Chapter 9 - Financing

**Learning Goals:**

- Define *title theory*, *lien theory*, and *intermediate theory* and identify which best describes your state's laws.
- Define *hypothecation* and describe how it relates to the collateral for a loan.
- Compare and contrast a *mortgage* with a *deed of trust*.
- List and describe the provisions of a *note* and the requirements for a negotiable instrument.
- Define *interest* and differentiate between interest *in arrears* and interest *in advance*.
- Define *usury*.
- Explain *discount points*.
- Describe the reasons for prepayment clauses/prepayment penalties.
- Describe the various provisions found in a mortgage or a deed of trust, including those relating to default, assignment, release, foreclosure, redemption, and deficiency.
- Explain recording a mortgage or a deed of trust as it affects priority of liens.
- Explain the provisions of a land contract as a financing document and contrast it with a mortgage or a deed of trust.
- Relate the procedures involved in a foreclosure.
Terminology Related to Real Estate Financing

**Note**
A promissory note is a financing instrument, also just called a note. A note is a negotiable instrument, evidence of the promise to repay the debt. The note usually states the terms of the core obligation, and serves as proof of the debt.

**Promissory note or note** is defined as a contract\(^{69}\) detailing the terms of a promise by one party (the *maker*) to pay a sum of *money* to the other (the *payee*).

**Mortgage Loan Instrument**
The mortgage loan instrument secures financing for the note. There are two major types of mortgage loan security instruments 1) a mortgage and 2) a deed of trust. There are minor differences between a mortgage and a deed of trust. A mortgage is a two party instrument between the lender and the borrower. A deed of trust is a three party instrument that involves a trustee (usually a title company) that facilitates or oversees the instrument.

**Mortgage** is defined as “a legal document used to secure the performance of a financial obligation.”\(^{70}\) It is a two-party instrument, consisting of a mortgagor (borrower) and a mortgagee (lender).

**Deed of trust** is also used to ‘secure the performance of an obligation’, but is a 3 party document that grants a trustee power to carry out the transaction. The parties consist of a trustor (borrower), a beneficiary (lender) and a trustee (usually a title company).

**Title**
A title is the evidence that an owner has that they hold the legal right to possess something.

**Lien**
A lien is defined as a charge or claim that one person has on the property of another as security for a debt. A lien is a type of encumbrance, but an encumbrance isn’t always a lien.

**Hypothecation**
Used in home ownership. It is pledging property as security for payment of a loan without surrendering possession of the property.

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**Encumbrance**

An encumbrance is a claim, lien, charge or liability affixed to real property. It is a right or interest held by someone other than the owner of the property that affects title to real estate. It may be a restriction or condition of use, a utility company’s right to use a piece of property (easement), a mortgage, a debt for unpaid taxes or construction costs. A blanket encumbrance or blanket loan covers more than one parcel, lot, or unit. It is a type of financing used to finance multiple lots or units. When a developer owns more than one parcel of land, it is important for the developer to be able to sell one individual parcel/unit without affecting the mortgage on the entire project. This would be allowed by ensuring that the mortgage covering the project includes a ‘partial release clause’. This clause permits the developer to release a particular mortgage, insuring that the encumbrance/loan will continue to cover all other unreleased units or lots.

**Escrow**

Escrow is defined as the process by which money and/or documents are held by a disinterested third party until satisfaction of the contract terms and conditions have been completed.

**Conveyed**

Convey means to transfer ownership or title.

**Usury Laws**

Laws that control the amount or rate that can be charged to borrowers when securing a loan.

**Hypothecation**

The act of pledging property as security for payment of a loan without surrendering possession of the property.

**Equity**

Equity is defined as property value minus debt owed.

**Collateral**

Collateral is defined as something of value pledged as security for a debt. The collateral for a real estate mortgage loan is the property itself.

**Deed**

Deed is defined as "a written instrument that, when executed and delivered, conveys title to or an interest in real estate.”

**Usury Laws**

State laws that control the amount of interest that can be charged on a debt. If the state (Nevada) offers pay-day loans, often the state does not have usury laws in place.

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**Equity:**

Equity is defined as the difference between the amount of money owed and the value of the property. If a property appreciates in value, and the amount of debt stays the same, the owner’s equity in the property increases. If the property depreciates or decreases in value and their amount of debt or loan amount stays the same, the owner’s equity in the property decreases. If a buyer purchases a property with zero down and the property depreciates in value, the owner can become ‘upside down’, in other words they owe more on the loan than the property is worth, and they have zero or even negative equity in the property.

What is equity?

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\text{Property value} - \text{debt owed} = \text{Equity} \\
\text{Sales price} + \text{appreciation} - \text{existing mortgage amt} = \text{Equity}
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