Modern Real Estate Practice in Illinois, 6th Edition
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Chapter 15: Real Estate Financing: Principles

Learning Objectives

After reading this chapter, students should be able to:

- Identify the basic provisions of security and debt instruments: promissory notes, mortgage documents, deeds of trust, and land contracts.
- Describe the effect of discount points on yield.
- Explain the procedures involved in foreclosure.
- Distinguish between lien, title, and intermediate theories.
- Define the following key terms: acceleration; acceleration clause; alienation clause; beneficiary; certificate of sale; deed in lieu of foreclosure; deed of reconveyance; deed of trust; defeasance clause; deficiency judgment; discount points; equitable right of redemption; escrow account; equitable title; foreclosure; hypothecation; impound account; interest; intermediate theory; judicial foreclosure; judicial sale; land contract; lien theory; loan amount; loan origination fee; mortgage; mortgagee; mortgagor; negotiable instrument; non-judicial foreclosure; note; prepayment penalty; promissory note; release deed; satisfaction of mortgage; sheriff's deed; statutory right of redemption; statutory right of reinstatement; strict foreclosure; title theory; trust account; usury.

Why Learn About Real Estate Financing Principles?

Perhaps the biggest, most important investment decision your clients will be making is the one you can help them with: buying a home. In the United States, relatively few homes are purchased for cash. Most homes are bought with borrowed money, and a huge lending industry has been built to service the financial requirements of home buyers. In addition, by altering the terms of the basic mortgage or deed of trust and note, a borrower and a lender can tailor financing instruments to suit the type of transaction and the financial needs of both parties. In this chapter and the next one, you will learn about the basic tools, concepts, and procedures involved in financing a real estate transaction.

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Suggested Items to Bring To Class

1. Copies of the types of financing documents used in Illinois.
2. Copies of your local newspapers that contain the legally required advertising notices for mortgage foreclosures.
3. Copies of mortgage rate columns in your local newspapers.

Lecture Outline

I. Mortgage Law

A mortgage is a voluntary lien on real estate. The borrower (mortgagor) pledges the land to the lender (mortgagee) as security for the debt.

- In title theory states, the mortgagor actually gives legal title to the mortgagee and retains equitable title.
- In lien theory states, the mortgagor retains both legal and equitable title; the mortgagee simply has a lien on the property as security for the mortgage debt.

IN ILLINOIS . . . *neither the title theory nor the lien theory is strictly followed. Illinois is often referred to as an intermediate theory state. Mortgages and deeds of trust in Illinois may convey a qualified title to be used as security for the debt during the existence of the debt. The mortgagor remains the owner of the mortgaged property for all beneficial purposes, subject to the lien created by the mortgage or deed of trust. Title is subject to the defeasance clause and must be reconveyed, or released back, to the mortgagor at the time the debt is repaid in full.*

II. Security and Debt

A. Mortgage Loan Instruments

There are two parts to a mortgage loan: the debt and the security for the debt. When a property is to be mortgaged, the owner must execute (sign) two instruments.

- The *promissory note* is the borrower's promise to repay the debt.
- The *mortgage* (security instrument) creates the lien on the property.

1. **Hypothecation:** the pledging of property as security for payment of a loan without actually surrendering possession of the property.
2. **Deeds of trust:** conveys title without the right of possession. The deed is given as security for the loan by the borrower/trustor to a trustee who holds title on behalf of the lender/beneficiary.

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IN ILLINOIS . . . *a deed of trust is treated like a mortgage and is subject to the same rules, including foreclosure. The trustor holds the title to the real estate.*

III. Provisions of The Note

A promissory note executed by a borrower (known as the maker or payor) generally states the amount of the debt, the time and method of payment, and the rate of interest.

A. Interest

A charge for using money

1. Usury

Charging interest on a loan in excess of the maximum legally allowable rate is called *usury*. To protect consumers from unscrupulous lenders, many states have enacted laws limiting the interest rate on loans.

IN ILLINOIS . . . *Technically there is currently no state limit on the rate of interest that a lender may charge a borrower when the loan is secured by real estate.*

2. Loan origination fee

The processing of a mortgage application is known as loan origination. A loan origination fee is usually charged to cover the expenses involved in generating the loan.

3. Discount points

To make up the difference between the interest rate a lender charges the borrower and the rate of return demanded by an investor, the lender charges the borrower discount points.

- One discount point equals 1 percent of the loan amount and is paid as prepaid interest at the closing.

B. Prepayment

If the borrower repays the loan before the end of the term, the lender collects less than the anticipated interest. For this reason, some mortgage notes contain a prepayment clause that requires the borrower to pay a penalty against the unearned portion of the interest for any payments made ahead of schedule.

IN ILLINOIS . . . *lenders are prohibited from charging a borrower a prepayment penalty on any loan secured by residential real estate when the loan's interest rate is greater than 8 percent per year.*

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IV. PROVISIONS OF THE MORTGAGE DOCUMENT OR DEED OF TRUST

A. Duties of the Mortgagor or Trustor

- Payment of the debt in accordance with the terms of the note
- Payment of all real estate taxes on the property given as security
- Maintenance of adequate insurance to protect the lender if the property is destroyed or damaged by fire, windstorm, or other hazard
- Maintenance of the property in good repair at all times
- Receipt of lender authorization before making any major alterations on the property

B. Provisions for Default

- *Acceleration Clause*: If a borrower defaults, an acceleration clause gives the lender the right to accelerate the maturity of the debt.

C. Assignment of the Mortgage

A note may be sold to a third party, such as an investor or another mortgage company. The assignee becomes the owner of the debt and security instrument.

D. Release of the Mortgage Lien

A *defeasance clause* requires the mortgagee to execute a *satisfaction of mortgage* when the note has been fully paid.

IN ILLINOIS . . . *a mortgagee who fails to deliver a release within one month after full payment and satisfaction will be liable to pay the mortgagor or grantor a $200 penalty. The release must state:* FOR THE PROTECTION OF THE OWNER, THIS RELEASE SHALL BE FILED WITH THE RECORDER OR THE REGISTRAR OF TITLES IN WHOSE OFFICE THE MORTGAGE OR DEED OF TRUST WAS FILED. *It is the mortgagor's responsibility to record the release.*

E. Tax and Insurance Reserves

Many lenders require borrowers to provide a reserve fund (called an impound, trust, or an escrow account) to meet future real estate taxes and property insurance premiums.

IN ILLINOIS . . . *state law prescribes additional guidelines that must be followed by lenders who require escrow accounts for mortgage loans on single-family, owner-occupied residential properties. The Illinois Mortgage Escrow Account Act provides that when the principal loan balance has been reduced to 65 percent of its original amount, the borrower may terminate his or her escrow account. This right does not apply to loans insured, guaranteed, supplemented or assisted by the state of Illinois or the federal government. Additionally, borrowers have the*

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right to pledge an interest-bearing deposit in an amount sufficient to cover the entire amount of anticipated future tax bills and insurance premiums instead of establishing an escrow account. Both state and federal legislation sets restrictions on excess escrow account contributions being demanded by a lender. Lenders must give borrowers written notice of the act's provisions at closing.

1. Flood insurance reserves

The National Flood Insurance Reform Act of 1994 imposes certain mandatory obligations on lenders and loan services to set aside funds for flood insurance on new loans.

F. Assignment of Rents

The borrower may provide for rents to be assigned to the lender in the event of the borrower's default. Often the court will appoint a receiver to collect rents and manage the property.

G. Buying "Subject to" or "Assuming" a Seller's Mortgage or Deed of Trust

- *Subject to* the mortgage: the buyer is responsible for making payments on the preexisting debt but is not personally liable. Upon default, if the sale does not pay off the entire debt, the purchaser is not liable for the difference.
- *Assumption* of the mortgage: the buyer becomes personally obligated for the payment of the entire debt. If the mortgage is foreclosed and the court sale does not bring enough money to pay the debt in full, a deficiency judgment may be obtained for the unpaid balance of the note.

1. Alienation clause

Provides that when the property is sold, the lender may either declare the entire debt due immediately or permit the buyer to assume the loan at the current market interest rate.

H. Recording a Mortgage or Deed of Trust

The mortgage document or deed of trust must be recorded in the recorder's office of the county in which the real estate is located.

I. Priority of a Mortgage or Deed of Trust

Priority of mortgages and other liens normally is determined by the order in which they were recorded.

V. Provisions of Land Contracts

- Under a land contract, the buyer (vendee) agrees to make a down payment and a monthly loan payment that includes interest and principal (and may include real estate tax and insurance reserves).

The Seller (vendor) retains legal title to the property during the contract term, and the buyer is granted equitable title and possession. When the entire debt is paid, the seller delivers clear title.

VI. Foreclosure

A legal procedure in which property pledged as security is sold to satisfy a debt.

A. Methods of Foreclosure

IN ILLINOIS . . . *by statute, mortgage foreclosures may be brought about only through a court proceeding. As a result, Illinois is classified as a judicial foreclosure state.*

1. Nonjudicial foreclosure

In nonjudicial foreclosure states, no court action is required. In those states that recognize deed of trust loans, the trustee is generally given the power of sale.

2. Judicial foreclosure

Allows the property to be sold by court order after the mortgagee has given sufficient public notice.

IN ILLINOIS . . . *Power of Sale documents are not recognized in Illinois and any default on a deeds of trust financing arrangement must be handled through judicial foreclosure*

3. Strict foreclosure

If, after receiving adequate notice, the borrower does not pay off the loan by a court-appointed date, the court simply awards full legal title to the lender without a sale.

B. Deed in Lieu of Foreclosure

A lender may accept a deed in lieu of foreclosure from the borrower, sometimes known as a *friendly foreclosure* because it is carried out by mutual agreement. The mortgagee takes the real estate subject to all junior liens.

C. Redemption

Some states allow defaulted borrowers a period in which to redeem their real estate before the foreclosure sale (equitable right of redemption) or after (statutory right of redemption).

IN ILLINOIS . . . *there is no statutory right of redemption. A mortgagor in default who wishes to exercise the equitable right of redemption to avoid loss of the mortgaged real estate may do so after the date of judgment of foreclosure is entered. When a property is redeemed, the sale does not occur.*

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The mortgagor generally has a right to remain in possession of the property from the time of service of summons until the entry of a judgment of foreclosure. After judgment and through the 30th day after confirmation of the sale, the mortgagor can retain possession, but he or she must pay rent to the holder of the certificate of sale. Thirty-one days after judgment, the mortgagor must vacate the property or can be evicted by the owner of the certificate of sale, who receives a sheriff's deed and gains the right to possession.

While Illinois does not offer mortgagors in default a statutory right of redemption, there is the statutory right of reinstatement, applicable when the defaulting mortgagor wishes to cure the default and reinstate the loan as if no acceleration had occurred. The mortgagor has the right to exercise this statutory right for a period of 90 days after service of summons. However, the right may be exercised only once every five years. After reinstatement, the lender must dismiss the suit, and the mortgage loan remains in effect just as before.

IN ILLINOIS . . . *when a default is not cured by redemption or reinstatement, the entry of a decree of foreclosure will lead to a judicial sale of the property, usually called a sheriff's sale. Each defendant to the suit must be given written personal notice of the sale, and public notice of the sale must be published in a newspaper of general circulation. The successful bidder at the sale receives a certificate of sale, not a deed. Only after the sale is confirmed by the court will the certificate-holder receive a sheriff's deed (a quitclaim deed).*

D. Deficiency Judgment

If the foreclosure sale does not produce enough cash to pay the loan balance in full, the mortgagee may be entitled to a personal judgment against the borrower for the unpaid balance.

IN ILLINOIS . . . *under the Mortgage Foreclosure Law, there is no deficiency judgment allowed on residential property.*

Discussion Questions

1. What is the purpose of a promissory note? What is the purpose of a mortgage?
2. Who are the mortgagor and mortgagee in a real estate loan? Who are the trustor, trustee, and beneficiary in a trust? Who are the vendor and the vendee in seller financing procedures?

Classroom Exercises

1. Have the students act as "lenders" with each other: have one student explain the provisions of a financing document to another.

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2. Ask members of the class to take on the role of mortgagor and mortgagee; trustor, trustee and beneficiary; and vendor and vendee. Have them determine who "holds title" to the property? Who owns it?

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