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Fannie/Freddie Documents

- This limits borrower from negotiating for more favorable terms (other than interest rate, points, etc.), but many of the standard terms are very borrower-favorable, *e.g.*,
  – Prepayment right, without fee [Note ¶ 4]
  – Right to reinstate after default [DOT ¶ 19]
  – Can use insurance proceeds for rebuilding [DOT ¶ 5]

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Occupancy [¶ 6 DOT]

- Why require Borrower to occupy/use the Property as his/her principal residence?
  – Lender has different standards for underwriting loan on an owner-occupied home (underwritten based on ratio of owner's income to debt-service) vs. rental home (underwritten based on ability of rent stream to service the mortgage debt)
  – Secondary market investors may not be willing to buy mortgages secured by "second home" or "rental home" (such loans are often "riskier" loans, greater risk of default)

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Occupancy [¶ 6 DOT]

- What if Borrower lied (and was planning to "flip" the house)?
  – Failure to comply with ¶ 6 is a default; ¶ 22 would thus allow lender to accelerate and foreclose — even if Borrower was current on its payments!
  – Lying on loan application is also punishable as crime under both federal and state laws

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Mortgage Insurance [DOT ¶ 10]

- Lender typically requires mortgage insurance, (or "PMI") for any mortgage loan with loan amount >> 80% of FMV of mortgaged land
  – PMI allows someone to buy a home with a smaller downpayment, rather than having to wait to accrue 20% for a "downpayment"

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- The less the borrower puts "down," the greater the risk that a foreclosure sale may produce a "deficiency" (i.e., sale proceeds don't pay off full amount of the debt)
- Low down-payment borrower must pay for PMI to insure lender against this risk (note: secondary market investors won't buy low down-payment loans w/out PMI coverage)
- If borrower defaults, and foreclosure sale results in a deficiency, lender/assignee can recover this loss from the PMI insurer
- Once borrower builds up enough equity (20-23%, depending on loan type), borrower has right to cancel PMI coverage [Homeowner's Protection Act of 1998]

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Escrow [DOT ¶ 3]

- In addition to P&I payments, borrower must pay lender each month 1/12th of the estimated annual cost of (a) real estate taxes, (b) casualty insurance premiums, (c) PMI premiums, and (d) in some cases, homeowner association dues
- Lender holds these funds in escrow, and uses them to pay the taxes, insurance, PMI, and/or homeowners association dues directly when they are due

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- Nonpayment of these items poses key threats to lender
  - Nonpayment of real estate taxes = tax lien in favor of taxing authority (and that tax lien has priority over all other interests, ***including prior mortgages!***)
  - Nonpayment of insurance = cancellation of insurance = uninsured loss in event of casualty
  - Nonpayment of PMI = loss of recourse to insurance if borrower defaults and foreclosure results in deficiency judgment

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Escrow [DOT ¶ 3]

- "Lender may waive Borrower's obligation to pay to Lender Funds for any or all Escrow items at any time."
- On residential loans, borrower can't really get escrow waived (secondary market buyer won't purchase loans on which borrower has no escrow obligation)
- On commercial loans, deed of trust typically has escrow provision in it, but lender is more likely to waive escrow in exchange for timely proof of payment by borrower

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Riders (DOT Def. H)

- For some transactions, a "Rider" may be needed b/c the basic Fannie/Freddie DOT form lacks a provision needed for that specific transaction
  - E.g., "Condo" Rider includes covenants to pay all condo association fees, comply with condo rules, etc.
  - E.g., "Second Home" Rider has covenants that limit ability of Borrower to rent or time share the property

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Exemptions: Missouri

- Debtor can keep certain property exempt from creditor claims (not a complete list):
  - Up to $15,000 equity in home (homestead)
  - Up to $3,000 equity in one car
  - Up to $3,000 in household goods
  - Up to $500 in jewelry ($1,500 for wedding rings)
  - $3,000 in "tools of the trade"
  - $600 "wild card" (any asset)

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- Exemptions allow a debtor to retain exempt assets free and clear of the claims of creditors generally
- Example: Bailey gets judgment vs. Uphoff for $4,000
  - If Uphoff's house is worth $15,000 or less, his house is exempt from Bailey's claim (i.e., Bailey can't have house sold at execution sale)
  - If Uphoff's house is worth > $15,000, Bailey can have it sold at execution sale, but the first $15,000 of sale proceeds would be paid to Uphoff (Bailey can only be paid from any surplus proceeds, over $15,000)

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Exemptions and Secured Creditors

- But, exemption in an asset doesn't apply with respect to a secured creditor as to that asset
- E.g., if Uphoff grants Bailey a deed of trust in his house to secure his debt to Bailey, Bailey can foreclose if Uphoff defaults, w/out regard to Uphoff's exemption rights
- Granting security interest in an asset = waiver of exemption as to that asset [¶ 26, Freddie Missouri form DOT]

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"Uniform" vs. "Nonuniform" Covenants

- The first 21 sections of the Fannie/Freddie deed of trust are essentially the same in all states (other than terminology differences)
- The "non-uniform" sections address issues that may take account of differences in state law/practice
  - E.g., ¶ 24: substitution of trustee
  - E.g., other substantive state law differences

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Mortgagee's Rights in Leases and Rents

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Lender's "Due Diligence"

- In part, mortgagee's "due diligence" (its pre-transaction investigation) focuses upon the borrower's creditworthiness (i.e., can the borrower make the mortgage payments?)
- But, mortgagee also must focus on its position if it has to foreclose; i.e. it must think of itself as a potential "buyer" (which it might be at a foreclosure sale, if borrower defaults!)

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"Due Diligence": Residential Loans

- Focuses mostly on:
  - 1) Borrower's creditworthiness (can Borrower make the monthly payments?)
  - 2) Borrower's title (is Borrower's title marketable?)
  - 3) Value of collateral (measured by appraisal, based on sales of properties adjudged to be "comparable" within the very recent past

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Commercial Loans (Income-Producing Land)

- Due diligence will focus on title and ***the building's leases***
  - The money Borrower will use to make mortgage payments will come from building cash flows (e.g., net rentals paid by tenants, after Borrower pays expenses of operating the building)
  - Borrower's loan may even be nonrecourse (i.e., no personal liability to repay) (typical where Borrower is a single-asset entity)
  - Lender must think: "If we have to foreclose, will the leases generate enough cash flow (net rents) to enable me to recover what we loaned (either by operating land myself or through resale)?"

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Lease Review

- Will the leases produce enough rents, after payment of operating expenses, so borrower can repay (service) the mortgage debt?
  - Lender will require certain ***debt service coverage ratio*** (e.g., 125% or higher) before it will make the loan
- Does a lease contain provisions that the Lender wouldn't want to accept, if it became Landlord?

Debt Service Coverage Ratio: ratio of the net rentals (gross rents minus operating expenses) to the debt service (i.e., the mortgage payment)

Gross Rents	$450,000
Expenses	
Maintenance	45,000
Management/Insurance	120,000
Property Taxes	60,000
Net Rents Before Debt Service	$ 225,000
Debt Service	180,000
Net Cash Flow After Debt Service	$ 45,000

Coverage Ratio: 225,000/180,000 = 125%

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Concerns for the Mortgage Lender

- ***1) What rights does the mortgagee have versus the tenants, during and after foreclosure sale?***
- 2) What rights does the mortgagee have in rents versus other creditors such a junior mortgagees, judgment lien creditors, or the trustee in bankruptcy (if borrower files for bankruptcy)?