In reality, the present value of the remaining 240 payments on the note is much less. However, the seller may get just what he or she needs—a chunk of cash now and an income stream for his or her retirement years.

Wraparound Financing

We are in a unique time in history in that real estate prices are rising, yet interest rates are dropping. At the same time, there is fierce competition for subprime loans, that is, loans to people with less than perfect credit and income. Virtually anyone can obtain a home loan, but interest rates and points charged for these loans are astronomical. This means that those who can borrow at low interest rates and loan at higher interest rates are making a bundle! Combine the interest rate spread and a hot housing market and your ability to make a profit grows exponentially.

The Basics of Wraparound Financing

In its most basic form, a “wraparound” mortgage, or “wrap,” is an arrangement wherein you sell a property encumbered with existing financing by accepting payments in monthly installments rather than all cash.

 **Example:** Susie Seller buys a \$90,000 house at a 10% discount (\$81,000). She borrows \$81,000 from First Federal Financial on a favorable 8% 30-year loan. Her principal and interest payments are roughly \$594 per month. She sells the

The Secret of How Bankers Make Money

Actually, it's not a secret at all. In fact, bankers have been doing this for hundreds of years. Bankers make money by borrowing at low interest rates, then lending at higher interest rates. You deposit money in a savings account and they pay you 3 percent interest. They lend the same money back to you for home loans at 8 percent or more. The spread between the interest rate they pay and the interest rate they collect over the life of the loan is incredibly profitable.

Consider this simple example: You are shopping for rates to refinance your home loan. A lender quotes you 7 percent interest. On a \$100,000 loan, the monthly payment (amortized over 30 years) is about \$665 per month. However, at the last minute (always happens), someone at the bank decides that the color of your underwear isn't right, so your interest rate changes to 7.25 percent. Your monthly payment will now be \$682. You aren't terribly upset because, after all, what's \$17 per month? What you do not realize is that the additional $\frac{1}{4}$ percent amounts to over \$6,000 in interest over the life of your loan!

property to Barney Buyer for \$100,000 (about 10% above market), taking \$10,000 down and carrying the balance of \$90,000 at 11% for 30 years. She does not pay off the underlying loan but rather collects payments (\$952 per month) from Barney on a monthly basis and continues to make payments on the underlying loan. She collects \$358 per month cash flow on the "spread" for 30 years!

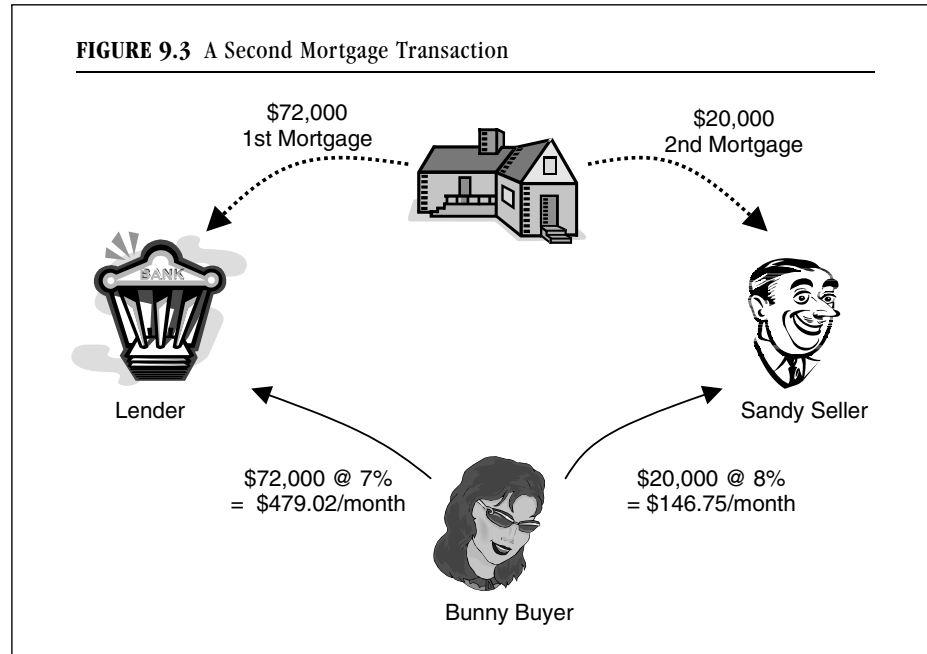
This is a basic example of a wraparound deal. As you can see, the profitability with wraps is based on two simple financial principles: “borrow low, lend high” and “buy low, sell high.” Susie bought the property a little below market price and sold it a little above market price. A new owner-carry loan at a higher interest rate was created that wrapped around the existing loan.

In a wrap transaction, the buyer gives the seller a promissory note for substantially all of the purchase price that is secured by a mortgage or deed of trust. Because the first mortgage is not satisfied at closing, the seller’s mortgage is a junior lien. At closing of the transaction, the buyer has title and the seller has a second wraparound mortgage that is junior in position to the existing first mortgage. The wraparound mortgage is essentially the same as a regular mortgage, but it incorporates the terms of the underlying senior mortgage. The buyer typically makes payments of principal, interest, taxes, and insurance to the seller, who then satisfies his or her monthly obligations on the underlying mortgage for the same items. See Figure 9.3.

In states that use deeds of trust rather than mortgages, the term “all-inclusive trust deed” (AITD) is used. The document is slightly different, but the concept is the same.

Wraparound Land Contract

A wrap can also be done with an installment land contract. You can buy on land contract, then sell on land contract. Or, you can buy with conventional financing, then sell on land contract. Either way, the wrap concept means you are collecting one payment and paying an underlying loan.



Wraparound versus Second Mortgage

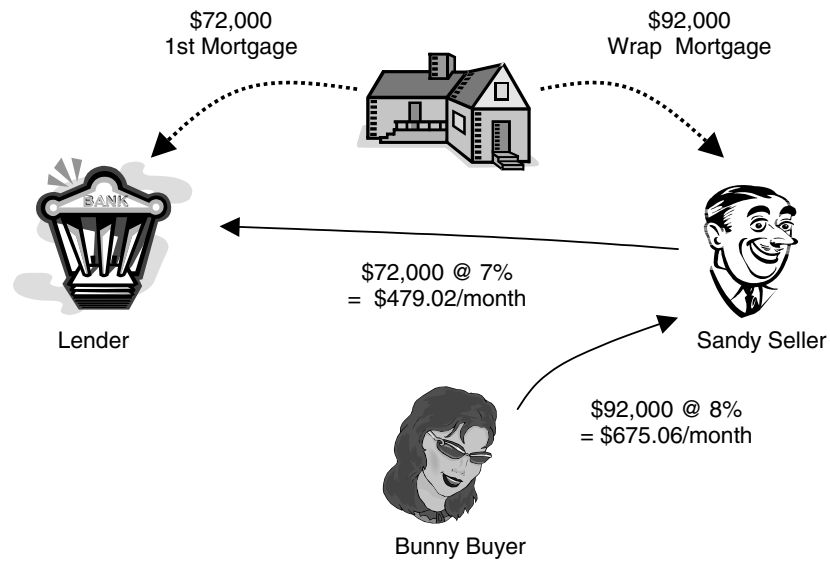
By definition, a wraparound is subordinate, or second, to the existing financing. Technically, it is a second mortgage or lien. However, let's contrast the wrap with the traditional method of owner financing, in which the seller accepts a note and second mortgage.

Consider Sandy Seller who has a house worth \$100,000. He has a mortgage loan balance of \$72,000. He has \$28,000 in equity. The interest rate on the \$72,000 mortgage note is 7 percent.

Bunny Buyer offers \$8,000 cash to Sandy Seller subject to the existing first mortgage of \$72,000. At closing, Bunny also gives Sandy a \$20,000 note at 8 percent interest, secured by a second mortgage lien on the property. See Figure 9.3.

Now consider the transaction if Sandy Seller counteroffers with a wraparound scenario, in which he takes \$8,000 down and a wrap-around note and mortgage for \$92,000 at 8 percent interest. Notice

FIGURE 9.4 A Wraparound Transaction



the difference between the two? It is a subtle distinction, but note that in both cases, Sandy Seller makes 8 percent interest on the \$20,000 carryback. However, in the wraparound scenario, Sandy also makes a 1 percent point spread on the \$72,000 balance because he has financed that portion at 7 percent interest and is charging Bunny Buyer 8 percent interest on the entire owner-carry portion. See Figure 9.4.

The payment on \$92,000 at 8 percent interest is approximately \$675 per month. The payment on the first/second mortgage combo is approximately \$625 per month. That's a \$50 per month difference! Thus, the wraparound payment is immensely more profitable in most situations.

Loan Term Differential Means More Profit!

An additional point worth noting here is that the existing \$72,000 loan was figured at \$479.02 per month based on the assumption that the loan was originated at \$70,000. In other words, the original loan balance may have been more, meaning, of course, that the monthly payment may be more. However, if the existing first mortgage loan was paid for 8 years, the remaining balance is just 22 years. If the wraparound loan is amortized over 30 years, the seller has a very bright future at the end!

Mirror Wraparound

A slight variation to the subject-to purchase is the mirror wrap-around. A mirror wrap is commonly done where the seller has little or no equity but is not willing to simply hand over a deed to the buyer. So, for example, if the seller owed \$97,000 on a \$100,000 house at 7 percent interest amortized over 30 years, the wrap would be for \$97,000 at 7 percent interest. At any given time, the buyer's payoff will be exactly the same as the payoff amount on the underlying loan. In fact, the paperwork on a mirror wrap is often prepared by attaching a copy of the underlying note to the wraparound contract. The wording is usually something like the following:

Purchaser agrees to pay Seller as the full purchase price for the Property the sum of \$97,000, a sum equal to the balance of a certain promissory note (hereinafter "Note") executed by the Sellers on September 23, 2002, to ABC Mortgage Company, a copy of which is annexed hereto as exhibit "A," the terms of which are incorporated herein. Beginning on March 1, 2003, and continuing on the 1st day

of each month thereafter, the buyer shall make monthly payments to the seller for principal and interest that mirror the payments due each month on said Note.

Wraparound Mortgage versus Land Contract

You may be wondering what the difference is between a wrap-around mortgage and a land contract. As far as the payments go, a wraparound is a concept that refers to collecting a payment while continuing to make payments on underlying financing. A traditional wrap-around mortgage involves the seller transferring title to the buyer, leaving the existing financing in place, and taking a note with an all-inclusive payment for the purchase price secured by a second mortgage. In a trust deed state, the lien would be an all-inclusive trust deed, or AITD.

With a land contract wraparound, the title remains in the seller's name, and the seller and buyer execute a contract under which the buyer makes all-inclusive payments to the seller, who in turn makes payments on the underlying mortgage note. The numbers are the same in all of these transactions—the difference lies in the way the transaction is collateralized.

Key Points

- Owner financing is one of the most powerful ways to borrow money.
- The land contract is an excellent way to finance an owner-carry sale.
- Create purchase money notes, then sell the notes for cash.
- The wraparound can increase your monthly cash flow.

CHAPTER 10

Epilogue

Hindsight is always twenty-twenty.

-Billy Wilder, Film Director

Recall Chapter 1, where I told a story about a deal that went bad and cost me my \$1,000 in earnest money. I had just come from a real estate conference where I heard a speaker give a brief presentation on financing. I took a “nugget” of information and ran with it—a little knowledge can be a dangerous thing!

Now that you have completed this book, you can help me work through what I should have done. I'll round the numbers off to simplify the concepts.

The property was worth \$160,000 or so, and the seller was asking \$160,000. The property was listed with a real estate broker. After some lengthy discussions with the seller and his broker, I discovered that the seller had a first mortgage with a balance of about \$125,000. His loan was at 9 percent interest, which is about \$1,000 per month in principal and interest payments. The seller's primary motivation was getting rid of the house and the monthly obligations.

I offered the seller the following deal:

- \$140,000 purchase price
- Subject to existing first mortgage of \$125,000
- Promissory note for \$15,000 secured by a second mortgage on the property; no payments on the note, simple interest payments at 5 percent interest (\$62.50 per month), balloon payment due in 5 years

The only issue remaining was how to pay the real estate agent. His commission was supposed to be 7 percent of the sales price, which was \$10,500. I negotiated his fee down to \$6,000, which would be paid by me at closing, which was 45 days away.

My intention was to find a buyer within the 45 days that could buy it from me in a double closing (see Chapter 5). I offered the property for sale under the following terms:

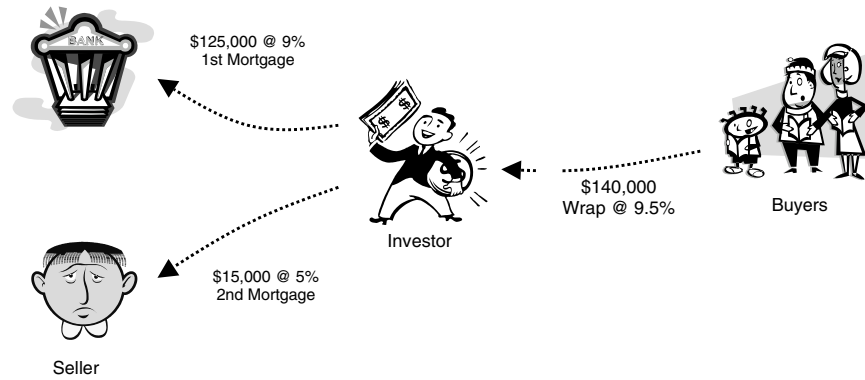
- \$155,000 purchase
- \$15,000 cash, subject to existing first mortgage loan of 9 percent and second owner-carry mortgage loan at 5 percent

Having read this book, it is easy to see a good deal—a buyer could put down just \$15,000 and take title to the property subject to two existing loans with a blended interest rate of about 8 percent. Because the deal was subject to existing mortgage loans, there were no loan costs, points, or other lender fees. I would use the \$15,000 to pay the real estate agent (\$6,000) and pocket the rest (\$9,000).

I placed an ad in the paper: “No Bank Qualifying—Take Over Payments.” The phone rang off the hook. But, 150 phone calls and 45 days later, I didn’t have a buyer. The problem was: The idea was so foreign to every person who called that I couldn’t get anyone to do the deal!

In retrospect, this was a perfect candidate for (you guessed it) a wraparound transaction. With a blended interest rate of about 8 percent, I could have easily sold the property at 9.5 percent interest.

FIGURE 10.1 How I Could Have Saved \$1,000 and Made a Bundle



With the purchase price at \$155,000 and \$15,000 down, I could carry \$140,000 at 9.5 percent, which is \$1,177 per month. See Figure 10.1.

Because the payments on the underlying first and second mortgages would be at \$1,000 per month, I would have \$177 per month in cash flow. Furthermore, by staying in the middle of the deal, I would collect one single monthly payment from the buyer, a concept that is very easy for the average person to grasp.

Hindsight is always twenty-twenty, but take away an important lesson here: The more you learn, the more you earn!

Interest Payments Chart

Interest Rate Chart
Monthly Payment per \$1,000 Borrowed

| Interest Rate % | 15-Year Term | 30-Year Term | Interest Rate % | 15-Year Term | 30-Year Term |
|-------------------------------|---------------------|---------------------|--------------------------------|---------------------|---------------------|
| 4 | 7.40 | 4.77 | 8 | 9.56 | 7.34 |
| 4 ¹ / ₈ | 7.46 | 4.85 | 8 ¹ / ₈ | 9.63 | 7.42 |
| 4 ¹ / ₄ | 7.52 | 4.92 | 8 ¹ / ₄ | 9.70 | 7.51 |
| 4 ³ / ₈ | 7.59 | 4.99 | 8 ³ / ₈ | 9.77 | 7.60 |
| 4 ¹ / ₂ | 7.65 | 5.07 | 8 ¹ / ₂ | 9.85 | 7.69 |
| 4 ⁵ / ₈ | 7.71 | 5.14 | 8 ⁵ / ₈ | 9.92 | 7.78 |
| 4 ³ / ₄ | 7.78 | 5.22 | 8 ³ / ₄ | 9.99 | 7.87 |
| 4 ⁷ / ₈ | 7.84 | 5.29 | 8 ⁷ / ₈ | 10.07 | 7.96 |
| 5 | 7.91 | 5.37 | 9 | 10.14 | 8.05 |
| 5 ¹ / ₈ | 7.97 | 5.44 | 9 ¹ / ₈ | 10.22 | 8.14 |
| 5 ¹ / ₄ | 8.04 | 5.52 | 9 ¹ / ₄ | 10.29 | 8.23 |
| 5 ³ / ₈ | 8.10 | 5.60 | 9 ³ / ₈ | 10.37 | 8.32 |
| 5 ¹ / ₂ | 8.17 | 5.68 | 9 ¹ / ₂ | 10.44 | 8.41 |
| 5 ⁵ / ₈ | 8.24 | 5.76 | 9 ⁵ / ₈ | 10.52 | 8.50 |
| 5 ³ / ₄ | 8.30 | 5.84 | 9 ³ / ₄ | 10.59 | 8.59 |
| 5 ⁷ / ₈ | 8.37 | 5.92 | 9 ⁷ / ₈ | 10.67 | 8.68 |
| 6 | 8.44 | 6.00 | 10 | 10.75 | 8.77 |
| 6 ¹ / ₈ | 8.51 | 6.08 | 10 ¹ / ₈ | 10.82 | 8.87 |
| 6 ¹ / ₄ | 8.57 | 6.16 | 10 ¹ / ₄ | 10.90 | 8.96 |
| 6 ³ / ₈ | 8.64 | 6.24 | 10 ³ / ₈ | 10.98 | 9.05 |
| 6 ¹ / ₂ | 8.71 | 6.32 | 10 ¹ / ₂ | 11.05 | 9.15 |
| 6 ⁵ / ₈ | 8.78 | 6.40 | 10 ⁵ / ₈ | 11.13 | 9.24 |
| 6 ³ / ₄ | 8.85 | 6.48 | 10 ³ / ₄ | 11.21 | 9.33 |
| 6 ⁷ / ₈ | 8.92 | 6.57 | 10 ⁷ / ₈ | 11.29 | 9.43 |
| 7 | 8.99 | 6.65 | 11 | 11.36 | 9.52 |
| 7 ¹ / ₈ | 9.06 | 6.74 | 11 ¹ / ₈ | 11.44 | 9.62 |
| 7 ¹ / ₄ | 9.13 | 6.82 | 11 ¹ / ₄ | 11.52 | 9.71 |
| 7 ³ / ₈ | 9.20 | 6.91 | 11 ³ / ₈ | 11.60 | 9.81 |
| 7 ¹ / ₂ | 9.27 | 6.99 | 11 ¹ / ₂ | 11.68 | 9.90 |
| 7 ⁵ / ₈ | 9.34 | 7.08 | 11 ⁵ / ₈ | 11.76 | 10.00 |
| 7 ³ / ₄ | 9.41 | 7.16 | 11 ³ / ₄ | 11.84 | 10.09 |
| 7 ⁷ / ₈ | 9.48 | 7.25 | 11 ⁷ / ₈ | 11.92 | 10.19 |

Example: \$150,000 loan at 7% amortized over 30 years. Annual payment per \$1,000 is \$6.65, so 150 × 6.65 = \$997.50 per month. This is a calculation of principal and interest only. It does not include property taxes, insurance, association dues, or other charges.

State-by-State
Foreclosure Guide

| STATE | TYPE OF SECURITY MOST COMMONLY USED | FORECLOSURE METHOD | REDEMPTION PERIOD | MISC |
|-------------------|-------------------------------------|--------------------------------------|---|---|
| Alabama | Mortgage | Power of Sale | 12 months | Borrower can reinstate loan within 5 days of sale |
| Alaska | Deed of Trust | Power of Sale | None | Borrower can reinstate loan up to date of sale so long as a notice of defaulted has not been filed more than 2x in the past |
| Arizona | Mortgage | Judicial | None | |
| Arkansas | Deed of Trust | Power of Sale | Within one year | |
| California | Deed of Trust | Power of Sale | None | |
| Colorado | Deed of Trust | Power of Sale | 75 days | Borrower can cure up to sale date |
| Connecticut | Mortgage | Strict Foreclosure | None, unless ordered by the court | A strict foreclosure vests title in the lender without a sale. Borrower cannot reinstate the loan. A court may delay the foreclosure for up to six months if the borrower is not making enough money! |
| Delaware | Mortgage | Judicial | None | |
| Dist. of Columbia | Deed of Trust | Power of Sale | None | Borrower can reinstate up to 45 days before sale once in two consecutive years |
| Florida | Mortgage | Judicial | Up to the date the clerk files the certificate of sale | |
| Georgia | Mortgage | Power of Sale | None | |
| Hawaii | Mortgage | Power of Sale | None | |
| Idaho | Deed of Trust | Power of Sale | None | Borrower can cure with 115 days of the filing of the notice of default |
| Illinois | Mortgage | Judicial | Until the latter of 3 months of entry of judgment or 7 months of service of the foreclosure complaint | Borrower has 90 days from the service of the complaint to reinstate |
| Indiana | Mortgage | Judicial | None | |
| Iowa | Mortgage | Judicial | One year | |
| Kansas | Mortgage | Judicial | 3-12 months, depending on the property's equity | |
| Kentucky | Mortgage & Deed of Trust | Judicial | Up to one year if the sale does not bring at least 2/3 of the property's value | |
| Louisiana | Mortgage | Judicial | None | |
| Maine | Mortgage | Judicial | Within one year unless the mortgage agreement provides for less | Borrower can reinstate within 30 days of default |
| Maryland | Deed of Trust | Power of Sale with court supervision | None stated, although equitable redemption permitted | |
| Massachusetts | Mortgage | Power of Sale | None | |
| Michigan | Mortgage | Power of Sale | Varies, but generally 6 months on houses | |
| Minnesota | Mortgage | Power of Sale | 6 to 12 months, depending on equity | |
| Mississippi | Deed of Trust | Power of Sale | None | Borrower can reinstate up to the date of sale |
| Missouri | Deed of Trust | Power of Sale | One year if the lender purchases the property at sale | |
| Montana | Deed of Trust | Judicial | None | |
| Nebraska | Deed of Trust | Judicial | None | Borrower can reinstate before sale |
| Nevada | Deed of Trust | Power of Sale | None | Borrower has 35 days from filing of notice of default to reinstate loan |
| New Hampshire | Mortgage | Power of Sale | None | NH mortgage can also have a strict foreclosure provision |
| New Jersey | Mortgage | Judicial | 6 months after entry of judgment | |
| New Mexico | Mortgage | Judicial | 9 months, but may be as little as 1 month by agreement in writing | |
| New York | Mortgage | Judicial | None | |
| North Carolina | Deed of Trust | Power of Sale | None | |
| North Dakota | Mortgage | Judicial | One year | |
| Ohio | Mortgage | Judicial | Only up to the date of confirmation of sale | |
| Oklahoma | Mortgage | Judicial | Only up to the date of confirmation of sale | |
| Oregon | Deed of Trust | Power of Sale | None | Borrower may reinstate up to 5 days before sale |
| Pennsylvania | Mortgage | Judicial | None | Borrower may reinstate before the sale, up to 3x in 1 year |
| Rhode Island | Mortgage | Power of Sale | Up to 3 years by filing a lawsuit | |
| South Carolina | Mortgage | Judicial | None | |
| South Dakota | Mortgage | Power of Sale | None | Borrower can make lender go through a judicial foreclosure |
| Tennessee | Deed of Trust | Power of Sale | Up to 2 years | |
| Texas | Deed of Trust | Power of Sale | None | Borrower has 20 days from notice of default to reinstate loan |
| Utah | Deed of Trust | Judicial | 6 months | Borrower can reinstate within 3 months of notice of default |
| Vermont | Mortgage | Strict Foreclosure | None | |
| Virginia | Deed of Trust | Power of Sale | None | |
| Washington | Deed of Trust | Power of Sale | None | Borrower can reinstate loan up to 11 days before sale |
| West Virginia | Deed of Trust | Power of Sale | None if the sale is confirmed by the court | Borrower has 10 days from notice of default to reinstate loan |
| Wisconsin | Mortgage | Judicial | None | Borrower has until sale date to cure default |
| Wyoming | Mortgage | Power of Sale | None | |

Sample Forms

Uniform Residential Loan Application [FNMA Form 1003]
Good Faith Estimate of Settlement Costs
Settlement Statement [HUD-1]
Note [Promissory–FNMA]
California Deed of Trust (Short Form)
Mortgage [Florida–FNMA]
Option to Purchase Real Estate [Buyer-Slanted]
Wrap Around Mortgage [or Deed of Trust] Rider
Installment Land Contract
Subordination Agreement

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower", as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when the income or assets of a person other than the "Borrower" (including the Borrower's spouse) will be used as a basis for loan qualification or the income or assets of the Borrower's spouse will not be used as a basis for loan qualification, but his or her liabilities must be considered because the Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

| I. TYPE OF MORTGAGE AND TERMS OF LOAN | | | |
|---------------------------------------|--|--------------------|--------------------|
| Mortgage Applied for: | <input type="checkbox"/> V.A. <input type="checkbox"/> Conventional <input type="checkbox"/> Other | Agency Case Number | Lender Case Number |
| | <input type="checkbox"/> FHA <input type="checkbox"/> FmHA | | |

| | | | | |
|-----------|-----------------|---------------|---|---|
| Amount \$ | Interest Rate % | No. of Months | Amortization Type | <input type="checkbox"/> Fixed Rate <input type="checkbox"/> Other (explain): |
| | | | <input type="checkbox"/> GPM <input type="checkbox"/> ARM (type): | |

II. PROPERTY INFORMATION AND PURPOSE OF LOAN

| | |
|---|--------------|
| Subject Property Address (street, city, state, ZIP) | No. of Units |
| Legal Description of Subject Property (attach description if necessary) | Year Built |

| | |
|--|---|
| Purpose of Loan: <input type="checkbox"/> Purchase <input type="checkbox"/> Construction <input type="checkbox"/> Other (explain): | Property will be: |
| <input type="checkbox"/> Refinance <input type="checkbox"/> Construction-Permanent | <input type="checkbox"/> Primary Residence <input type="checkbox"/> Secondary Residence <input type="checkbox"/> Investment |

Complete this line if construction or construction-permanent loan.

| | | | | | |
|-------------------|---------------|-----------------------|--------------------------|--------------------------|-------------|
| Year Lot Acquired | Original Cost | Amount Existing Liens | (a) Present Value of Lot | (b) Cost of Improvements | Total (a+b) |
| \$ | \$ | \$ | \$ | \$ | \$ |

Complete this line if this is a refinance loan.

| | | | | |
|---------------|---------------|-----------------------|----------------------|---|
| Year Acquired | Original Cost | Amount Existing Liens | Purpose of Refinance | Describe Improvements <input type="checkbox"/> made <input type="checkbox"/> to be made |
| \$ | \$ | \$ | | Cost \$ |

| | | |
|------------------------------------|------------------------------------|---|
| Title will be held in what Name(s) | Manner in which Title will be held | Estate will be held in: |
| | | <input type="checkbox"/> Fee Simple <input type="checkbox"/> Leasehold (show expiration date) |

Source of Down Payment, Settlement Charges and/or Subordinate Financing (explain)

III. BORROWER INFORMATION

| Borrower | | | | Co-Borrower | | | |
|--|---|---|---|--|---|---|---|
| Borrower's Name (include Jr. or Sr. if applicable) | | | | Co-Borrower's Name (include Jr. or Sr. if applicable) | | | |
| Social Security Number | Home Phone (incl. area code) | Age | Yrs. School | Social Security Number | Home Phone (incl. area code) | Age | Yrs. School |
| <input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed) | Dependents (not listed by Co-Borrower) no. ages | <input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed) | Dependents (not listed by Co-Borrower) no. ages | <input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed) | Dependents (not listed by Co-Borrower) no. ages | <input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed) | Dependents (not listed by Co-Borrower) no. ages |
| Present Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. | | | | Present Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. | | | |

If residing at present address for less than two years, complete the following:

| | |
|---|---|
| Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. | Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. |
| Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. | Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent No. Yrs. |

IV. EMPLOYMENT INFORMATION

| Borrower | | Co-Borrower | |
|---------------------------------|---|---------------------------------|---|
| Name and Address of Employer | <input type="checkbox"/> Self Employed | Name and Address of Employer | <input type="checkbox"/> Self Employed |
| Yrs. on this job | Yrs. employed in this line of work/profession | Yrs. on this job | Yrs. employed in this line of work/profession |
| Position/Title/Type of Business | Business Phone (incl. area code) | Position/Title/Type of Business | Business Phone (incl. area code) |

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

| | | | | | |
|---------------------------------|--|-------------------|---------------------------------|--|-------------------|
| Name and Address of Employer | <input type="checkbox"/> Self Employed | Dates (from-to) | Name and Address of Employer | <input type="checkbox"/> Self Employed | Dates (from-to) |
| | | Monthly Income \$ | | | Monthly Income \$ |
| Position/Title/Type of Business | Business Phone (incl. area code) | | Position/Title/Type of Business | Business Phone (incl. area code) | |
| Name and Address of Employer | <input type="checkbox"/> Self Employed | Dates (from-to) | Name and Address of Employer | <input type="checkbox"/> Self Employed | Dates (from-to) |
| | | Monthly Income \$ | | | Monthly Income \$ |
| Position/Title/Type of Business | Business Phone (incl. area code) | | Position/Title/Type of Business | Business Phone (incl. area code) | |

| V. MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION | | | | | | |
|--|-----------|-------------|-----------|----------------------------------|-----------|-----------|
| Gross Monthly Income | Borrower | Co-Borrower | Total | Combined Monthly Housing Expense | Present | Proposed |
| Base Empl. Income* | \$ | \$ | \$ | Rent | \$ | \$ |
| Overtime | | | | First Mortgage (P&I) | | |
| Bonuses | | | | Other Financing (P&I) | | |
| Commissions | | | | Hazard Insurance | | |
| Dividends/Interest | | | | Real Estate Taxes | | |
| Net Rental Income | | | | Mortgage Insurance | | |
| OTHER (before completing see the notice in "Describe Other Income," below) | | | | Homeowner Assn. Dues | | |
| | | | | Other: | | |
| Total | \$ | \$ | \$ | Total | \$ | \$ |

*Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.

Describe Other Income Notice: Alimony, child support, or separate maintenance income need not be revealed if the Borrower(B) or Co-Borrower(C) does not choose to have it considered for repaying this loan.

| B/C | Monthly Amount |
|-----|----------------|
| | \$ |
| | |

VI. ASSETS AND LIABILITIES

This statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise separate Statements and Schedules are required. If the Co-Borrower section was completed about a spouse, this Statement and supporting schedules must be completed about that spouse also.

Completed Jointly Not Jointly

| ASSETS | Cash or Market Value | LIABILITIES | Monthly Payt. & Mos. Left to Pay | Unpaid Balance |
|---|----------------------|--|----------------------------------|-----------------------------|
| Description | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Cash deposit toward purchase held by: | \$ | Acct. No. | | |
| List checking and savings accounts below | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Name and address of Bank, S&L, or Credit Union | | Acct. No. | | |
| Acct. no. | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Name and address of Bank, S&L, or Credit Union | | Acct. No. | | |
| Acct. no. | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Name and address of Bank, S&L, or Credit Union | | Acct. No. | | |
| Acct. no. | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Name and address of Bank, S&L, or Credit Union | | Acct. No. | | |
| Acct. no. | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Stocks & Bonds (Company Name/number & description) | \$ | Acct. No. | | |
| Life Insurance net cash value | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Face amount: | \$ | Acct. No. | | |
| Subtotal Liquid Assets | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Real estate owned (enter market value from schedule of real estate owned) | \$ | Acct. No. | | |
| Vested interest in retirement fund | \$ | Name and Address of Company | \$ Payt./Mos. | \$ |
| Net worth of business(es) owned (attach financial statement) | \$ | Acct. No. | | |
| Automobiles owned (make and year) | \$ | Alimony/Child Support/Separate Maintenance Payments Owed to: | \$ | |
| Other Assets (itemize) | \$ | Job Related Expense (child care, union dues, etc.) | \$ | |
| | | Total Monthly Payments | \$ | |
| Total Assets a. | \$ | Net Worth (a-b) | \$ | Total Liabilities b. |

VI. ASSETS AND LIABILITIES (cont.)

Schedule of Real Estate Owned (if additional properties are owned, use continuation sheet.)

Table with 7 columns: Property Address, Type of Property, Present Market Value, Amount of Mortgages & Liens, Gross Rental Income, Mortgage Payments, Insurance Maintenance Taxes & Misc., Net Rental Income.

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Table with 3 columns: Alternate Name, Creditor Name, Account Number.

VII. DETAILS OF TRANSACTION VIII. DECLARATIONS

Form with multiple sections for transaction details (a-l) and declarations (a-m). Includes checkboxes for 'Yes/No' and 'Borrower/Co-Borrower'.

IX. ACKNOWLEDGMENT AND AGREEMENT

The undersigned specifically acknowledge(s) and agree(s) that: (1) the loan requested by this application will be secured by a first mortgage or deed or trust on the property described herein; (2) the property will not be used for any illegal or prohibited purpose or use; (3) all statements made in this application are made for the purpose of obtaining the loan indicated herein; (4) occupation of the property will be as indicated above; (5) verification or re-verification of any information contained in the application may be made at any time by the Lender, its agents, successors and assigns, either directly or through a credit reporting agency, from any source named in this application, and the original copy of this application will be retained by the Lender, even if the loan is not approved; (6) the Lender, its agents successors and assigns will rely on the information contained in the application and I/we have a continuing obligation to amend and/or supplement the information provided in this application of any of the material facts which I/we have represented herein should change prior to closing; (7) in the event my/our payments on the loan indicated in this application become delinquent, the Lender, its agents, successors and assigns, may in addition to all their other rights and remedies, report my/our names(s) and account information to a credit reporting agency; (8) ownership of the loan may be transferred to successor or assign of the Lender with prior notice to me; (9) the Lender, its agents, successors and assigns make no representations or warranties, express or implied, to the Borrower(s) regarding the property, the condition of the property, or the value of the property.

Certification: I/We certify that the information provided in this application is true and correct as of the date set forth opposite my/our signature(s) on this application and acknowledge my/our understanding that any intentional or negligent misrepresentation(s) of the information contained in this application may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, (United States Code, Section 1001, et seq. and liability for monetary damages to the Lender, its agents, successors and assigns, insurers and any other person who may suffer any loss due to reliance upon any misrepresentation which I/we have made on this application.

Signature lines for Borrower's Signature, Date, Co-Borrower's Signature, Date.

X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling, in order to monitor the Lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a Lender may neither discriminate on the basis of this information, nor on whether you choose to furnish it. However, if you choose not to furnish it, under Federal regulations this Lender is required to note race and sex on the basis of visual observation or surname. If you do not wish to furnish the above information, please check the box below. (Lender must review the above material to assure that the disclosure satisfy all requirements to which the Lender is subject under applicable law for the particular type of loan applied for.)

Form for Race/National Origin and Sex information for Borrower and Co-Borrower.

Form for Interviewer information: Name, Signature, Date, Phone Number, Address, Employer Name.

| Continuation Sheet/Residential Loan Application | | |
|--|---------------------------------------|--|
| Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark B for Borrower or C for Co-Borrower. | Borrower: _____ Co-Borrower: _____ | Agency Case Number: _____ Lender Case Number: _____ |

| VI. ASSETS AND LIABILITIES (cont.) | | | | |
|--|----------------------|-----------------------------|----------------------------------|----------------|
| ASSETS | Cash or Market Value | LIABILITIES | Monthly Payt. & Mos. Left to Pay | Unpaid Balance |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |
| Name and address of Bank, S&L, or Credit Union | | Name and Address of Company | \$ Payt./Mos. | \$ |
| Acct. no. | \$ | Acct. No. | | |

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

| | | | |
|--------------------------------|------|-----------------------------------|------|
| Borrower's Signature: X | Date | Co-Borrower's Signature: X | Date |
|--------------------------------|------|-----------------------------------|------|

| A. SETTLEMENT STATEMENT | | U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT | | OMB No. 2502-0265 | |
|---|--|--|---|--|------------------------------------|
| B. TYPE OF LOAN | | | | | |
| 1. <input type="checkbox"/> FHA | 2. <input type="checkbox"/> FmHA | 3. <input checked="" type="checkbox"/> CONV. UNINS. | 6. File Number: | 7. Loan Number: | 8. Mortgage Insurance Case Number: |
| 4. <input type="checkbox"/> VA | 5. <input type="checkbox"/> CONV. INS. | | | | |
| C. NOTE: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals. | | | | | |
| D. NAME AND ADDRESS OF BORROWER: | | E. NAME AND ADDRESS OF SELLER/TAX I.D.: | | F. NAME AND ADDRESS OF LENDER: | |
| | | | | Resource Bank 10461 White Granite Drive Oakton, Virginia 22124 | |
| G. PROPERTY LOCATION: | | H. SETTLEMENT AGENT: NORTH AMERICAN TITLE COMPANY OF COLORADO PLACE OF SETTLEMENT: 6501 E. Belleview Avenue, Suite 130 Englewood, CO 80111 | | I. SETTLEMENT DATE: 05/14/01 | |
| J. SUMMARY OF BORROWER'S TRANSACTION | | | K. SUMMARY OF SELLER'S TRANSACTION | | |
| 100. GROSS AMOUNT DUE FROM BORROWER: | | | 400. GROSS AMOUNT DUE TO SELLER: | | |
| 101. Contract Sales Price | 115,000.00 | 401. Contract Sales Price | 115,000.00 | | |
| 102. Personal property | | 402. Personal property | | | |
| 103. Settlement charges to borrower (line 1400) | 4,463.00 | 403. | | | |
| 104. Add'l Working capital | 68.00 | 404. | | | |
| 105. HOA dues/ June & July | 254.00 | 405. | | | |
| Adjustments for items paid by seller in advance | | | Adjustments for items paid by seller in advance | | |
| 106. City/town taxes | to | 406. City/town taxes | to | | |
| 107. County taxes | to | 407. County taxes | to | | |
| 108. Assessments | to | 408. Assessments | to | | |
| 109. | | 409. | | | |
| 110. HOA working capital | 186.00 | 410. HOA working capital | 186.00 | | |
| 111. | | 411. | | | |
| 112. | | 412. | | | |
| 113. | | 413. | | | |
| 114. | | 414. | | | |
| 120. GROSS AMOUNT DUE FROM BORROWER | 119,971.00 | 420. GROSS AMOUNT DUE TO SELLER | 115,186.00 | | |
| 200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER: | | | 500. REDUCTIONS IN AMOUNT DUE TO SELLER: | | |
| 201. Deposit or earnest money | 2,000.00 | 501. Excess deposit (see instructions) | | | |
| 202. Principal amount of new loan(s) | 92,000.00 | 502. Settlement charges to seller (line 1400) | 6,775.26 | | |
| 203. Existing loan(s) taken subject to | | 503. Existing loan(s) taken subject to | | | |
| 204. | | 504. Payoff of first mortgage loan | 53,633.00 | | |
| 205. | | 505. Payoff of second mortgage loan | | | |
| 206. | | 506. | | | |
| 207. | | 507. HOA statement fee | 60.00 | | |
| 208. | | 508. 2nd half 2000 taxes | 256.31 | | |
| 209. | | 509. HOA transfer fee | 100.00 | | |
| Adjustments for items unpaid by seller | | | Adjustments for items unpaid by seller | | |
| 210. City/town taxes | to | 510. City/town taxes | to | | |
| 211. County taxes 01/01/01 to 05/14/01 | 186.80 | 511. County taxes 01/01/01 to 05/14/01 | 186.80 | | |
| 212. Assessments | to | 512. Assessments | to | | |
| 213. | | 513. | | | |
| 214. | | 514. | | | |
| 215. | | 515. | | | |
| 216. | | 516. | | | |
| 217. | | 517. | | | |
| 218. | | 518. | | | |
| 219. | | 519. | | | |
| 220. TOTAL PAID BY/FOR BORROWER | 94,186.80 | 520. TOTAL REDUCTION AMOUNT DUE SELLER | 61,011.37 | | |
| 300. CASH AT SETTLEMENT FROM/TO BORROWER | | | 600. CASH AT SETTLEMENT TO/FROM SELLER | | |
| 301. Gross amount due from borrower (line 120) | 119,971.00 | 601. Gross amount due to seller (line 420) | 115,186.00 | | |
| 302. Less amounts paid by/for borrower (line 220) | 94,186.80 | 602. Less reductions in amount due seller (line 520) | 61,011.37 | | |
| 303. CASH (<input checked="" type="checkbox"/> FROM) (<input type="checkbox"/> TO) BORROWER | 25,784.20 | 603. CASH (<input checked="" type="checkbox"/> TO) (<input type="checkbox"/> FROM) SELLER | 54,174.63 | | |
| I have carefully reviewed the HUD-1 Settlement Statement and to the best of my knowledge and belief it is a true and accurate statement of all receipts and disbursements made on my account or by me in this transaction. I further certify that I have received a copy of the HUD-1 Settlement Statement. | | | | | |
| Borrowers The HUD-1 Settlement Statement which I have prepared is a true and accurate account of this transaction. I have caused or will cause the funds to be disbursed in accordance with this statement. <i>Wade H. Gumbel</i> Settlement Agent | | | Sellers I have caused or will cause the funds to be disbursed in accordance with this statement. <i>5/14/01</i> Date | | |
| Warning: It is a crime to knowingly make false statements to the United States on this or any similar form. Penalties upon conviction can include a fine and imprisonment. For details see: Title 18 U.S. Code Section 1001 and Section 1010. HUD-1 (8-87) RESPA, HB 4305-2 Previous edition is obsolete. | | | | | |

| L. SETTLEMENT CHARGES | | | |
|---|----------------------|-------------------------------|----------|
| 700. TOTAL SALES/BROKER'S COMMISSION | | | |
| based on price \$ 115,000.00 | @ 5.00 % | = | 5,750.00 |
| Division of Commission (Line 700) as follows: | | | |
| 701. \$ 2,530.00 | to | RE/Max Classic | |
| 702. \$ 3,220.00 | to | Kelley Williams | |
| 703. Commission paid at Settlement | | | 5,750.00 |
| 704. | | | |
| 800. ITEMS PAYABLE IN CONNECTION WITH LOAN | | | |
| 801. Loan Origination Fee | 1.000 % | Stonecreek Funding | 1,500.00 |
| 802. Loan Discount | 0.050 % | Resource Bank | 460.00 |
| 803. Appraisal Fee to | | Stonecreek Funding | 350.00 |
| 804. Credit Report to | | Stonecreek Funding | 15.00 |
| 805. Lenders Inspection Fee | | | |
| 806. Mortgage Insurance Application Fee to | | | |
| 807. Assumption Fee | | | |
| 808. Tax Service Fee | | Resource Bank | 61.00 |
| 809. doc prep. fee | | Resource Bank | 275.00 |
| 810. portfolio review | | Resource Bank | 100.00 |
| 811. Flood cert. | | Resource Bank | 26.00 |
| 812. underwriting fee | | Resource Bank | 150.00 |
| 813. | | | |
| 814. | | | |
| 815. | | | |
| 816. | | | |
| 900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE | | | |
| 901. Interest from | 05/14/01 to 06/01/01 | @ 17.888800 /day | 322.00 |
| 902. Mortgage Insurance Premium for | months to | | |
| 903. Hazard Insurance Premium for | years to | | |
| 904. Flood Insurance Premium for | years to | | |
| 905. | | | |
| 1000. RESERVES DEPOSITED WITH LENDER | | | |
| 1001. Hazard Insurance | months @ | per month | |
| 1002. Mortgage Insurance | months @ | per month | |
| 1003. City property taxes | months @ | per month | |
| 1004. County property taxes | 9 months @ | 42.72 per month | 384.48 |
| 1005. Annual assessments | months @ | per month | |
| 1006. Flood insurance | months @ | per month | |
| 1007. | months @ | per month | |
| 1008. Aggregate Adjustment | months @ | per month | -42.72 |
| 1100. TITLE CHARGES | | | |
| 1101. Settlement or closing fee | to | North American Title Company | 75.00 |
| 1102. Abstract or title search | to | | |
| 1103. Title examination | to | | |
| 1104. Title insurance binder | to | | |
| 1105. Document preparation | to | | |
| 1106. Notary fees | to | | |
| 1107. Attorney's fees | to | | |
| (includes above items numbers:) | | | |
| 1108. Title insurance | to | North American Title Company | 125.00 |
| (includes above items numbers:) | | | 852.00 |
| 1109. Lender's coverage | \$ 93,000.00 | 852.00 | |
| 1110. Owner's coverage | \$ 115,000.00 | 852.00 | |
| 1111. Endorsement Forms 100 & 6.1 | | North American Title Company | 80.00 |
| 1112. End. 115.1 | | North American Title Company | 100.00 |
| 1113. Tax Certificate | | North American Title Company | 30.00 |
| 1114. Loan closing fee | | North American Title Company | 175.00 |
| 1115. | | | |
| 1200. GOVERNMENT RECORDING AND TRANSFER CHARGES | | | |
| 1201. Recording fees: Deed \$ 5.00; Mortgage \$ 125.00; Releases \$ 25.00 | | | 130.00 |
| 1202. State tax/stamps: Deed \$; Mortgage \$ | | | 11.50 |
| 1203. escrow recording | | Arapahoe Cty Clerk & Recorder | 20.00 |
| 1204. | | | |
| 1205. | | | |
| 1300. ADDITIONAL SETTLEMENT CHARGES | | | |
| 1301. Survey to | | | |
| 1302. Pest inspection to | | | |
| 1303. HOA dues May | | Spinnaker Run HOA | 73.74 |
| 1304. UPS charges | | North American Title Company | 20.00 |
| 1305. | | | |
| 1306. | | | |
| 1307. | | | |
| 1308. | | | |
| 1309. | | | |
| 1310. | | | |
| 1311. | | | |
| 1400. TOTAL SETTLEMENT CHARGES (enter on lines 103, Sect J and 502, Sect K) | | | 4,463.00 |
| | | | 6,775.26 |

NOTEJanuary 15, 2002
[Date]Denver
[City]Colorado
[State]123 Main Street, Denver, CO 80231
[Property Address]**1. BORROWER'S PROMISE TO PAY**

In return for a loan that I have received, I promise to pay U.S. \$ 100,000.00 (this amount is called "principal"), plus interest, to the order of the Lender. The Lender is ABC Home Loan Mortgage Corporation

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note is called the "Note Holder."

2. INTEREST

Interest will be charged on unpaid principal until the full amount of principal has been paid. I will pay interest at a yearly rate of 10 %.

The interest rate required by this Section 2 is the rate I will pay both before and after any default described in Section 6(B) of this Note.

3. PAYMENTS**(A) Time and Place of Payments**

I will pay principal and interest by making payments every month.

I will make my monthly payments on the First day of each month beginning on Feb 15, 2002. I will make these payments every month until I have paid all of the principal and interest and any other charges described below that I may owe under this Note. My monthly payments will be applied to interest before principal. If, on March 15, 2007, I still owe amounts under this Note, I will pay those amounts in full on that date, which is called the "Maturity Date."

I will make my monthly payments at PO Box 1234, Denver, CO 80202

or at a different place if required by the Note Holder.

(B) Amount of Monthly Payments

My monthly payment will be in the amount of U.S.\$ 112.00

4. BORROWER'S RIGHT TO PREPAY

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment." When I make a prepayment, I will tell the Note Holder in writing that I am doing so.

I may make a full prepayment or partial prepayments without paying any prepayment charge. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes.

5. LOAN CHARGES

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (i) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit, and (ii) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the principal I owe under this Note or by making a direct payment to me. If a refund reduces principal, the reduction will be treated as a partial prepayment.

6. BORROWER'S FAILURE TO PAY AS REQUIRED**(A) Late Charge for Overdue Payments**

If the Note Holder has not received the full amount of any monthly payment by the end of 15 calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be 5 % of my overdue payment of principal and interest. I will pay this late charge promptly but only once on each late payment.

(B) Default

If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.

(C) Notice of Default

If I am in default, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date, the Note Holder may require me to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount. That date must be at least 30 days after the date on which the notice is delivered or mailed to me.

(D) No Waiver by Note Holder

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(E) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees.

7. GIVING OF NOTICES

Unless applicable law requires a different method, any notice that must be given to me under this Note will be given by delivering it or by mailing it by first class mail to me at the Property Address above or at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by mailing it by first class mail to the Note Holder at the address stated in Section 3(A) above or at a different address if I am given a notice of that different address.

8. OBLIGATIONS OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each person is fully and personally obligated to keep all of the promises made in this Note, including the promise to pay the full amount owed. Any person who is a guarantor, surety or endorser of this Note is also obligated to do these things. Any person who takes over these obligations, including the obligations of a guarantor, surety or endorser of this Note, is also obligated to keep all of the promises made in this Note. The Note Holder may enforce its rights under this Note against each person individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

9. WAIVERS

I and any other person who has obligations under this Note waive the rights of presentment and notice of dishonor. "Presentment" means the right to require the Note Holder to demand payment of amounts due. "Notice of dishonor" means the right to require the Note Holder to give notice to other persons that amounts due have not been paid.

10. UNIFORM SECURED NOTE

This Note is a uniform instrument with limited variations in some jurisdictions. In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust or Security Deed (the "Security Instrument"), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Security Instrument describes how and under what conditions I may be required to make immediate payment in full of all amounts I owe under this Note. Some of those conditions are described as follows:

Transfer of the Property or a Beneficial Interest in Borrower. If all or any part of the Property or any interest in it is sold or transferred (or if a beneficial interest in Borrower is sold or transferred and Borrower is not a natural person), without Lender's prior written consent, Lender may, at its option, require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if exercise is prohibited by federal law as of the date of this Security Instrument.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The notice shall provide a period of not less than 30 days from the date the notice is delivered or mailed within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

WITNESS THE HAND(S) AND SEAL(S) OF THE UNDERSIGNED.

Barney Borrower (Seal) _____ (Seal)
-Borrower -Borrower

SSN: _____ SSN: _____

_____ (Seal) _____ (Seal)
-Borrower -Borrower

SSN: _____ SSN: _____

[Sign Original Only]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

CALIFORNIA DEED OF TRUST (SHORT FORM)

SHORT FORM DEED OF TRUST, executed this 1st day of March, 2001 by and between between

Harry Homeowner, an unmarried man, herein called Trustor, whose address is PO Box 12, Los Angeles, CA 90000 California Trust Company, herein called Trustee, and ABC Home Loan Corporation, herein called Beneficiary,

THE TRUSTOR IRREVOCABLY GRANTS, TRANSFERS AND ASSIGNS TO TRUSTEE IN TRUST, WITH POWER OF SALE, that property located in Los Angeles County, California, described as:

Lot 12, Block 14, Shady Acres Subdivision, 2nd Filing, City and County of Los Angeles, State of California Also known as 12345 Bobcat Lane, Los Angeles, CA 90000

TOGETHER WITH the rents, issues and profits thereof, SUBJECT, HOWEVER, to the right, power and authority given to and conferred upon Beneficiary by paragraph (10) of the provisions incorporated herein by reference to collect and apply such rents, issues and profits.

For the Purpose of Securing: 1. Performance of each agreement of Trustor incorporated by reference or contained herein. 2. Payment of the indebtedness evidenced by one promissory note of even date herewith, and any extension or renewal thereof, in the principal sum of \$ 100,000.00 executed by Trustor in favor of Beneficiary or order. 3. Payment of such further sums as the then record owner of said property may borrow from Beneficiary, when evidenced by another note (or notes) reciting it is so secured.

To Protect the Security of This Deed of Trust, Trustor Agrees: By the execution and delivery of this Deed of Trust and the rate secured hereby, that provisions (1) to (14), inclusive, of the fictitious deed of trust recorded October 23, 1961, in the book and at the page of Official Records in the office of the county recorder of the county where said property is located, noted below opposite the name of such county, viz:

Table with columns: COUNTY, DATE, BOOK, PAGE, COUNTY, DATE, BOOK, PAGE, COUNTY, DATE, BOOK, PAGE, COUNTY, DATE, BOOK, PAGE. Includes entries for IMPERIAL, KERN, RIVERSIDE, ORANGE, VENTURA, SAN BERNARDINO, SAN LUIS OBISPO, SAN DIEGO, SANTA BARBARA, LOS ANGELES.

(which provisions, identical in all counties, are printed on the reverse hereof) hereby are adopted and incorporated herein and made a part hereof as fully as though set forth herein at length; that he will observe and perform said provisions; and that the references to property, obligations, and parties in said provisions shall be construed to refer to the property, obligations, and parties set forth in this Deed of Trust.

The undersigned Trustor requests that a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to him at his address hereinbefore set forth.

Harry Homeowner Trustor

Trustor

STATE OF CALIFORNIA COUNTY OF Los Angeles } SS.

On March 1st, 2002 before me, Nancy Notary personally appeared Harry Homeowner personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Notary Signature Nancy Notary

DO NOT RECORD THIS PORTION

The following is a copy of provisions (1) to (14), inclusive, of the fictitious deed of trust, recorded in each county in California, as stated in the foregoing Deed of Trust and incorporated by reference in said Deed of Trust as being a part thereof as if set forth at length therein

To Protect the Security of This Deed of Trust, Trustor Agrees:

(1) To keep said property in good condition and repair, not to remove or demolish any building thereon, to complete or restore promptly and in good and workmanlike manner any building which may be constructed, damaged or destroyed thereon and to pay when due all claims for labor performed and materials furnished therefor, to comply with all laws affecting said property or requiring any alterations or improvements to be made thereon, not to commit or permit waste thereof, not to commit, suffer or permit any act upon said property in violation of law to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of said property may be reasonably necessary, the specific enumerations herein not excluding the general

(2) To provide maintain and deliver to Beneficiary fire insurance satisfactory to and with loss payable to Beneficiary. The amount collected under any fire or other insurance policy may be applied by Beneficiary upon indebtedness secured hereby and in such order as Beneficiary may determine, or at option of Beneficiary the entire amount so collected or any part thereof may be released to Trustor. Such application or release shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice

(3) To appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee, and to pay all costs and expenses including cost of evidence of title and attorney's fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear, and in any suit brought by Beneficiary to foreclose this Deed

(4) To pay at least ten days before delinquency all taxes and assessments affecting said property, including assessments on appurtenant water stock, when due, all encumbrances, charges and liens, with interest, on said property or any part thereof, which appear to be prior or superior hereto, all costs, fees and expenses of this Trust

Should Trustor fail to make any payment or to do any act as herein provided, then Beneficiary or Trustee, but without obligation so to do and without notice to or demand upon Trustor and without releasing Trustor from any obligation hereof, may make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof Beneficiary or Trustee being authorized to enter upon said property for such purposes; appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee, pay, purchase, contest or compromise any encumbrance, charge or lien which in the judgment of either appears to be prior or superior hereto, and in exercising any such powers, pay necessary expenses, employ counsel and pay his reasonable fees

(5) To pay immediately and without demand all sums so expended by Beneficiary or Trustee, with interest from date of expenditure at the amount allowed by law in effect at the date hereof, and to pay for any statement provided for by law in effect at the date hereof regarding the obligation secured hereby any amount demanded by the Beneficiary not to exceed the maximum allowed by law at the time when said statement is demanded

(6) That any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned and shall be paid to Beneficiary who may apply or release such moneys received by him in the same manner and with the same effect as above provided for disposition of proceeds of fire or other insurance.

(7) That by accepting payment of any sum secured hereby after its due date, Beneficiary does not waive his rights either to require prompt payment when due of all other sums so secured or to declare default for failure so to pay.

(8) That at any time or from time to time, without liability therefor and without notice, upon written request of Beneficiary and presentation of this Deed and said note for endorsement, and without affecting the personal liability of any person for payment of the indebtedness secured hereby, Trustee may reconvey any part of said property, consent to the making of any map or plot thereof; join in granting any easement thereon; or join in any extension agreement or any agreement subordinating the lien or charge hereof.

(9) That upon written request of Beneficiary state that all sums secured hereby have been paid, and upon surrender of this Deed and said note to Trustee for cancellation and retention and upon payment of its fees, Trustee shall reconvey, without warranty, the property then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in such reconveyance may be described as "The person or persons legally entitled thereto "Five years after issuance of such full reconveyance, Trustee may destroy said note and this Deed (unless directed in such request to retain them)

(10) That as additional security, Trustor hereby give to and confers upon Beneficiary the right, power and authority, during the continuance of these Trusts, to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect and retain such rents, issues and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, and without regard to the adequacy of any security for the indebtedness hereby secured, enter upon and take possession of said property or any part thereof, in his own name sue for or otherwise collect such rents, issues and profits, including those past due and unpaid, and apply the same, less costs and expenses of operation and collection, including reasonable attorney's fees. Upon any indebtedness secured hereby, and in such order as Beneficiary may determine. The entering upon and taking possession of said property, the collection of such rents, issues and profits and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.

(11) That upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, Beneficiary may declare all sums secured hereby immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and of written notice of default and of election to cause to be sold said property which notice Trustee shall cause to be filed for record. Beneficiary also shall deposit with Trustee this Deed, said note and all documents evidencing expenditures secured hereby.

After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States, payable at time of sale. Trustee may postpone sale of all or any portion of said property by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement at the time fixed by the preceding postponement Trustee shall deliver to such purchaser its deed conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be conclusive proof of the truthfulness thereof. Any person, including Trustor, Trustee, or Beneficiary as hereinafter defined, may purchase at such sale.

After deducting all costs, fees and expenses of Trustee and of this Trust, including cost of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of all sums expended under the terms hereof, not then repaid, with accrued interest at the amount allowed by law in effect at the date hereof, all other sums then secured hereby, and the remainder, if any, to the person or persons legally entitled thereto.

(12) Beneficiary, or any successor in ownership of any indebtedness secured hereby, may from time to time, by instrument in writing, substitute a successor or successors to any Trustee named herein or acting hereunder, which instrument, executed by the Beneficiary and duly acknowledged and recorded in the office of the recorder of the county or counties where said property is situated, shall be conclusive proof of proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the Trustee predecessor, succeed to all its title, estate, rights, powers and duties. Said instrument must contain the name of the original Trustor, Trustee and Beneficiary hereunder, the book and page where this Deed is recorded and the name and address of the new Trustee.

(13) That this Deed applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the owner and holder, including pledgees, of the note secured hereby whether or not named as Beneficiary herein in this Deed, whenever the context so requires, the masculine gender includes the feminine and/or neuter, and the singular number includes the plural.

(14) That Trustee accepts this Trust when this Deed, duly executed and acknowledged, is made a public record as provided by law. Trustee is not obligated to notify any party hereto of pending sale under any other Deed of Trust or of any action or proceeding in which Trustor, Beneficiary or Trustee shall be a party unless brought by Trustee.

After Recording Return To:

-----[Space Above This Line For Recording Data]-----

MORTGAGE

DEFINITIONS

Words used in multiple sections of this document are defined below and other words are defined in Sections 3, 11, 13, 18, 20 and 21. Certain rules regarding the usage of words used in this document are also provided in Section 16.

(A) "Security Instrument" means this document, which is dated March 1, 2001, together with all Riders to this document.

(B) "Borrower" is Harry Homeowner. Borrower is the trustor under this Security Instrument.

(C) "Lender" is ABC Home Loan Corporation. Lender is a _____ organized and existing under the laws of Florida. Lender's address is PO BOX 322, Miami, FL 38473. Lender is the beneficiary under this Security Instrument.

(D) "Note" means the promissory note signed by Borrower and dated March 1, 2001. The Note states that Borrower owes Lender One hundred seventy thousand Dollars (U.S. \$\$170,000.00) plus interest. Borrower has promised to pay this debt in regular Periodic Payments and to pay the debt in full not later than _____.

(E) "Property" means the property that is described below under the heading "Transfer of Rights in the Property."

(F) "Loan" means the debt evidenced by the Note, plus interest, any prepayment charges and late charges due under the Note, and all sums due under this Security Instrument, plus interest.

(G) "Riders" means all riders to this Security Instrument that are executed by Borrower. The following riders are to be executed by Borrower [check box as applicable]:

- | | | |
|--|---|---|
| <input type="checkbox"/> Adjustable Rate Rider | <input type="checkbox"/> Condominium Rider | <input type="checkbox"/> Second Home Rider |
| <input type="checkbox"/> Balloon Rider | <input type="checkbox"/> Planned Unit Development Rider | <input type="checkbox"/> Other(s) [specify] _____ |
| <input type="checkbox"/> 1-4 Family Rider | <input type="checkbox"/> Biweekly Payment Rider | |

(H) “Applicable Law” means all controlling applicable federal, state and local statutes, regulations, ordinances and administrative rules and orders (that have the effect of law) as well as all applicable final, non-appealable judicial opinions.

(I) “Community Association Dues, Fees and Assessments” means all dues, fees, assessments and other charges that are imposed on Borrower or the Property by a condominium association, homeowners association or similar organization.

(J) “Electronic Funds Transfer” means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, computer, or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, transfers initiated by telephone, wire transfers, and automated clearinghouse transfers.

(K) “Escrow Items” means those items that are described in Section 3.

(L) “Miscellaneous Proceeds” means any compensation, settlement, award of damages, or proceeds paid by any third party (other than insurance proceeds paid under the coverages described in Section 5) for: (i) damage to, or destruction of, the Property; (ii) condemnation or other taking of all or any part of the Property; (iii) conveyance in lieu of condemnation; or (iv) misrepresentations of, or omissions as to, the value and/or condition of the Property.

(M) “Mortgage Insurance” means insurance protecting Lender against the nonpayment of, or default on, the Loan.

(N) “Periodic Payment” means the regularly scheduled amount due for (i) principal and interest under the Note, plus (ii) any amounts under Section 3 of this Security Instrument.

(O) “RESPA” means the Real Estate Settlement Procedures Act (12 U.S.C. §2601 et seq.) and its implementing regulation, Regulation X (24 C.F.R. Part 3500), as they might be amended from time to time, or any additional or successor legislation or regulation that governs the same subject matter.

As used in this Security Instrument, “RESPA” refers to all requirements and restrictions that are imposed in regard to a “federally related mortgage loan” even if the Loan does not qualify as a “federally related mortgage loan” under RESPA.

(P) “Successor in Interest of Borrower” means any party that has taken title to the Property, whether or not that party has assumed Borrower’s obligations under the Note and/or this Security Instrument.

TRANSFER OF RIGHTS IN THE PROPERTY

This Security Instrument secures to Lender: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note; and (ii) the performance of Borrower’s covenants and agreements under this Security Instrument and the Note. For this purpose, Borrower irrevocably

County _____ of Pinellas _____ :
[Type of Recording Jurisdiction] [Name of Recording Jurisdiction]

Lots 8 and 9, Block 35, Orange Subdivision

which currently has the address of 1245 Orange Blossom Way _____
Alligator Alley, FL 33333 [Street]
[City], [State, Zip Code] (“Property Address”):

TOGETHER WITH all the improvements now or hereafter erected on the property, and all easements, appurtenances, and fixtures now or hereafter a part of the property. All replacements and additions shall also be covered by this Security Instrument. All of the foregoing is referred to in this Security Instrument as the “Property.”

BORROWER COVENANTS that Borrower is lawfully seized of the estate hereby conveyed and has the right to mortgage, grant and convey the Property and that the Property is unencumbered, except for encumbrances of record. Borrower warrants and will defend generally the title to the Property against all claims and demands, subject to any encumbrances of record.

THIS SECURITY INSTRUMENT combines uniform covenants for national use and non-uniform covenants with limited variations by jurisdiction to constitute a uniform security instrument covering real property.

UNIFORM COVENANTS. Borrower and Lender covenant and agree as follows:

1. Payment of Principal, Interest, Escrow Items, Prepayment Charges, and Late Charges. Borrower shall pay when due the principal of, and interest on, the debt evidenced by the Note and any prepayment charges and late charges due under the Note. Borrower shall also pay funds for Escrow Items pursuant to Section 3. Payments due under the Note and this Security Instrument shall be made in U.S. currency. However, if any check or other instrument received by Lender as payment under the Note or this Security Instrument is returned to Lender unpaid, Lender may require that any or all subsequent payments due under the Note and this Security Instrument be made in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer’s check or cashier’s check, provided any such check is

drawn upon an institution whose deposits are insured by a federal agency, instrumentality, or entity; or (d) Electronic Funds Transfer.

Payments are deemed received by Lender when received at the location designated in the Note or at such other location as may be designated by Lender in accordance with the notice provisions in Section 15. Lender may return any payment or partial payment if the payment or partial payments are insufficient to bring the Loan current. Lender may accept any payment or partial payment insufficient to bring the Loan current, without waiver of any rights hereunder or prejudice to its rights to refuse such payment or partial payments in the future, but Lender is not obligated to apply such payments at the time such payments are accepted. If each Periodic Payment is applied as of its scheduled due date, then Lender need not pay interest on unapplied funds. Lender may hold such unapplied funds until Borrower makes payment to bring the Loan current. If Borrower does not do so within a reasonable period of time, Lender shall either apply such funds or return them to Borrower. If not applied earlier, such funds will be applied to the outstanding principal balance under the Note immediately prior to foreclosure. No offset or claim which Borrower might have now or in the future against Lender shall relieve Borrower from making payments due under the Note and this Security Instrument or performing the covenants and agreements secured by this Security Instrument.

2. Application of Payments or Proceeds. Except as otherwise described in this Section 2, all payments accepted and applied by Lender shall be applied in the following order of priority: (a) interest due under the Note; (b) principal due under the Note; (c) amounts due under Section 3.

Such payments shall be applied to each Periodic Payment in the order in which it became due. Any remaining amounts shall be applied first to late charges, second to any other amounts due under this Security Instrument, and then to reduce the principal balance of the Note.

If Lender receives a payment from Borrower for a delinquent Periodic Payment which includes a sufficient amount to pay any late charge due, the payment may be applied to the delinquent payment and the late charge. If more than one Periodic Payment is outstanding, Lender may apply any payment received from Borrower to the repayment of the Periodic Payments if, and to the extent that, each payment can be paid in full. To the extent that any excess exists after the payment is applied to the full payment of one or more Periodic Payments, such excess may be applied to any late charges due. Voluntary prepayments shall be applied first to any prepayment charges and then as described in the Note.

Any application of payments, insurance proceeds, or Miscellaneous Proceeds to principal due under the Note shall not extend or postpone the due date, or change the amount, of the Periodic Payments.

3. Funds for Escrow Items. Borrower shall pay to Lender on the day Periodic Payments are due under the Note, until the Note is paid in full, a sum (the "Funds") to provide for payment of amounts due for: (a) taxes and assessments and other items which can attain priority over this Security Instrument as a lien or encumbrance on the Property; (b) leasehold payments or ground rents on the Property, if any; (c) premiums for any and all insurance required by Lender under Section 5; and (d) Mortgage Insurance premiums, if any, or any sums payable by Borrower to Lender in lieu of the payment of Mortgage Insurance premiums in accordance with the provisions of Section 10. These items are called "Escrow Items." At origination or at any time during the

term of the Loan, Lender may require that Community Association Dues, Fees and Assessments, if any, be escrowed by Borrower, and such dues, fees and assessments shall be an Escrow Item. Borrower shall promptly furnish to Lender all notices of amounts to be paid under this Section. Borrower shall pay Lender the Funds for Escrow Items unless Lender waives Borrower's obligation to pay the Funds for any or all Escrow Items. Lender may waive Borrower's obligation to pay to Lender Funds for any or all Escrow Items at any time. Any such waiver may only be in writing. In the event of such waiver, Borrower shall pay directly, when and where payable, the amounts due for any Escrow Items for which payment of Funds has been waived by Lender and, if Lender requires, shall furnish to Lender receipts evidencing such payment within such time period as Lender may require.

Borrower's obligation to make such payments and to provide receipts shall for all purposes be deemed to be a covenant and agreement contained in this Security Instrument, as the phrase "covenant and agreement" is used in Section 9. If Borrower is obligated to pay Escrow Items directly, pursuant to a waiver, and Borrower fails to pay the amount due for an Escrow Item, Lender may exercise its rights under Section 9 and pay such amount and Borrower shall then be obligated under Section 9 to repay to Lender any such amount. Lender may revoke the waiver as to any or all Escrow Items at any time by a notice given in accordance with Section 15 and, upon such revocation, Borrower shall pay to Lender all Funds, and in such amounts, that are then required under this Section 3.

Lender may, at any time, collect and hold Funds in an amount (a) sufficient to permit Lender to apply the Funds at the time specified under RESPA, and (b) not to exceed the maximum amount a lender can require under RESPA. Lender shall estimate the amount of Funds due on the basis of current data and reasonable estimates of expenditures of future Escrow Items or otherwise in accordance with Applicable Law.

The Funds shall be held in an institution whose deposits are insured by a federal agency, instrumentality, or entity (including Lender, if Lender is an institution whose deposits are so insured) or in any Federal Home Loan Bank. Lender shall apply the Funds to pay the Escrow Items no later than the time specified under RESPA. Lender shall not charge Borrower for holding and applying the Funds, annually analyzing the escrow account, or verifying the Escrow Items, unless Lender pays Borrower interest on the Funds and Applicable Law permits Lender to make such a charge. Unless an agreement is made in writing or Applicable Law requires interest to be paid on the Funds, Lender shall not be required to pay Borrower any interest or earnings on the Funds. Borrower and Lender can agree in writing, however, that interest shall be paid on the Funds. Lender shall give to Borrower, without charge, an annual accounting of the Funds as required by RESPA.

If there is a surplus of Funds held in escrow, as defined under RESPA, Lender shall account to Borrower for the excess funds in accordance with RESPA. If there is a shortage of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the shortage in accordance with RESPA, but in no more than twelve monthly payments. If there is a deficiency of Funds held in escrow, as defined under RESPA, Lender shall notify Borrower as required by RESPA, and Borrower shall pay to Lender the amount necessary to make up the deficiency in accordance with RESPA, but in no more than twelve monthly payments.

Upon payment in full of all sums secured by this Security Instrument, Lender shall promptly refund to Borrower any Funds held by Lender.

4. Charges; Liens. Borrower shall pay all taxes, assessments, charges, fines, and impositions attributable to the Property which can attain priority over this Security Instrument, leasehold payments or ground rents on the Property, if any, and Community Association Dues, Fees, and Assessments, if any. To the extent that these items are Escrow Items, Borrower shall pay them in the manner provided in Section 3.

Borrower shall promptly discharge any lien which has priority over this Security Instrument unless Borrower: (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to Lender, but only so long as Borrower is performing such agreement; (b) contests the lien in good faith by, or defends against enforcement of the lien in, legal proceedings which in Lender's opinion operate to prevent the enforcement of the lien while those proceedings are pending, but only until such proceedings are concluded; or (c) secures from the holder of the lien an agreement satisfactory to Lender subordinating the lien to this Security Instrument. If Lender determines that any part of the Property is subject to a lien which can attain priority over this Security Instrument, Lender may give Borrower a notice identifying the lien. Within 10 days of the date on which that notice is given, Borrower shall satisfy the lien or take one or more of the actions set forth above in this Section 4.

Lender may require Borrower to pay a one-time charge for a real estate tax verification and/or reporting service used by Lender in connection with this Loan.

5. Property Insurance. Borrower shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, hazards included within the term "extended coverage," and any other hazards including, but not limited to, earthquakes and floods, for which Lender requires insurance. This insurance shall be maintained in the amounts (including deductible levels) and for the periods that Lender requires. What Lender requires pursuant to the preceding sentences can change during the term of the Loan. The insurance carrier providing the insurance shall be chosen by Borrower subject to Lender's right to disapprove Borrower's choice, which right shall not be exercised unreasonably. Lender may require Borrower to pay, in connection with this Loan, either: (a) a one-time charge for flood zone determination, certification and tracking services; or (b) a one-time charge for flood zone determination and certification services and subsequent charges each time remappings or similar changes occur which reasonably might affect such determination or certification. Borrower shall also be responsible for the payment of any fees imposed by the Federal Emergency Management Agency in connection with the review of any flood zone determination resulting from an objection by Borrower.

If Borrower fails to maintain any of the coverages described above, Lender may obtain insurance coverage, at Lender's option and Borrower's expense. Lender is under no obligation to purchase any particular type or amount of coverage. Therefore, such coverage shall cover Lender, but might or might not protect Borrower, Borrower's equity in the Property, or the contents of the Property, against any risk, hazard or liability and might provide greater or lesser coverage than was previously in effect. Borrower acknowledges that the cost of the insurance coverage so obtained might significantly exceed the cost of insurance that Borrower could have obtained. Any amounts disbursed by Lender under this Section 5 shall become additional debt of Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

All insurance policies required by Lender and renewals of such policies shall be subject to Lender's right to disapprove such policies, shall include a standard mortgage clause, and shall name Lender as mortgagee and/or as an additional loss payee. Lender shall have the right to hold the policies and renewal certificates. If Lender requires, Borrower shall promptly give to Lender all receipts of paid premiums and renewal notices. If Borrower obtains any form of insurance coverage, not otherwise required by Lender, for damage to, or destruction of, the Property, such policy shall include a standard mortgage clause and shall name Lender as mortgagee and/or as an additional loss payee.

In the event of loss, Borrower shall give prompt notice to the insurance carrier and Lender. Lender may make proof of loss if not made promptly by Borrower. Unless Lender and Borrower otherwise agree in writing, any insurance proceeds, whether or not the underlying insurance was required by Lender, shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such insurance proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such insurance proceeds, Lender shall not be required to pay Borrower any interest or earnings on such proceeds. Fees for public adjusters, or other third parties, retained by Borrower shall not be paid out of the insurance proceeds and shall be the sole obligation of Borrower. If the restoration or repair is not economically feasible or Lender's security would be lessened, the insurance proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such insurance proceeds shall be applied in the order provided for in Section 2.

If Borrower abandons the Property, Lender may file, negotiate and settle any available insurance claim and related matters. If Borrower does not respond within 30 days to a notice from Lender that the insurance carrier has offered to settle a claim, then Lender may negotiate and settle the claim. The 30-day period will begin when the notice is given. In either event, or if Lender acquires the Property under Section 22 or otherwise, Borrower hereby assigns to Lender (a) Borrower's rights to any insurance proceeds in an amount not to exceed the amounts unpaid under the Note or this Security Instrument, and (b) any other of Borrower's rights (other than the right to any refund of unearned premiums paid by Borrower) under all insurance policies covering the Property, insofar as such rights are applicable to the coverage of the Property. Lender may use the insurance proceeds either to repair or restore the Property or to pay amounts unpaid under the Note or this Security Instrument, whether or not then due.

6. Occupancy. Borrower shall occupy, establish, and use the Property as Borrower's principal residence within sixty days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.

7. Preservation, Maintenance and Protection of the Property; Inspections. Borrower shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not Borrower is residing in the Property, Borrower shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition. Unless it is determined pursuant to Section 5 that repair or restoration is not economically feasible, Borrower shall promptly repair the Property if damaged to avoid further deterioration or damage. If insurance or condemnation proceeds are paid in connection with damage to, or the taking of, the Property, Borrower shall be responsible for repairing or restoring the Property only if Lender has released proceeds for such purposes. Lender may disburse proceeds for the repairs and restoration in a single payment or in a series of progress payments as the work is completed. If the insurance or condemnation proceeds are not sufficient to repair or restore the Property, Borrower is not relieved of Borrower's obligation for the completion of such repair or restoration.

Lender or its agent may make reasonable entries upon and inspections of the Property. If it has reasonable cause, Lender may inspect the interior of the improvements on the Property. Lender shall give Borrower notice at the time of or prior to such an interior inspection specifying such reasonable cause.

8. Borrower's Loan Application. Borrower shall be in default if, during the Loan application process, Borrower or any persons or entities acting at the direction of Borrower or with Borrower's knowledge or consent gave materially false, misleading, or inaccurate information or statements to Lender (or failed to provide Lender with material information) in connection with the Loan. Material representations include, but are not limited to, representations concerning Borrower's occupancy of the Property as Borrower's principal residence.

9. Protection of Lender's Interest in the Property and Rights Under this Security Instrument. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender's interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Instrument or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. Lender's actions can include, but are not limited to: (a) paying any sums secured by a lien which has priority over this Security Instrument; (b) appearing in court; and (c) paying reasonable attorneys' fees to protect its interest in the Property and/or rights under this Security Instrument, including its secured position in a bankruptcy proceeding. Securing the Property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off. Although Lender may take action under this Section 9, Lender does not have to do so and is not under any duty or obligation to do so. It is agreed that Lender incurs no liability for not taking any or all actions authorized under this Section 9.

Any amounts disbursed by Lender under this Section 9 shall become additional debt of

Borrower secured by this Security Instrument. These amounts shall bear interest at the Note rate from the date of disbursement and shall be payable, with such interest, upon notice from Lender to Borrower requesting payment.

If this Security Instrument is on a leasehold, Borrower shall comply with all the provisions of the lease. If Borrower acquires fee title to the Property, the leasehold and the fee title shall not merge unless Lender agrees to the merger in writing.

10. Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan, Borrower shall pay the premiums required to maintain the Mortgage Insurance in effect. If, for any reason, the Mortgage Insurance coverage required by Lender ceases to be available from the mortgage insurer that previously provided such insurance and Borrower was required to make separately designated payments toward the premiums for Mortgage Insurance, Borrower shall pay the premiums required to obtain coverage substantially equivalent to the Mortgage Insurance previously in effect, at a cost substantially equivalent to the cost to Borrower of the Mortgage Insurance previously in effect, from an alternate mortgage insurer selected by Lender. If substantially equivalent Mortgage Insurance coverage is not available, Borrower shall continue to pay to Lender the amount of the separately designated payments that were due when the insurance coverage ceased to be in effect. Lender will accept, use and retain these payments as a non-refundable loss reserve in lieu of Mortgage Insurance. Such loss reserve shall be non-refundable, notwithstanding the fact that the Loan is ultimately paid in full, and Lender shall not be required to pay Borrower any interest or earnings on such loss reserve. Lender can no longer require loss reserve payments if Mortgage Insurance coverage (in the amount and for the period that Lender requires) provided by an insurer selected by Lender again becomes available, is obtained, and Lender requires separately designated payments toward the premiums for Mortgage Insurance. If Lender required Mortgage Insurance as a condition of making the Loan and Borrower was required to make separately designated payments toward the premiums for Mortgage Insurance, Borrower shall pay the premiums required to maintain Mortgage Insurance in effect, or to provide a non-refundable loss reserve, until the Lender's requirement for Mortgage Insurance ends in accordance with any written agreement between Borrower and Lender providing for such termination or until termination is required by Applicable Law. Nothing in this Section 10 affects Borrower's obligation to pay interest at the rate provided in the Note.

11. Assignment of Miscellaneous Proceeds; Forfeiture. All Miscellaneous Proceeds are hereby assigned to and shall be paid to Lender.

If the Property is damaged, such Miscellaneous Proceeds shall be applied to restoration or repair of the Property, if the restoration or repair is economically feasible and Lender's security is not lessened. During such repair and restoration period, Lender shall have the right to hold such Miscellaneous Proceeds until Lender has had an opportunity to inspect such Property to ensure the work has been completed to Lender's satisfaction, provided that such inspection shall be undertaken promptly. Lender may pay for the repairs and restoration in a single disbursement or in a series of progress payments as the work is completed. Unless an agreement is made in writing or Applicable Law requires interest to be paid on such Miscellaneous Proceeds, Lender shall not be required to pay Borrower any interest or earnings on such Miscellaneous Proceeds. If the restoration or repair is not economically feasible or Lender's security would be lessened, the

Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower. Such Miscellaneous Proceeds shall be applied in the order provided for in Section 2.

In the event of a total taking, destruction, or loss in value of the Property, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument, whether or not then due, with the excess, if any, paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is equal to or greater than the amount of the sums secured by this Security Instrument immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the sums secured by this Security Instrument shall be reduced by the amount of the Miscellaneous Proceeds multiplied by the following fraction: (a) the total amount of the sums secured immediately before the partial taking, destruction, or loss in value divided by (b) the fair market value of the Property immediately before the partial taking, destruction, or loss in value. Any balance shall be paid to Borrower.

In the event of a partial taking, destruction, or loss in value of the Property in which the fair market value of the Property immediately before the partial taking, destruction, or loss in value is less than the amount of the sums secured immediately before the partial taking, destruction, or loss in value, unless Borrower and Lender otherwise agree in writing, the Miscellaneous Proceeds shall be applied to the sums secured by this Security Instrument whether or not the sums are then due.

If the Property is abandoned by Borrower, or if, after notice by Lender to Borrower that the Opposing Party (as defined in the next sentence) offers to make an award to settle a claim for damages, Borrower fails to respond to Lender within 30 days after the date the notice is given, Lender is authorized to collect and apply the Miscellaneous Proceeds either to restoration or repair of the Property or to the sums secured by this Security Instrument, whether or not then due. "Opposing Party" means the third party that owes Borrower Miscellaneous Proceeds or the party against whom Borrower has a right of action in regard to Miscellaneous Proceeds. Borrower shall be in default if any action or proceeding, whether civil or criminal, is begun that, in Lender's judgment, could result in forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. Borrower can cure such a default and, if acceleration has occurred, reinstate as provided in Section 19, by causing the action or proceeding to be dismissed with a ruling that, in Lender's judgment, precludes forfeiture of the Property or other material impairment of Lender's interest in the Property or rights under this Security Instrument. The proceeds of any award or claim for damages that are attributable to the impairment of Lender's interest in the Property are hereby assigned and shall be paid to Lender.

All Miscellaneous Proceeds that are not applied to restoration or repair of the Property shall be applied in the order provided for in Section 2.

12. Borrower Not Released; Forbearance By Lender Not a Waiver. Extension of the time for payment or modification of amortization of the sums secured by this Security Instrument granted by Lender to Borrower or any Successor in Interest of Borrower shall not operate to release the liability of Borrower or any Successors in Interest of Borrower. Lender shall not be required to commence proceedings against any Successor in Interest of Borrower or to refuse to

extend time for payment or otherwise modify amortization of the sums secured by this Security Instrument by reason of any demand made by the original Borrower or any Successors in Interest of Borrower. Any forbearance by Lender in exercising any right or remedy including, without limitation, Lender's acceptance of payments from third persons, entities or Successors in Interest of Borrower or in amounts less than the amount then due, shall not be a waiver of or preclude the exercise of any right or remedy.

13. Joint and Several Liability; Co-signers; Successors and Assigns Bound. Borrower covenants and agrees that Borrower's obligations and liability shall be joint and several. However, any Borrower who co-signs this Security Instrument but does not execute the Note (a "co-signer"): (a) is co-signing this Security Instrument only to mortgage, grant and convey the co-signer's interest in the Property under the terms of this Security Instrument; (b) is not personally obligated to pay the sums secured by this Security Instrument; and (c) agrees that Lender and any other Borrower can agree to extend, modify, forbear or make any accommodations with regard to the terms of this Security Instrument or the Note without the co-signer's consent.

Subject to the provisions of Section 18, any Successor in Interest of Borrower who assumes Borrower's obligations under this Security Instrument in writing, and is approved by Lender, shall obtain all of Borrower's rights and benefits under this Security Instrument. Borrower shall not be released from Borrower's obligations and liability under this Security Instrument unless Lender agrees to such release in writing. The covenants and agreements of this Security Instrument shall bind (except as provided in Section 20) and benefit the successors and assigns of Lender.

14. Loan Charges. Lender may charge Borrower fees for services performed in connection with Borrower's default, for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument, including, but not limited to, attorneys' fees, property inspection and valuation fees. In regard to any other fees, the absence of express authority in this Security Instrument to charge a specific fee to Borrower shall not be construed as a prohibition on the charging of such fee. Lender may not charge fees that are expressly prohibited by this Security Instrument or by Applicable Law.

If the Loan is subject to a law which sets maximum loan charges, and that law is finally interpreted so that the interest or other loan charges collected or to be collected in connection with the Loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from Borrower which exceeded permitted limits will be refunded to Borrower. Lender may choose to make this refund by reducing the principal owed under the Note or by making a direct payment to Borrower. If a refund reduces principal, the reduction will be treated as a partial prepayment without any prepayment charge (whether or not a prepayment charge is provided for under the Note).

Borrower's acceptance of any such refund made by direct payment to Borrower will constitute a waiver of any right of action Borrower might have arising out of such overcharge.

15. Notices. All notices given by Borrower or Lender in connection with this Security

Instrument must be in writing. Any notice to Borrower in connection with this Security Instrument shall be deemed to have been given to Borrower when mailed by first class mail or when actually delivered to Borrower's notice address if sent by other means. Notice to any one Borrower shall constitute notice to all Borrowers unless Applicable Law expressly requires otherwise. The notice address shall be the Property Address unless Borrower has designated a substitute notice address by notice to Lender. Borrower shall promptly notify Lender of Borrower's change of address. If Lender specifies a procedure for reporting Borrower's change of address, then Borrower shall only report a change of address through that specified procedure. There may be only one designated notice address under this Security Instrument at any one time. Any notice to Lender shall be given by delivering it or by mailing it by first class mail to Lender's address stated herein unless Lender has designated another address by notice to Borrower. Any notice in connection with this Security Instrument shall not be deemed to have been given to Lender until actually received by Lender. If any notice required by this Security Instrument is also required under Applicable Law, the Applicable Law requirement will satisfy the corresponding requirement under this Security Instrument.

16. Governing Law; Severability; Rules of Construction. This Security Instrument shall be governed by federal law and the law of the jurisdiction in which the Property is located. All rights and obligations contained in this Security Instrument are subject to any requirements and limitations of Applicable Law. Applicable Law might explicitly or implicitly allow the parties to agree by contract or it might be silent, but such silence shall not be construed as a prohibition against agreement by contract. In the event that any provision or clause of this Security Instrument or the Note conflicts with Applicable Law, such conflict shall not affect other provisions of this Security Instrument or the Note which can be given effect without the conflicting provision.

As used in this Security Instrument: (a) words of the masculine gender shall mean and include corresponding neuter words or words of the feminine gender; (b) words in the singular shall mean and include the plural and vice versa; and (c) the word "may" gives sole discretion without any obligation to take any action.

17. Borrower's Copy. Borrower shall be given one copy of the Note and of this Security Instrument.

18. Transfer of the Property or a Beneficial Interest in Borrower. As used in this Section 18, "Interest in the Property" means any legal or beneficial interest in the Property, including, but not limited to, those beneficial interests transferred in a bond for deed, contract for deed, installment sales contract or escrow agreement, the intent of which is the transfer of title by Borrower at a future date to a purchaser.

If all or any part of the Property or any Interest in the Property is sold or transferred (or if Borrower is not a natural person and a beneficial interest in Borrower is sold or transferred) without Lender's prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument. However, this option shall not be exercised by Lender if such exercise is prohibited by federal law.

If Lender exercises this option, Lender shall give Borrower notice of acceleration. The

notice shall provide a period of not less than 30 days from the date the notice is given in accordance with Section 15 within which Borrower must pay all sums secured by this Security Instrument. If Borrower fails to pay these sums prior to the expiration of this period, Lender may invoke any remedies permitted by this Security Instrument without further notice or demand on Borrower.

19. Borrower's Right to Reinstate After Acceleration. If Borrower meets certain conditions, Borrower shall have the right to have enforcement of this Security Instrument discontinued at any time prior to the earliest of: (a) five days before sale of the Property pursuant to any power of sale contained in this Security Instrument; (b) such other period as Applicable Law might specify for the termination of Borrower's right to reinstate; or (c) entry of a judgment enforcing this Security Instrument. Those conditions are that Borrower: (a) pays Lender all sums which then would be due under this Security Instrument and the Note as if no acceleration had occurred; (b) cures any default of any other covenants or agreements; (c) pays all expenses incurred in enforcing this Security Instrument, including, but not limited to, reasonable attorneys' fees, property inspection and valuation fees, and other fees incurred for the purpose of protecting Lender's interest in the Property and rights under this Security Instrument; and (d) takes such action as Lender may reasonably require to assure that Lender's interest in the Property and rights under this Security Instrument, and Borrower's obligation to pay the sums secured by this Security Instrument, shall continue unchanged. Lender may require that Borrower pay such reinstatement sums and expenses in one or more of the following forms, as selected by Lender: (a) cash; (b) money order; (c) certified check, bank check, treasurer's check or cashier's check, provided any such check is drawn upon an institution whose deposits are insured by a federal agency, instrumentality or entity; or (d) Electronic Funds Transfer. Upon reinstatement by Borrower, this Security Instrument and obligations secured hereby shall remain fully effective as if no acceleration had occurred. However, this right to reinstate shall not apply in the case of acceleration under Section 18.

20. Sale of Note; Change of Loan Servicer; Notice of Grievance. The Note or a partial interest in the Note (together with this Security Instrument) can be sold one or more times without prior notice to Borrower. A sale might result in a change in the entity (known as the "Loan Servicer") that collects Periodic Payments due under the Note and this Security Instrument and performs other mortgage loan servicing obligations under the Note, this Security Instrument, and Applicable Law. There also might be one or more changes of the Loan Servicer unrelated to a sale of the Note. If there is a change of the Loan Servicer, Borrower will be given written notice of the change which will state the name and address of the new Loan Servicer, the address to which payments should be made and any other information RESPA requires in connection with a notice of transfer of servicing. If the Note is sold and thereafter the Loan is serviced by a Loan Servicer other than the purchaser of the Note, the mortgage loan servicing obligations to Borrower will remain with the Loan Servicer or be transferred to a successor Loan Servicer and are not assumed by the Note purchaser unless otherwise provided by the Note purchaser.

Neither Borrower nor Lender may commence, join, or be joined to any judicial action (as either an individual litigant or the member of a class) that arises from the other party's actions pursuant to this Security Instrument or that alleges that the other party has breached any provision of, or any duty owed by reason of, this Security Instrument, until such Borrower or

Lender has notified the other party (with such notice given in compliance with the requirements of Section 15) of such alleged breach and afforded the other party hereto a reasonable period after the giving of such notice to take corrective action. If Applicable Law provides a time period which must elapse before certain action can be taken, that time period will be deemed to be reasonable for purposes of this paragraph. The notice of acceleration and opportunity to cure given to Borrower pursuant to Section 22 and the notice of acceleration given to Borrower pursuant to Section 18 shall be deemed to satisfy the notice and opportunity to take corrective action provisions of this Section 20.

21. Hazardous Substances. As used in this Section 21: (a) "Hazardous Substances" are those substances defined as toxic or hazardous substances, pollutants, or wastes by Environmental Law and the following substances: gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials; (b) "Environmental Law" means federal laws and laws of the jurisdiction where the Property is located that relate to health, safety or environmental protection; (c) "Environmental Cleanup" includes any response action, remedial action, or removal action, as defined in Environmental Law; and (d) an "Environmental Condition" means a condition that can cause, contribute to, or otherwise trigger an Environmental Cleanup.

Borrower shall not cause or permit the presence, use, disposal, storage, or release of any Hazardous Substances, or threaten to release any Hazardous Substances, on or in the Property. Borrower shall not do, nor allow anyone else to do, anything affecting the Property (a) that is in violation of any Environmental Law, (b) which creates an Environmental Condition, or (c) which, due to the presence, use, or release of a Hazardous Substance, creates a condition that adversely affects the value of the Property. The preceding two sentences shall not apply to the presence, use, or storage on the Property of small quantities of Hazardous Substances that are generally recognized to be appropriate to normal residential uses and to maintenance of the Property (including, but not limited to, hazardous substances in consumer products). Borrower shall promptly give Lender written notice of (a) any investigation, claim, demand, lawsuit or other action by any governmental or regulatory agency or private party involving the Property and any Hazardous Substance or Environmental Law of which Borrower has actual knowledge, (b) any Environmental Condition, including but not limited to, any spilling, leaking, discharge, release or threat of release of any Hazardous Substance, and (c) any condition caused by the presence, use or release of a Hazardous Substance which adversely affects the value of the Property. If Borrower learns, or is notified by any governmental or regulatory authority, or any private party, that any removal or other remediation of any Hazardous Substance affecting the Property is necessary, Borrower shall promptly take all necessary remedial actions in accordance with Environmental Law. Nothing herein shall create any obligation on Lender for an Environmental Cleanup.

N NON-UNIFORM COVENANTS. Borrower and Lender further covenant and agree as follows:

22. Acceleration; Remedies. Lender shall give notice to Borrower prior to acceleration following Borrower's breach of any covenant or agreement in this Security

Instrument (but not prior to acceleration under Section 18 unless Applicable Law provides otherwise). The notice shall specify: (a) the default; (b) the action required to cure the default; (c) a date, not less than 30 days from the date the notice is given to Borrower, by which the default must be cured; and (d) that failure to cure the default on or before the date specified in the notice may result in acceleration of the sums secured by this Security Instrument, foreclosure by judicial proceeding and sale of the Property. The notice shall further inform Borrower of the right to reinstate after acceleration and the right to assert in the foreclosure proceeding the non-existence of a default or any other defense of Borrower to acceleration and foreclosure. If the default is not cured on or before the date specified in the notice, Lender at its option may require immediate payment in full of all sums secured by this Security Instrument without further demand and may foreclose this Security Instrument by judicial proceeding. Lender shall be entitled to collect all expenses incurred in pursuing the remedies provided in this Section 22, including, but not limited to, reasonable attorneys' fees and costs of title evidence.

23. Release. Upon payment of all sums secured by this Security Instrument, Lender shall release this Security Instrument. Borrower shall pay any recordation costs. Lender may charge Borrower a fee for releasing this Security Instrument, but only if the fee is paid to a third party for services rendered and the charging of the fee is permitted under Applicable Law.

24. Attorneys' Fees. As used in this Security Instrument and the Note, "attorneys' fees" shall include any attorneys' fees awarded by an appellate court and any attorneys' fees incurred in a bankruptcy proceeding.

25. Jury Trial Waiver. The Borrower hereby waives any right to a trial by jury in any action, proceeding, claim, or counterclaim, whether in contract or tort, at law or in equity, arising out of or in any way related to this Security Instrument or the Note.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and covenants contained in this Security Instrument and in any rider(s) executed by Borrower and recorded with it.

Harry Homeowner
Borrower _____ Borrower

STATE OF FLORIDA
COUNTY OF Pinellas

The foregoing instrument was acknowledged before me this 1st day of March, 2001 (year), by Harry Homeowner (name of person acknowledging)

Nancy Notary (Signature) (Seal)
Nancy Notary

(Name of Notary printed, typed or stamped)
____ Personally known OR

* Produced identification
Type of identification produced: Driver's License

Option To Purchase Real Estate

THIS OPTION is made and entered into this 1st day of October 2000 by and between Harry Homeowner hereinafter referred to as "Optionor," and Ira Investor and/or assigns, hereinafter referred to as "Optionee".

WITNESSETH, that for and in consideration of \$ 100.00 and the mutual promises and covenants hereinafter set forth, the parties hereto agree as follows:

1. Option to Purchase Real Property. Optionor grants unto Optionee the exclusive right to purchase the real property described exhibit "A" annexed hereto.

2. Term of Option. This option shall commence on Oct 1st 2000 and expire on October 1, 2001.

3. Terms of Sale. The terms of sale shall be: Cash

The following items shall be prorated at closing:
property taxes, HOA dues, water/sewer, rents

All personal property, appliances, attachments and fixtures shall be included in said sale except:
Hot tub

The Optionor shall convey title by a good and marketable Warranty deed and shall furnish a policy of insurance from a reputable title insurance company.

4. Extension of Option Period. Upon payment of \$ 500.00, Optionee shall have the right to extend this option by 1 years under the same terms and conditions.

5. Notice of Exercise. This option may be exercised at any time during the option period as described above, and Optionee may exercise said option with or without notice to Optionor.

6. Escrow of Closing Documents. All documents necessary for title transfer, including, but not limited to a warranty deed and bill of sale, shall be executed and held in escrow with an escrow agent of Optionee's choosing. Optionor shall execute a deed of trust or mortgage in favor of Optionee to secure performance of this agreement.

7. Insurance. Optionor shall protect Optionee's interest by maintaining hazard insurance upon the property, naming the Optionee as additional insured. In the event of destruction in whole or in part of the property, Optionee shall have the option to proceed with the closing and accept the insurance proceeds for said damage, or to declare this agreement null and void, releasing both parties from any obligations hereunder, except for the return of monies paid by Optionee which shall become immediately due and payable from the insurance proceeds.

8. Other Encumbrances. Optionor representing that the following liens and encumbrances currently exist on the property:
1st mortgage to ABC Savings & Loan

Optionor covenants that he will not further impair or encumber the property without Optionee's express written permission. In the event Optionor defaults on the payment of any of said security instruments, Optionee shall have the right to cure and/or satisfy said security instruments, and, in this event, shall be entitled to a 18% interest on actual expenses incurred in doing so.

9. Assignment: Optionee shall be permitted the right of assignment of this option.

10. Agreement Binding. This Agreement shall be binding upon the parties hereto and their respective heirs, administrators, successors, and assigns.

11. Governing Law. This agreement, and all transactions contemplated hereby, shall be governed by, construed and enforced in accordance with the laws of the State of Colorado. In the event that litigation results from or arises out of this Agreement or the performance thereof, the parties agree to reimburse the prevailing party's reasonable attorney's fees, court costs, and all other expenses, whether or not taxable by the court as costs, in addition to any other relief to which the prevailing party may be entitled.

IN WITNESS WHEREOF, the parties hereto have hereunto set their hands and seals the day and year first above written.

Harry Homeowner

Optionor

Optionor

On March 1, 20 01, before me, Nancy Notary, a notary public in and for said state personally appeared Harry Homeowner, personally known to me (or proved to me based upon satisfactory evidence) to be the person(s) whose name(s) are subscribed to the within instrument and acknowledged that (s)he/they executed the same in his/her/their signature on the instrument the person(s) or entity on behalf of which they acted, executed the instrument.

Nancy Notary

Signature of Notary

NOTARY SEAL

My commission expires 3/1/2003

EXHIBIT "A" - Legal Description of Real Property

Lot 1, Block 2, Breezy Hills 3rd Filing, City & County of Denver, State of Colorado also known by street address as 123 Main Street, Denver, CO 80231

WRAP AROUND MORTGAGE RIDER

Rider and addendum to Security Instrument dated May 12, 2002

The attached security instrument is a "wrap-around" mortgage/deed of trust subordinate to a certain mortgage/deed of trust dated Nov 1st, 2000, executed in favor of First Capital Mortgage Group, Inc. and currently held by Countrywide Home Loans, Inc. in the original principal amount of \$ 129,000.00, which was recorded on the 15th day of Dec, 2000 in the county records of Pleasant County, State Anystate as follows:

Book 6671, Pg 3242 Recording #2000374683

Borrower agrees to comply with all the terms and conditions of the above described mortgage, including, but not limited to, those concerning taxes and insurance, other than with respect to the payment of principal or interest due under said mortgage. If Borrower herein shall fail to comply with all the terms, provisions and conditions of said mortgage so as to result in a default thereunder (other than with respect to payments of principal or interest due), that failure on the part of Borrower herein shall constitute a default under this security instrument and shall entitle the lender, at its option, to exercise any and all rights and remedies given this security instrument in the event of a default under this security instrument.

If the lender hereunder shall default in making any required payment of principal or interest under the above described mortgage or deed of trust, the Borrower shall have the right to advance funds necessary to cure that default and all funds so advanced by Borrower shall be credited against the next installment of principal and interest due under the Note secured by this security instrument.

Ira Investor
Borrower

State of Anystate)
County of Pleasant) ss:

On May 12, 2002, before me, Nancy Notary, a notary public in and for said state personally appeared Ira Investor personally known to me (or proved to me based upon satisfactory evidence) to be the person(s) whose name(s) are subscribed to the within instrument and acknowledged that (s)he/they executed the same in his/her/their signature on the instrument the person(s) or entity on behalf of which they acted, executed the instrument.

Nancy Notary [NOTARY SEAL]

Signature of Notary
My commission expires 3/1/2003

6. **Indemnity** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Vendor, and to pay all costs and expenses.

7. **Taxes & Senior Encumbrances** — To pay, all taxes and assessments affecting the property, including water stock assessments at least ten days before delinquency; all encumbrances, charges and liens, with interest, on the property when due, which are not the responsibility of the Vendor and are or appear to be senior to this agreement; and all expenses of this agreement.

8. **Acts & Advances to Protect the Security** — If Vendee fails to make any payment or to perform any act provided for in this agreement, then Vendor may, at the option of the Vendor and without notice, and without releasing Vendee from any obligation under this agreement:

- (a) make or do the same to the extent necessary to protect the security, Vendor being authorized to enter upon the property to do so;
- (b) appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Vendor;
- (c) pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this agreement.

In exercising the power of this provision, Vendor may incur necessary expenses and reasonable attorney fees.

Vendee to pay immediately all sums expended by Vendor provided for in this agreement, with interest from date of expenditure at the same rate as the principal debt hereby secured.

Vendor and Vendee agree:

9. **Assignment of Damages** — Vendee assigns to Vendor any award of damages made in connection with:

- (a) condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or
- (b) injury to the property by any third party.

10. **Waiver** — By accepting payment of any sum due after its due date, Vendor does not waive Vendor's right to either require prompt payment when due of all other sums or to declare default for failure to pay. Vendor may waive a default of any provision of this agreement, by consent or acquiescence, without waiving any prior or subsequent default.

11. **Conveyance of Title** — Vendor to convey title free of liens and encumbrances to Vendee upon Vendee's payment of all sums due to Vendor under this agreement.

11.1 On conveyance of title from Vendor to Vendee on full performance of this agreement by Vendee, the interest of Vendor and Vendee under this agreement will be insured by a title insurance policy obtained from any reputable Title Insurance Company, premium to be paid by Vendor, OR Vendee.

11.2 On Vendee's deposit into escrow of all sums and instruments due to Vendor under this agreement and charges, Vendor to deposit into the escrow all instruments and instructions necessary to convey title and fully perform this agreement.

12. **Due-on-sale** — Should Vendee sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, Vendor may, at Vendor's option, declare all sums secured by this agreement immediately due and payable.

13. **Assignment of Rents** — Vendee hereby assigns and transfers to Vendor all the rights, title and interest in rents

generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this agreement.

Prior to a default on the trust deed by the Vendee, Vendee shall collect and retain the rents. On default by Vendee, and without the necessity of the Vendor to make demand or take possession of the property in person, by agent or by court appointed receiver, Vendor shall immediately be entitled to possession of all unpaid rents.

14. **Acceleration** — If payment of any indebtedness or performance of this agreement is in default, then Vendor may at Vendor's option, without notice, declare all sums secured immediately due and payable by:

- (a) commencing suit for their recovery by foreclosure of this lien; or
- (b) delivering to Trustee a written notice declaring default with demand for sale; a written notice of default and election to sell to be recorded.

15. **Power of Sale** — On default under any obligation of this agreement and acceleration of all sums due, Vendor may elect to proceed with a power of sale by a trustee substituted under Civil Code §2934a, noticed and held in accordance with California Civil Code §2924 et seq.

15.1 The undersigned Vendee requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Vendee at the address herein set forth.

16. **Prepayment Penalty** — Any principal paid in addition to regular installments will, if so requested by Vendee, be paid by Vendor to holders of Underlying Obligations for a reduction in the principal. If the holders are entitled to a prepayment penalty Vendee shall pay the amount to Vendor for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or accrued interest on the debt remaining on this agreement.

17. **Cure of Default** — If Vendor defaults in his performance on this agreement, including payment of the Underlying Obligations, Vendee may cure the default and credit the payments against the principal and interest due under this agreement, or recover from Vendor, on demand, the amount of the payments including interest thereon at the note rate.

18. **Successors, Assigns & Pledges** — This agreement is for the benefit of, and binds all parties, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Vendor shall mean the holder and owner of the agreement, or, if the agreement has been pledged, the pledgee.

19. **Vendee's Offset Statement** — Within ten days of Vendee's receipt of a written request by Vendor, Vendee shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of the Vendor: the then owner of the secured property; the terms of the secured debt, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured debt is valid and the Vendee received full and valid consideration for it; and that the Vendee understands the debt and this agreement are being assigned.

20. **Final Balloon Payment Notice** — This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

21. **Addenda** — The following checked addenda are a part of this agreement: Impounds rider for taxes & insurance; Owner-occupancy rider; Contract collection rider;

22. **Attorneys Fees** — The prevailing party in any dispute shall be entitled to attorneys fees and costs.

STATE OF CALIFORNIA)
COUNTY OF Los Angeles)
On this 1st day of July, 2002
before me, Nancy Notary
(name of notary public)
personally appeared Mark Motivated & Ira Investor
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that or he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature Nancy Notary
(Signature of notary public)

Date: 7/1/2002
Vendor: Mark Motivated
Vendor:
Date: 7/1/2002
Vendee: Ira Investor
Vendee:

RECORDING REQUESTED BY
 XYZ ESCROW COMPANY
 AND WHEN RECORDED MAIL TO
 XYZ ESCROW, PO BOX 12, San Diego, CA 92123

SUBORDINATION AGREEMENT

THIS SUBORDINATION AGREEMENT, made this 12th day of April, 20 02, by and between Harry Homeowner,

owner of real property described herein ("Owner,"), and ABC Home Loan Corporation, the current holder of the security interest hereinafter described herein ("Beneficiary");

WHEREAS, OWNER has executed a security instrument, dated Jan 15th, 20 02, to XYZ ESCROW COMPANY, as trustee, to secure a note in the sum of \$ 150,000.00, dated Jan 15th, 20 02, in favor of ABC Home Loan Corporation as beneficiary the real property as described in the annexed exhibit "A" hereto, which instrument was recorded on Jan 21st, 20 02, in the county of San Diego under the following recording information Recording #34567-2002, Book 3456, Page 454; and

WHEREAS, Owner has executed, or is about to execute, a deed of trust and note in the sum of \$ 100,000.00 dated April 12th, 2002, in favor of US Savings Bank ("Lender"), payable with interest and upon the terms and conditions described therein, which deed of trust is to be recorded concurrently herewith; and

WHEREAS, it is a condition precedent to obtaining said loan that said deed of trust last above mentioned shall unconditionally be and remain at all times a lien or charge upon the land hereinbefore described, prior and superior to the lien or charge of the security instrument first above mentioned; and

WHEREAS, Lender is willing to make said loan provided the deed of trust securing the same is a lien or charge upon the above described property prior and superior to the lien or charge of the security instrument first above mentioned and provided that Beneficiary will specifically and unconditionally subordinate the lien or charge of the security instrument first above mentioned to the lien or charge of the deed of trust in favor of Lender; and

WHEREAS, it is to the mutual benefit of the parties hereto that Lender make such loan to Owner; and Beneficiary is willing that the deed of trust securing the same shall, when recorded, constitute a lien or charge upon said land which is unconditionally prior and superior to the lien or charge of the deed of trust first above mentioned.

NOW, THEREFORE, in consideration of the mutual benefits accruing to the parties hereto and other valuable consideration, the receipt and sufficiency of which consideration is hereby acknowledged, and in order to induce Lender to make the loan above referred to, it is hereby declared, understood and agreed as follows:

(1) That said deed of trust securing said note in favor of Lender, and any renewals or extensions thereof, shall unconditionally be and remain at all times a lien or charge on the property therein described, prior and superior to the lien or charge of the security instrument first above mentioned.

(2) That Lender would not make its loan above described without this subordination agreement.

(3) That this agreement shall be the whole and only agreement between the parties hereto with regard to the subordination of the lien or charge of the security instrument first above mentioned to the lien or charge of the deed of trust in favor of Lender above referred to and shall supersede and cancel any prior agreements as to such, or any, subordination including, but not limited to, those provisions, if any, contained in the deed of trust first above mentioned, which provide for the subordination of the lien or charge thereof to a deed or deeds of trust or to a mortgage or mortgages to be thereafter executed.

Beneficiary declares, agrees and acknowledges that

(a) He consents to and approves (i) all provisions of the note and deed of trust in favor of Lender above referred to, and (ii) all agreements, including but not limited to any loan or escrow agreements, between Owner and Lender for the disbursement of the proceeds of Lender's loan;

(b) Lender in making disbursements pursuant to any such agreement is under no obligation or duty to, nor has Lender represented that it will, see to the application of such proceeds by the person or persons to whom Lender disburses such proceeds and any application or use of such proceeds for purposes other than those provided for in such agreement or agreements shall not defeat the subordination herein made in whole or in part;

(c) He intentionally and unconditionally waives, relinquishes and subordinates the lien or charge of the security instrument first above mentioned in favor of the lien or charge upon said land of the deed of trust in favor of Lender above referred to and understands that in reliance upon, and in consideration of, this waiver, relinquishment and subordination specific loans and advances are being and will be made and, as part and parcel thereof, specific monetary and other obligations are being and will be entered into which would not be made or entered into but for said reliance upon this waiver, relinquishment and subordination; and

John Smith, Vice Pres
Beneficiary

Harry Homeowner
Owner

STATE OF CALIFORNIA
COUNTY OF San Diego } SS.

On April 12th, 2002 before me, Nancy Notary,
personally appeared John Smith, Vice President of ABC Home Loan Corporation and Harry Homeowner
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Notary Signature Nancy Notary

EXHIBIT "A": REAL PROPERTY DESCRIPTION:

LOTS 12, 13 of BLOCK 35, SUNNY DAZE SUBDIVISION,
THIRD FILING, COUNTY OF SAN DIEGO, STATE OF CALIFORNIA

KNOWN BY STREET ADDRESS AS:
12345 Happy Canyon Road, San Diego, CA 93746

GLOSSARY

abstract of title A compilation of the recorded documents relating to a parcel of land from which an attorney may give an option as to the condition of title. Also known in some states as a “preliminary title report.”

acceleration clause *See* due-on-sale clause.

acknowledgment A declaration made by a person signing a document before a notary public or other officer.

all-inclusive deed of trust *See* wraparound mortgage.

ALTA American Land Title Association.

amortize To reduce a debt by regular payments of both principal and interest.

appraised value The value of a property at a given time, based on facts regarding the location, improvements, etc., of the property and surroundings.

arrears Payment made after it is due or is in arrears. Interest is said to be paid in arrears because it is paid to the date of payment rather than in advance.

assignment of contract A process by which a person sells, transfers, and/or assigns his or her rights under an agreement. Often used in the context of the assignment of a purchase contract by a buyer or the assignment of a lease by a tenant.

- assignment of mortgage** The process of assigning the collateral (mortgage or deed of trust) that secures a debt obligation, such as a note.
- assumable loan** A loan secured by a mortgage or deed of trust containing no due-on-sale provision. Most pre-1989 FHA loans and pre-1988 VA loans are assumable without qualification. Some newer loans may be assumed with the express permission of the note holder.
- assumption of mortgage** Agreement by a buyer to assume the liability under an existing note secured by a mortgage or deed of trust.
- balloon mortgage** A note calling for periodic payments that are insufficient to fully amortize the face amount of the note prior to maturity, so that a principal sum known as a “balloon” is due at maturity.
- beneficiary** One for whose benefit trust property is held. Also known as the “lender” under a deed of trust.
- chain of title** The chronological order of conveyancing of a parcel of land from the original owner to the present owner.
- closing** The passing of a deed or mortgage, signifying the end of a sale or mortgage of real property. Also known in some areas as “passing papers” or “closing of escrow.”
- cloud on title** An uncertainty, doubt, or claim against the rights of the owner of a property, such as a recorded purchase contract or option.
- commitment** A written promise to make or insure a loan for a specified amount and on specified items. Also used in the context of title insurance (“title commitment”).
- comparables** Properties used as comparisons to determine the value of a specified property.
- condominium** A structure of two or more units, the interior space of which are individually owned. The common areas are owned as tenants in common by the condominium owners, and ownership is restricted by an association.
- contingency** The dependence on a stated event that must occur before a contract is binding. Used both in the context of a loan and a contract of sale.
- contract for deed** See installment land contract.
- contract of sale** A bilateral (two way) agreement wherein the seller agrees to sell and the buyer agrees to buy a certain parcel of land, usually with

improvements. Also used to reference to an installment land contract.
See land contract.

deficiency The difference between the amount owed to a note holder and the proceeds received from a foreclosure sale. The lender may, in some states, obtain a “deficiency judgment” against the borrower for the difference.

depreciation Decrease in value to real property improvements caused by deterioration or obsolescence.

documentary tax stamps Stamps, affixed to a deed, showing the amount of transfer tax. Some states simply charge the transfer tax without affixing stamps. Also known as “doc stamps” or “transfer tax.”

double closing A closing wherein a property is bought and then sold simultaneously. Also called “double escrow” and “flipping.” *See* flip.

due-on-sale clause A provision in a mortgage or deed of trust that gives the lender the option to require payment in full of the indebtedness upon transfer of title to the property (or any interest therein).

earnest money A good faith deposit or down payment.

encumbrance A claim, lien, or charge against real property.

equitable title The interest of the purchase under an installment land contract.

equity The difference between the market value of the property and the homeowner’s mortgage debt.

escrow Delivery of a deed by a grantor to a third party for delivery to the grantee upon the happening of a contingent event.

estate From the English feudal system, estate defines the extent of one’s ownership in a property.

Federal Housing Administration (FHA) A federal agency that insures first mortgages, enabling lenders to loan a very high percentage of the sale price.

Federal Reserve System (the Fed) Central bank of the United States, comprised by 12 regional member banks.

fee simple The highest form of ownership. An estate under which the owner is entitled to unrestricted powers to dispose of the property, and which can be left by will or inherited. Also known as “fee” or “fee simple absolute.”

flip To sell a property quickly.

foreclosure A proceeding to extinguish all rights, title, and interest of the owner(s) of property in order to sell the property to satisfy a lien

against it. About half of the states use a “mortgage foreclosure” that is a lawsuit in court. About half use a “power of sale” proceeding that is dictated by a deed of trust and is usually less time-consuming.

good faith estimate A lender’s estimate of closing costs and monthly payment required by RESPA.

grant deed A deed commonly used in California to convey title. By law, a grant deed gives certain warranties of title.

grantee A person receiving an interest in property.

grantor A person granting or giving up an interest in property.

grantor/grantee index The most common document recording indexing system is by grantor (the person conveying an interest, usually the seller or mortgagor) and grantee (the person receiving an interest, usually the buyer or mortgagee). All documents conveying property or an interest therein (deed, mortgage, lease, easement, etc.) are recorded by the grantor’s last name in the grantor index. The same transaction is cross-indexed by the grantee’s last name in the grantee index.

impound account Account held by a lender for payment of taxes, insurance, or other payments. Also known as an “escrow” account.

inflation Inflation is a general rise in the price levels of goods and services. In real estate, it refers to a rise in the cost of housing.

installment land contract The installment land contract (ILC) is an agreement wherein the buyer makes payments in a manner similar to a mortgage. The buyer has “equitable title.” However, the seller holds legal title to the property until the contract is paid off. The buyer has equitable title and, for all intents and purposes, is the owner of the property. Also known as a “contract for deed” or “contract of sale.”

installment sale A sale that involves the seller receiving payments over time. The Internal Revenue Code contains specific definitions and promulgates specific rules concerning installment sales and tax treatment of them. Also known as an “owner-carry sale.”

joint tenancy An undivided interest in property, taken by two or more joint tenants. Upon death of a joint tenant, the interest passes to the surviving joint tenants, rather than to the heirs of the deceased.

junior mortgage Mortgage of lesser priority than the previously recorded mortgage.

lease option An agreement by which the lessee (tenant) has the unilateral option to purchase the leased premises from the lessor (landlord). Some lease-option agreements provide for a portion of the rent to be

applied towards the purchase price. The price may be fixed at the beginning of the agreement or be determined by another formula, such as an appraisal at a later time. Also referred to as a “lease purchase.”

lease purchase Often used interchangeably with the expression “lease option,” but technically it means a lease in conjunction with a bilateral purchase agreement. Often used by real estate agents to mean a purchase agreement whereby the tenant takes possession prior to close of escrow.

leverage The control of assets that exceed the direct capital invested in their control.

lien An encumbrance against property for money, voluntary (e.g., mortgage), involuntary (e.g., judgment), or by operation of law (e.g., property tax lien).

limited liability company A creation of state law that provides liability protection for its owners and flexible tax treatment. Also known as “LLC.”

MAI Member Appraisal Institute (MAI) is a designation given to appraisers who are licensed by the Appraisal Institute.

marketable title Title that can be readily marketed to a reasonably prudent purchaser aware of the facts and their legal meaning concerning liens and encumbrances.

mortgage A voluntary lien filed against property to secure a debt. The borrower is called the “mortgagor,” the lender the “mortgagee.”

mortgage banker One who lends his or her own money; also known as “direct lender.”

mortgage broker One who negotiates a loan on behalf of a borrower from a lender.

net income Income minus expenses; pertaining to real estate, rents less operating expenses and mortgage debt payments.

net rents Rental income less operating expenses (but before mortgage debt payments).

nonrecourse debt A debt that limits the lender’s legal remedy to a claim against the collateral but not against the borrower.

notary public One authorized by law to acknowledge and certify documents and signatures as valid.

note A written promise to repay a certain sum of money on specified terms. Also known as a “promissory note.”

- option** The unilateral right to do something. For example, the right to renew a lease or purchase a property. The “optionee” is the holder of the option. The optionor is the grantor of the option. The optionor is bound by the option, but the optionee is not.
- performance mortgage** A mortgage or deed of trust given to secure performance of an obligation other than a promissory note (e.g., an option).
- PITI** Principal, interest, taxes, and insurance.
- power of attorney** A written document authorizing another to act on his or her behalf as an attorney in fact.
- private mortgage insurance (PMI)** Also known as “mortgage guaranty insurance,” PMI will cover the lender’s additional risk for a high loan-to-value program.
- prorate** To divide in proportionate shares. Used in the context of a closing, at which property taxes, interest, rents, and other items are adjusted in favor of the seller, buyer, or lender.
- quit claim deed** A deed by which the grantor gives up any claim he or she may have in the property. Often used to clear up a cloud on title.
- REALTOR®** Any member of the National Association of REALTORS.®
- recording** The act of publicly filing a document, such as a deed or mortgage.
- redemption** The right, in some states, for an owner or lien holder to satisfy the indebtedness due on a mortgage in foreclosure after sale.
- release** An instrument releasing a lien or encumbrance (e.g., mortgage) from a property.
- RESPA (Real Estate Settlement Procedures Act)** A federal law requiring disclosure of certain costs in the sale of residential property that is to be financed by a federally insured lender. Also requires that the lender provide a “good faith estimate” of closing costs prior to closing of the loan.
- seasoning of title** Formerly used in the context of a payment history on a promissory note; now used to mean a seller’s history of ownership in connection with the sale and financing of property.
- second mortgage** A loan secured by a mortgage or trust deed, which lien is junior to a first mortgage or deed of trust.
- secured loan** A loan collateralized with security, such as real estate, an automobile, or business equipment.

- security instrument** A document under which collateral is pledged (e.g., a mortgage)
- settlement statement** A statement prepared by a closing agent (usually a title or escrow company) giving a complete breakdown of costs and charges involved in a real estate transaction. Required by RESPA on a HUD-1 form.
- simple interest** Interest paid on a loan by multiplying the interest rate by the principal amount of the loan, then dividing by the payment period.
- subject to** When transferring title to a property encumbered by a mortgage lien without paying off the debt or assuming the note, the buyer is taking title “subject to.”
- subprime loan** A loan that does not conform with Federal National Mortgage Association (FNMA) lending guidelines.
- subordination of collateral** To move a lien to a junior position.
- substitution of collateral** To substitute another collateral for a loan.
- tenancy in common** With tenancy in common, each owner (called a “tenant”) has an undivided interest in the possession of the property. Each tenant’s interest is salable and transferable. Each tenant can convey his or her interest by deed, mortgage, or by a will. Joint ownership is presumed to be tenancy in common if nothing further is stated on the deed.
- title** Title is the evidence of ownership. In essence, title is more important than ownership because having proper title is proof of ownership. If you have a problem with your title, you will have trouble proving your ownership and thus selling or mortgaging your property.
- title insurance** An insurance policy that protects the insured (purchaser and/or lender) against loss arising from defects in title. A policy protecting the lender is called a “loan policy,” whereas a policy protecting the purchaser is called an “owner’s policy.” Virtually all transactions involving a loan require title insurance.
- title search** An examination of the public records to disclose facts concerning the ownership of real estate.
- trustor** One who creates a trust by granting property to a trustee. Also known as the borrower on a deed of trust.
- truth in lending** Federal law requiring, among other things, a disclosure of interest rates charges and other information about a loan.
- underwriting** The task of applying guidelines that provide standards for determining whether or not a loan should be approved.

- unsecured loan** A loan without collateral. A credit card is an example of a loan without collateral. Also known as a “signature” loan.
- VA loan** A long-term, low-down-payment or no-down-payment loan, guaranteed by the Department of Veterans Affairs, that is offered to individuals qualified by military service or other entitlements.
- warranty deed** A deed under which the seller makes a guarantee or warranty that title is marketable and will defend all claims against it.
- wraparound mortgage** A mortgage that is subordinate to and incorporates the terms of an underlying mortgage. The mortgagor (borrower) makes payments to the mortgagee (lender) who then makes payments on an underlying mortgage. Also referred to as an “all-inclusive deed of trust” in some states.

R E S O U R C E S

Suggested Reading

Alternative Real Estate Financing, by William Bronchick
(www.legalwiz.com, 2002).

Big Profits with Lease Options, by William Bronchick (www.legalwiz.com,
2002).

Flipping Properties, by William Bronchick and Robert Dahlstrom (Dearborn
Trade, 2001).

Formulas for Wealth, by Richard Powelson (Skyward Publishing, 2001).

A Fortune at Your Feet, by A.D. Kessler (Professional Publishers, 2000).

Free and Clear, by Sam Sadat (gofreeclear.com, 2000).

Real Estate Investor's Deskbook, by Alvin Arnold (West, 2002).

The New Home Buying Strategy, by Marilyn Sullivan (Venture, 1997).

Real Estate Financing and Investment Manual, by Jack Cummings
(Prentice Hall, 1997).

Suggested Web Sites

- www.legalwiz.com—hosted by attorney and author William Bronchick.
- www.inman.com—real estate news service, featuring articles by syndicated real estate columnist Robert Bruss.
- www.notenetwork.com—excellent resource for connecting buyers and sellers of real estate notes, mortgages, and trust deeds.
- www.nva-mortgage.com—home page for Carteret mortgage. Excellent discussions of underwriting criteria for nonconforming and investor loan programs.
- www.hud.gov—government Web site for HUD, with dozens of articles about FHA investor loans.
- www.fanniemae.com—Federal National Mortgage Association’s official Web site.
- www.HSH.com—publishers of mortgage information for consumers.
- www.realtytimes.com—industry news about real estate and mortgages.
- www.realestateabc.com—CNBC Power Lunch “cool site of the day.” Excellent articles about the real estate and mortgage industry and different types of loan programs.

Real Estate Financing Discussion Forums

- www.dealmakerscafe.com
- www.papergame.com/forum2/index.html
- www.realestateinvesting.com/cgi-bin/finance/index.html
- www.realestatelink.net/wwwboard/wwwboard.shtml
- www.reidepot.com/links/forums.html

I N D E X

A

Acceleration clause, 118
Adjustable-rate mortgages, 46-48
Agreement for deed, 122
AITD, 129, 133
All-cash closing, 113
Allen, Robert, 62
All-inclusive trust deed (AITD),
129, 133
Amortized loan, 2, 34-37
15- *vs.* 30-year, 36-37
sample schedule, 35
Application, 61-62
Application fee, 42
Appraisal(s), 7-8, 57-58
appraisal fee, 43
commercial, 32
gross rent multiplier, 58
income approach, 8, 57-58
market data approach, 57
ARM loans, 46-48
Assignment, 100-101
Assumable mortgages, owner
financing and, 117-18
Auctions, 18, 86

B

Back-end ratio, 26
Bacon, Francis, 1
Bait and switch, 49, 74

Balloon mortgage, 37
Bankruptcy, 52
"Big Profits with Lease Options,"
110
Biweekly payment programs, 37
Blanket mortgage, 79-80
Blended interest rate, 73
Bond for deed, 122
Bonds, as additional collateral,
80-82
Bridge loans, 30, 37
Byron, Lord George, 63

C

Capitalization (cap) rate, 58
Carteret Mortgage, 74-75
Cash, *vs.* financing, 9-10
Cash offers, 10
Cash out refinancing, 62
CD Index, 47
Closing
all-cash, 113
in escrow, 64
fee, 43
owner financing and, 116
COFI, 47
Commercial lenders, 31-32
Commercial projects, 32
Comparable sales, 7
Condominiums, 30, 31
Conforming loan, 23, 25-28, 59

Connecticut, 19
Consumer Fraud Departments,
53
Contingencies, 101
Contract for deed, 122
Cooperative apartments, 30
Cost of Funds Index, 47
Creative financing, 63-82
blanket mortgage, 79-80
bonds used as additional
collateral, 80-81
double closing (flip), 63-66
middleman technique,
67-71
no documentation/
nonincome verification,
72-76
seasoning of title, 65-67
subordination, 76-79
substitution of collateral,
77-79
two mortgages, 71-72
Credit, 52-56
credit report, 43, 52-53
credit score, 52
factors affecting, 54
improving, 55
rating, 26
worth of, 91
Credit bureaus, 52, 53
Credit cards, 56, 86-87

D

Deed of trust, 12, 15, 153-54
 Deficiency judgment, 18-19
 Department of Housing and Urban Development (HUD), 23, 29
 Department of Veterans Affairs, 30-31, 118, 125
 Depreciation, 91, 93
 Dickens, Charles, 11
 Discount points, 39
 Document preparation fees, 44
 Document recording fees, 42
 Double closing (flip), 63-66
 Double escrow, 64
 Down payments, 26, 59, 86
 owner financing and, 121
 taxes and, 8
 Due-on-sale clause, 118, 119-20

E

Elderly homeowners, reverse loans and, 38
 Emergency money, 83-84
 Entrust Administration, 9
 Equifax, 52
 Equity, lease option and, 108-9
 Equity lenders, 84
 Equity sharing. *See* Partnerships/equity sharing
 Escrow account, 38
 Experian, 52

F

Fair Credit Reporting Act, 52
 Fair Isaac, and Co., 54
 Fannie Mae, 13, 14, 22, 23, 25
 conforming loan guidelines, 67
 Form 1003, 61, 75
 provable income and, 55-56
 Federal Home Loan Mortgage Corporation (FHLMC), 22, 23
 Federal Housing Administration loans, 29-30
 Federal National Mortgage Association. *See* Fannie Mae
 Federal Reserve Board, 48
 Federal Reserve System, 3
 Fees, 39-44
 closing, 43
 document preparation, 44

document recording, 42
 junk fees, 40-41
 owner financing and, 116
 FHA mortgages, 26-27, 29-30, 118
 FICO score, 54
 Financial calculator, 36
 Financing
 appraisals and, 7
 vs. cash, 9-10
 creative. *See* Creative financing
 joint venture partnerships and, 94-95
 owner. *See* Owner financing
 real estate market and, 5-7
 tax impact of, 8
 use of, by investors, 8-9
 First mortgage, 16
 First-time homeowners, 29, 31
 5/1 ARM, 48
 Fixed-rate loan, 47
 Fixer-upper properties, 60
 Flip (double closing), 9, 63-66
Flipping Properties (Bronchick), 65
 FNMA. *See* Fannie Mae
 Foreclosure, 14, 17-19, 120
 auction, 86
 deficiency, 19
 guide, state by state, 141-42
 judicial foreclosure, 17-18
 nonjudicial foreclosure, 18-19
 strict foreclosure, 19
 Forms, sample, 142-78
 Deed of Trust, 153-54
 Good Faith Estimate of Settlement Costs, 148-50
 Mortgage, 155-70
 Note, 151-52
 Option to Purchase Real Estate, 171-72
 Real Property Description, 178
 Subordination Agreement, 176-77
 Uniform Residential Loan Application, 144-47
 Wrap Around Mortgage Rider, 173-75
Formulas for Wealth (Powelson), 81
 Franklin, Benjamin, 113
Frank Lyon Co. v. United States, 111

Fraud, 65-66, 69
 Freddie Mac, 23
 "Free and clear" ownership, 5-6
 Freely assumable loan, 118
 Front-end ratio, 26
 Funding a loan, 26

G

Ginnie Mae (GNMA), 23
 Good faith estimate, 41, 148-50
 Government bonds, 81
 Government loan programs, 28-31
 Federal Housing Administration loans, 29-30
 state and local programs, 31
 VA loans, 30-31
 Government National Mortgage Association, 23
 Gross rent multiplier, 58

H

Hard-money lenders, 83-85
 Hazard insurance, 38
 Home equity line of credit (HELOC), 86-87
 Housing and Urban Development, Department of (HUD), 23, 29, 41
 Hybrid ARM, 48

I

Illinois land contracts, 125
 Impound account, 38
 Improvement Location Certificate, 43
 Income, provable, 56
 Income appraisal approach, 57-58
 Income potential, of property, 60
 Income *vs.* expense ratios, 4-5
 Index, 47-48
 Individual retirement accounts, 9
 Inflation, 2
 Installment land contract, 122-25, 129
 Institutional lenders, 21-22
 Insurance escrows, 38
 Interest payments, calculating, 2
 Interest rates, 33-34

blended, 73
 Federal Reserve and, 3
 interest rate chart, 140
 Internet, finding lenders on,
 84–85
 Investor loans, 28
 IRAs, 9

J

Joint ventures, 94–95
 Junior mortgage, 16, 17–18
 Junker properties, 60–61
 Junk fees, 40–41

L

Land contract
 benefits of, 124
 disadvantages of, 125
 wraparound financing, 129,
 133
 LaRouche, Lyndon H. Jr., 83
 Lease option, 99–112
 alternative to selling, 102
 assignment, 100–101
 basics, 101–3
 case study, 104–6
 equity buildup, 107–8
 lease purchase, 103–4
 sale-leaseback, 110–12
 sandwich lease option,
 106–7, 109
 straight option without
 lease, 108–9
 sublease, 100
 Lenders
 choosing, 48–51
 friends/relatives, 85
 hard-money, finding, 84–85
 lines of credit, 86–87
 Leverage, 2, 4–5
 LIBOR, 47
 Liens, priority of, 16–17
 Limited liability company, 19,
 95, 117
 Limited partners, 95
 Lines of credit, 86–87
 Liquidated damages clause, 104
 Loan amortization, 34–38
 15-year *vs.* 30-year, 36–37
 sample schedule, 35
 Loan factors/types, 33–62
 application, 61–62
 appraisal, 57–58

ARM loans, 46–48
 balloon mortgage, 37
 biweekly payment
 programs, 37
 choosing a lender, 48–51
 costs, 39–44
 credit, 52–56
 down payment, 59
 fixed-rate, 46
 income potential/resale
 value, 60
 interest rate, 33–34
 junker properties, 60–61
 loan amortization, 34–38
 loan-to-value, 58–59
 nothing down, 45–46
 prepayment penalties, 49
 property as factor, 56
 property taxes/insurance
 escrows, 38
 refinancing, 61
 reverse amortization, 38
 risk, 44–45
 servicing, 23, 24
 term, 34, 46
 Loan junk fees, 40–41
 Loan-to-purchase, 59, 84
 Loan-to-value, 27, 58–59
 London Interbank Offered Rate
 (LIBOR), 47
 Low-income neighborhoods, 28

M

Market data appraisal approach,
 57
 Meyer, Martin, 33
 Mezzanine financing, 37
 Middleman double closing,
 67–71
 Mid Ohio Securities, 9
 Mirror wraparound, 133–34
 Money
 hard money and private
 money, 83–88
 time value of, 2
 Mortgage, 11–15
 aka deed of trust, 12, 15
 loan market. *See* Mortgage
 loan market
 as negotiable instrument, 13
 priority of liens, 16–17
 promissory note, 12–13
 sample contract, 155–70
 Mortgage banker, 24

Mortgage broker, 24–25
 Mortgage guaranty insurance, 27
 Mortgage loan market, 21–32
 bankers *vs.* brokers, 23–25
 commercial lenders, 31–32
 condominium loans, 31
 conforming loans, 25–28
 confusion of terms, 29
 conventional *vs.*
 nonconventional, 25–28
 government loan programs,
 28–31
 institutional lenders, 21–22
 loan servicing, 23, 24
 loan-to-value ratio, 27
 nonconforming loans, 28
 primary *vs.* secondary,
 22–23
 private mortgage insurance,
 27
 underwriting, 26
 Municipal bonds, 81

N

National Real Estate Investors
 Association, 85
 Net operating income, 57
 New Hampshire, 19
New Home Buying Strategy, The
 (Sullivan), 93
 New York, 18
 No documentation loans, 72–76
 Nonconforming loans, 28, 128
 Nonincome verification loans,
 72–75
 Nonrecourse debt, 13
 No ratio loans, 74
 North Dakota, 125
 Note, 12–13
 buyers, 125–27
 partial, 126–27
 sample, 151–52
 Nothing-down financing, 45–46
Nothing Down for the '90s
 (Allen), 62

O

Offers, cash, 10
 Office of Thrift Supervision, 48
 Ohio, 125
 Operating expenses, 57
 Option, 99. *See also* Lease option

- Option to Purchase Real Estate (sample), 171-72
 Origination fee, 39
 Owner-carry sale, 113-15
 Owner financing, 113-33
 advantages of, 115-19
 assumable loan 117-18
 buying subject to existing loan, 118-22
 convincing the seller, 120-21
 defined, 113-14
 down payment requirements, 121-22
 installment land contract, 122-25
 purchase money note, 125-27
 risk *vs.* reward, 119-20
 wraparound, 127-33
 Ownership "free and clear," 5, 6
- P**
- Paper loss, 93
 Partial (partial notes), 127-28
 Participation mortgages, 96
 Partnerships/equity sharing, 89-98
 basic arrangement, 90-91
 joint ventures, 94-95
 legal issues, 95
 pitfalls, 93
 profit considerations, 97-98
 shared equity mortgage, 95-96
 tax code compliance, 92
 Pennsylvania land contracts, 125
 PITI, 38
 PMI, 27-28
 POC fee, 40
 Points, 39
 Portfolio lenders, 22
 Powelson, Richard, 81
 Power of sale, 17, 18
 Preapproval of loan, 26
 Prepaid interest, 42
 Prepayment penalties, 49
 Primary mortgage lenders, 22
 Principal, 2, 38
 Principal, interest, taxes and insurance (PITI), 38
 Private lenders, 22
 Private mortgage insurance (PMI), 27
- Promissory note, 12-13
 Property description (sample), 178
 Property taxes, 38
 Property transfer, public recording, 15-16
 Property values, 7
 Public recording system, 15-16
 Purchase money note, 125-27
- Q**
- Qualification, owner financing and, 115-16
 Qualifying assumables, 118
- R**
- Race-notice rule, 16
 Real estate loans
 deed of trust, 15
 foreclosure, 17-19
 mortgage, 11-12, 14
 priority of liens, 16-17
 promissory note, 12-13
 public recording system, 15-16
 Real Estate Settlement Procedures Act (RESPA), 41
 Real property description (sample), 178
 Refinancing, 28, 61, 62, 106
 Rehab loans, 30
 Rent survey, 43
 Resale value, of property, 60
 Reserves, 42
 Retirement account, 9
 Return on investment, 4
 Reverse amortization, 38
 Risk, 44-45
 owner financing and, 116-17
- S**
- Sale-leaseback, 110-12
 Scams, 65-66
 Seasoning of title, 65
 Secondary mortgage market, 22, 126
 Second mortgage, 16, 131-32
 Seller-carryback loan, 71
 Shakespeare, William, 21
 Shared appreciation mortgages, 96
- Shared Equity Financing Agreement, 91
 Shared equity mortgage, 96
 Simple interest loan, 34
 State-by-state foreclosure guide, 141-42
 State income loans, 74
 Strict foreclosure, 19
 Subject to existing loan, 118-22
 Sublease, 100, 101
 Subordination, 76-79
 Subordination Agreement (sample), 176-77
 Subprime loans, 28, 128
 Substitution of collateral, 77-79
 Sullivan, Marilyn, 93
 Survey, 43
 Syndications, 90
- T**
- Tag team investing, 69-71
 Taxes, 8
 deducting HELOC interest, 87
 joint ventures and, 94
 middleman double closings, 72
 T-bills Index, 47
 TCM, 47
 Tenancies, 18
 Texas, 18, 125
 3 bureau merge, 43
 3/1 ARM, 48
 Title insurance policy, 41-42
 Title 1 loans, 29-30, 31
 Transfer tax, 16
 TransUnion, 52
 Treasury Constant Maturity, 47
 Trust deed, 15
 20 percent rule, 67
 203(b) program, 29
 203(k) loan, 29, 30
- U-V**
- U.S. Treasury bonds, 81
 Underwriting, 26
 Uniform Partnership Act, 95
 Uniform Residential Loan Application (sample), 144-47
 United Nations, 103
 VA mortgages, 30-31, 118, 124
 Variable-rate financing, 46

W

Washington Mutual, 22

Wilder, Billy, 135

World Savings, 22

Wraparound financing, 127-33,
136-37

 basics of, 127-29

 land contracts and, 129, 133

 mirror wraparound, 132-33

 and second mortgage

 compared, 130-31

Wrap Around Mortgage Rider

 (sample), 173-75

Y-Z

Yield spread premiums, 39-40

Zeckendorf, William, 103

Zero-coupon bonds, 80

Zero-interest financing, 79

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