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**TRUST DEED**  
**INVESTMENTS**  
*WHAT YOU SHOULD KNOW !!*



SERVING CALIFORNIANS SINCE 1917

Bureau OF REAL ESTATE

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*(Revised by CalBRE, March 2014)*

# **TRUST DEED INVESTMENTS**

## *WHAT YOU SHOULD KNOW !!*

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### NOTE

This brochure was originally produced through a research contract from the California Bureau of Real Estate (formerly the Department of Real Estate). The information in the brochure is a brief overview of the basic steps and factors involved in a trust deed investment. Since this brochure may not contain current law changes, it should only be used as a general source of information. You may wish to research the subject further before proceeding with a trust deed investment and, should the situation warrant, discuss the matter with an attorney or other qualified professional.

Some of the views and opinions contained in these materials are those of the authors and do not necessarily represent the views or opinions of the Administration, the State of California, or its Bureau of Real Estate.

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# INTRODUCTION

The purpose of this brochure is to provide basic information which you should know if you plan to purchase existing promissory notes or fund loans, the repayment of which is secured by deeds of trust recorded against California real property. **The funding of a loan or the purchase of a promissory note is an investment which involves risk.** Prior to becoming a lender of loans or a purchaser of promissory notes, you should be able to answer the following questions:

## 1. What is a “promissory note”?

A promissory note is a written promise to pay or repay a certain amount of money at a certain time, or in a certain number of installments, or on demand to a named person and it usually provides for payment of interest.

The person receiving the loan proceeds (**borrower**) becomes obligated to repay the debt by signing a promissory note which specifies: (1) the amount of the loan (**principal**); (2) the interest rate (**interest**); (3) the amount and frequency of payments (**debt service**); (4) when the borrower must repay the principal (**due date**); and (5) the penalties imposed if the borrower fails to timely pay or tender a payment (**late charge**) or decides to pay a portion or all of the principal prior to the due date (**prepayment penalty**). The promissory note identifies the borrower and the person who will receive the payments (**lender or note holder**).

## 2. How do you obtain a promissory note?

You obtain a promissory note (become a lender or note holder) by either making a loan or purchasing an existing promissory note. Unless the loan is made or arranged by a real estate broker, a private party when making a loan will be subject to an interest rate ceiling imposed by the California

State Constitution. Charging a rate in excess of this ceiling is referred to as usury. Even when purchasing an existing promissory note (unless the purchase is arranged by a real estate broker), a private party, depending upon the fact situation, may still be subject to usury.

A broker who for compensation, or in expectation of compensation (regardless of form) assists the public in making or arranging loans is commonly referred to as a mortgage loan broker (**MLB**).

### 3. What secures your investment?

Your investment is secured by a deed of trust recorded against the title of the borrower's property (**the Property**). Unlike deposits in a bank or savings and loan, which are generally insured by a federal agency (such as FDIC) and may usually be withdrawn with limited notice, the promissory note: (1) involves risk to principal (a typical feature of all **investments**); (2) establishes a specific and predetermined period of time for the repayment of your **investment**; and (3) does not benefit from insurance issued by a federal agency.

In a deed of trust, the borrower (**trustor**) transfers the Property, in trust, to an independent third party (**trustee**) who holds conditional title on behalf of the lender or note holder (**beneficiary**) for the purpose of exercising the following powers: (1) to reconvey the deed of trust once the borrower satisfies all obligations under the promissory note; or (2) to sell the Property if the borrower defaults (known as a **foreclosure**). Foreclosure involves the process of selling the Property to a third-party bidder or, in the absence of a sufficient third-party bid, acquiring title to the Property. The foreclosure sale, in most cases, satisfies the debt.

Depending upon the method of foreclosure, the nature of the loan, the circumstances of origination, and the value of the Property, you may or may not be able to recover your entire

**investment.** For example, if a third party bids at a nonjudicial foreclosure sale an amount equal to or greater than the amount you are owed (including fees, costs, and expenses of the foreclosure), your **investment** would be fully paid. On the other hand, if you bid the full amount that is owed to you, including all foreclosure fees, costs, and expenses (**full credit bid**) and there are no third-party bids, you will generally be limited to the Property and its value as the source of repayment of your **investment**.

If the loan is a nonpurchase money mortgage (deed of trust) and the Property's value is insufficient to recover all you are owed, a judicial foreclosure coupled with an action for a deficiency judgment may be the only way to recover your **investment**; i.e., collect any difference between the amount received at the foreclosure sale and the amount of money the borrower owes you.

Remember, the Property identified in the deed of trust is what secures your **investment**. This brochure includes, in Section 2, a discussion of what you should know about the Property.

# SEVEN ESSENTIAL ELEMENTS OF TRUST DEED INVESTMENTS

## *Seven Essential Elements*

1. Knowledge, experience, and integrity of the MLB through whom the transaction may be made or arranged.
2. Market value and equity in the Property and the security for your loan.
3. Borrower's financial standing and creditworthiness.
4. Escrow process involving the funding of the loan or the purchase of the promissory note.
5. Documents and instruments describing, evidencing, and securing the loan or purchase of the promissory note.
6. Loan servicing provisions, authority and compensation.
7. Recovering your investment when the borrower fails to pay.

The information that follows will assist you in considering the seven essential elements of a loan transaction which you should understand before funding a loan or purchasing a promissory note. Just read on!



## **1 . Knowledge, experience, and integrity of the MLB through whom the transaction may be made or arranged**

Before placing your trust and money with an MLB, you would be wise to call: (1) the Bureau of Real Estate (CalBRE) to determine if the MLB and his or her loan representatives are properly licensed, how long each has been licensed, and whether any of the licenses have been disciplined; and (2) the local Better Business Bureau to ask if any complaints have been lodged.

Ask the MLB to provide a professional profile for your review and information as to the approximate number and percentage of loans, if any, negotiated by the MLB which resulted in foreclosure (commenced and/or concluded) during the past few years.

Ask the MLB if he or she is the borrower or if he or she has any relationship to the borrower (e.g., if the MLB is a relative, a shareholder, an officer, a director, or a partner of the borrower). When the MLB is the borrower or related to the borrower, we refer to the transaction as “self-dealing.”

## **2 . Market value and equity of the property and the security for your loan**

The market value of the Property is critical to your decision to lend your funds or purchase a promissory note because there is a possibility that the only way to recover your investment is through the sale of the Property. Therefore, the market value of the Property should be correctly estimated and the total loan-to-value ratio properly analyzed as illustrated below. This information should be made available to you before you commit your money to the transaction.

**A. Market Value** — The sale price, the cost to build,

or the value in use to a specific owner does not necessarily represent the market value of the Property. A market value opinion requires consideration of comparable sales and other market data by a competent professional.

The market value conclusion may be presented in the form of an appraisal report. While the borrower customarily pays for the cost of the appraisal report, either you or the MLB usually retain the appraiser's services to prepare the report, which should be reviewed by you in advance of funding the loan or purchasing the promissory note. You should make every effort to inspect the Property which will be the security for your investment.

- B. Loan-to-Value Ratio** — The total loans against the Property, including your loan, divided by the market value of the Property determines the loan-to-value ratio. For example, if a borrower has a first deed of trust in the amount of \$25,000.00 and is requesting a second deed of trust in the amount of \$40,000.00 and no other liens will be placed against the Property, which is valued at \$100,000.00, the loan-to-value ratio is 65% ( $\$25,000.00 + \$40,000.00$  divided by  $\$100,000.00 = 65\%$ ).

The lower the loan-to-value ratio and the greater the borrower's equity, the more incentive for the borrower to protect the equity in the Property (i.e., sell or refinance the Property if unable to make payments under your promissory note) or for a third-party bidder to purchase the Property at a foreclosure sale. If the Property is overencumbered (the total loans or other liens exceed a reasonable loan-to-value ratio or exceed the market value), the Property will provide little or no security for your investment. A sufficient equity should be maintained in the Property to allow for the fees, costs, and expenses that you will incur in foreclosing if that becomes necessary.

Note: The borrower's equity is not the same as the protective equity. The borrower's equity is the difference between the market value of the Property and the total indebtedness secured by the Property. The protective equity is the difference between the market value of the Property and the total indebtedness of loans senior to your loan and your loan, but does not include loans junior to your loan.

The existence of a lien junior to your loan will diminish the borrower's equity, increase the borrower's payments or debt service, and reduce the borrower's ability to refinance. In the event of a default regarding senior loans (liens), beneficiaries who have a right of lien upon a property of another (lienors) and who are junior are entitled to protect their security interest in the Property by paying the borrower's delinquencies on senior liens and/or by commencing their own foreclosure action. Therefore, junior lienors should keep informed of defaults in connection with senior loans (liens).

- C. Preliminary Report (PRELIM)** — The MLB is required to provide you with the option to apply to purchase title insurance or an endorsement to an existing policy. The PRELIM, also known as the Preliminary Title Report, is prepared by a title company and is an offer to insure and does not provide conclusive information about the status of title.

Title insurance companies offer different types of coverage. You should ask your MLB or the title company from whom the report was obtained for an explanation of the different types of coverage available (e.g., CLTA and ALTA) and to what extent you are insured.

You should not consider a PRELIM as providing you with reasonably current information unless

it is dated within 90 days of your examination of the report. Therefore, you should ask the MLB to provide an amended and current PRELIM dated as closely as possible to your commitment to fund a loan or purchase a promissory note.

The **current PRELIM** should provide the following information regarding the Property:

- (1) The name(s) of the owner(s);
- (2) Legal description, street address (if available), and the assessor's parcel number;
- (3) Assessor's plat map, which illustrates the configuration, dimensions, and general location of the Property;
- (4) Assessed valuation;
- (5) Existence and priority of liens and encumbrances;
- (6) The name of the owner(s) of existing lien(s); i.e., the owner of record of any deed of trust (lien) which you may be purchasing;
- (7) Requests for notices concerning status of the liens, notices of default (**NOD**), and notices of trustee's sale (**NOS**);
- (8) Notice of a lawsuit or bankruptcy affecting the Property; and
- (9) Potential off-record interest of a spouse or other party.

In reviewing the current PRELIM for the above information, be alert to various problems which might affect **the market value and equity of the Property and the security for your loan**. If any of the following issues are encountered, ask the MLB or a title officer for a full explanation.

- (1) The borrower is not the owner, or the borrower is only one of the owners of record, or a person other than the borrower has an **unrecorded interest** in (or claim against) the Property and does not execute the loan documents.
- (2) The ownership (**estate**) is other than fee title (e.g., a leasehold estate), or there is an exception noted regarding the deed transferring title to the Property to the present purported owner of record.
- (3) The Property does not have **direct access** to a public road, has only easement access, or is unusually configured.
- (4) There is a substantial difference between **assessed and appraised value**, or the assessed valuation does not include improvements while the appraisal report includes both land and improvements.
- (5) There are: (a) taxes, assessments, or association dues unpaid or delinquent; or (b) deeds of trust, judgment liens, claims, or bonds which may or may not be discharged from the proceeds of the loan.
- (6) There is an NOD or NOS which will remain because the lien is not being removed by the proceeds of the loan.

*Note:* A default may indicate that the borrower's capacity and desire to repay the loan is in question and/or that the security for your loan may be impaired unless the notice of default or notice of sale of the senior lien which is to remain is rescinded. See Section 7: *Recovering Your Investment When the Borrower Fails to Pay.*

- (7) There are encumbrances remaining that have not been explained or considered.
- (8) There are unresolved lawsuits and active bankruptcies.
- (9) The owner of record of the deed of trust securing the promissory note you are purchasing is other than the person from whom the purchase is being made.

If you have any questions concerning the PRELIM, ask your MLB or title officer for assistance.

### **3. Borrower's financial standing and credit worthiness**

The borrower's ability to repay the loan involves the "capacity" and "desire" to make the loan payments.

The **borrower's capacity** is measured by: income; job position and stability; and overall financial standing, including assets, liabilities, and net worth, and any profit or losses incurred as the result of any business or investment activity. This information is reflected in the borrower's "Loan Application," which may be accompanied by a "Financial Statement" if the borrower is either self-employed or involved with significant business or investment activity. The MLB must give you a copy of the written loan application and the credit report.

To verify the borrower's representations about **capacity to pay**, you may examine:

- (1) Verification of employment;
  - (2) Income tax records;
  - (3) Verification of cash deposits or other assets;
- and

- (4) Statements from existing lenders reporting amounts owed (**beneficiary or payoff demand statements**).

The **desire to repay** is based on the borrower's past performance in handling credit. To verify the borrower's representations about desire to pay, you may ask to review:

- (1) Credit report;
- (2) Reports providing payment history on existing loans, including the number of late payments (**loan status reports**); and
- (3) Credit references.

When considering the borrower's capacity and desire to repay, you should ask whether the borrower has, immediately preceding the request for the loan, borrowed a substantial amount of money. A significant amount of concurrent borrowing may indicate the borrower is experiencing difficulty meeting his or her financial commitments. Extensive borrowing may make it more difficult for the borrower to meet financial commitments.

## **4. Escrow process involving the funding of the loan or the purchase of the promissory note**

Your funding of a loan or purchase of a promissory note should be transacted through an "escrow." An **escrow** is opened when money, documents, instruments, and written instructions regarding the transaction (**escrow instructions**) are conditionally delivered by the principals to a third party (**escrow agent**).

The escrow instructions set forth the conditions which must be satisfied or waived before the escrow agent may disburse your funds to either the borrower or the note holder. These conditions include, but are not limited to: (1) removal of certain liens; (2) payment of delinquent taxes;

(3) execution and delivery of the promissory note and deed of trust or execution and delivery of the assignment or endorsement of the promissory note and assignment of deed of trust (if you are purchasing an existing promissory note); (4) selection of title insurance coverage; and (5) recording of the deed of trust or assignment of deed of trust concurrently with the delivery of funds pursuant to the escrow instructions.

The information in the escrow instructions should be consistent with your understanding of the loan transaction. Compare the promissory note and deed of trust with what you were told at the time you agreed to make the **investment**. Before you approve of the escrow instructions and loan documents, make sure you have received an explanation and you have understood that which you have been told.

Both the promissory note and deed of trust should state the name of the borrower and you as the lender and note holder or the assignee or endorsee of the note holder. You should not deliver your funds to either the escrow agent or the MLB unless your instructions identify a specific promissory note and deed of trust (or interest therein).

The escrow instructions should require the promissory note and deed of trust be delivered to you or an independent custodian on your behalf at the close of escrow. A broker is required to deliver, or cause to be delivered, conformed copies of any deed of trust to both the investor and borrower within a reasonable amount of time after the recording date. If you are purchasing an existing promissory note, the following should be delivered to you or an independent custodian on your behalf at the close of escrow:

- Deed of trust
- Assignment of the deed of trust



- Promissory note
- Assignment or endorsement of the promissory note
- Title insurance policy or endorsement of the existing title policy.

Unless exempt, escrow agents are licensed by the Department of Business Oversight (DBO). An MLB is exempt when conducting loan escrows incidental to his or her loan brokerage business. As a result of this exemption, the MLB will frequently conduct escrows. Because the escrow holder should remain in a neutral position, you may wish to consider using an escrow agent other than the MLB, particularly when the MLB is either the borrower (or related to the borrower) or the note holder (or related to the note holder).

Escrow “closes” when all the conditions of the escrow instructions have been waived or satisfied, the instruments have been recorded, and the funds have been disbursed. You should receive a closing statement describing to whom and how the funds and the documents were disbursed.

## **5. Documents and instruments describing, evidencing, and securing the loan or purchase of the promissory note**

Your trust deed **investment** will either be secured by a “**whole**” (only one lender or note holder) or a “**fractionalized**” (more than one lender or note holder) deed of trust. “Fractionalized” promissory notes and deeds of trust, when negotiated by an MLB, are subject to regulation by the CalBRE, which enforces the Real Estate Law, and the DBO, which enforces the Securities Law.

The Real Estate Law includes what is known as the “multi-lender law.” This law imposes certain

restrictions including: (a) no more than 10 lenders or note holders (you and your spouse would count as one lender or note holder on a single investment); (b) the MLB must service your loan and have a written agreement with you to that effect, or the MLB and you must arrange for loan servicing by a person who is either properly licensed as a real estate broker or exempt from licensing by law; (c) defined loan-to-value ratios, based on the type of property being used as collateral, are generally not to be exceeded; (d) you may not invest more than 10% of your net worth or your annual income; (e) your loan must be directly secured by the Property and may not be indirectly secured through another promissory note and deed of trust (**collateralization**); (f) the MLB may not “self-deal” except in limited circumstances; (g) the deed of trust may not include a provision for subordination to a subsequent deed of trust; (h) with certain exceptions, the promissory note may not be one of a series of notes secured by liens on separate parcels of real property in one subdivision or contiguous subdivisions; and (i) your interest and the interests of other lenders or note holders must be recorded and identical in their underlying terms so that each note holder receives his or her proportionate share of the principal and interest. (There may, however, be different selling prices for interests in an existing note if the differences are reasonably related to changes in the market value of the loan which occur between sales of the interests.)

Licensed brokers can also offer these "fractionalized" promissory notes through an offering that has been qualified and registered by the Department of Business Oversight (DBO) and have obtained a permit. Pooling of investors' funds are not allowed except as authorized with a DBO permit. Licensed brokers can also offer

"fractionalized" promissory notes through

private placements as authorized by the Corporate Securities Law. If a permit or private placement is used, the "multi-lender law" will not apply. A broker should advise you under which of these authorities the offering is being made to you. If not you should ask!

The documents and instruments will be substantially the same whether your investment is in a whole or fractionalized promissory note and deed of trust. When funding a loan or purchasing a promissory note you should receive: the promissory note; the deed of trust; the assignment of deed of trust and assignment or endorsement of promissory note (if applicable); the preliminary report; the appraisal report; the loan application and related documents previously described; and the policy of title insurance describing the coverage you selected.

In addition, if the loan is negotiated by an MLB you should receive a lender/purchaser disclosure statement (LPDS) prepared in accordance with California law. A properly completed LPDS will identify: the MLB and his or her representative; the amount and terms of the loan to be funded or purchased; whether the loan terms include a balloon payment; any servicing arrangements; and information about the borrower, including employment, income, credit history, and credit references.

The LPDS will also disclose to you the status of all existing encumbrances or liens against the Property, including whether any payments are delinquent, whether any notices of default (NOD) or notices of trustee's sale (NOS) have been recorded, and whether there are any bankruptcy proceedings or active lawsuits involving the borrower or the Property.

You will also receive, as a part of the LPDS, information about the Property, including its address and/or assessor's parcel number and

legal description (if available); the age, size, and type of construction of any building improvements; an appraisal or, if you (the lender or note purchaser) have waived the appraisal, the MLB's written estimate of market value. When the Property's income is the primary source of payment of the debt service, you will receive income and expense information.

Further, the LPDS will list the encumbrances and liens which are to remain against the Property and those encumbrances and liens which are expected or anticipated after your loan has been funded or the promissory note has been purchased. The loan-to-value ratio should be calculated for you so that you may determine the borrower's equity and the protective equity in the Property (remember, they are different).

Finally, the LPDS will identify the MLB's capacity in the transaction: whether he or she is acting merely as an agent in arranging the loan or the sale of the promissory note; or whether the MLB or some related entity is the owner and/or seller of an existing promissory note or the borrower of the loan funds.

If the loan is fractionalized, the LPDS will include:

- The name and address of the escrow holder.
- The anticipated closing date.
- Descriptions and estimated amounts of the costs payable by the lender (or purchaser) and borrower (or seller).
- For the sale of an existing note: the aggregate sale price; the percent of the premium over, or discount from, the principal balance plus accrued/unpaid interest; and the effective rate of return if the note is paid according to its terms.
- The estimated closing date of a loan

origi- nation.

- The MLB's explanation if certain statutory loan- to-value limitations are exceeded. [Business and Professions Code Section 10238(h)]
- The MLB's (or his/her affiliate's) interest as a principal in the transaction, as limited by stat- ute. [Business and Professions Code Section 10238(e)]
- Any other information known to the MLB and necessary to clarify information in the LPDS.

There are also special rules that apply to fractionalized loans for the purpose of construction or rehabilitation. In order for the loan-to-value ratio to be based on the completed, or built-out, value of the property, 1) the broker must use an independent third-party escrow- holder to handle the funds, 2) the loan must be fully funded, 3) there must be a comprehensive and detailed draw schedule, 4) a qualified independent person must verify work completed, 5) an appraisal must be done by a qualified independent appraiser, 6) the documents must include a description of what actions can be taken in the event the project fails, and 7) the entire loan amount cannot exceed \$2,500,000.00. [Business and Professions Code Section 10238(h)(4)]

If the fractionalized loan is secured by more than one property, you are entitled to an addendum to the LPDS detailing how the loan-to-value ratio has been apportioned for each property securing the loan and the amount of equity in each property securing the loan. These cannot exceed the required maximum for each type of property. [Business and Professions Code Section 10238(h)(5)]

Just as you (the lender) are entitled to receive a

lender/ purchaser disclosure statement, an MLB must give a borrower a statement known as the Mortgage Loan Disclosure Statement (MLDS). The MLDS explains the fees, costs, expenses and loan origination fees or commissions which the borrower will pay to the MLB or to others in connection with the loan. There could be an exception to receipt of the MLDS if the loan is a federally related loan and the borrower receives the appropriate Truth-in-Lending disclosures and a Good Faith Estimate conformed to California disclosure requirements.

Another disclosure statement that may appear with your loan documents is a federal Truth-in-Lending disclosure statement, which is required when applicable, pursuant to the federal Truth-in-Lending Act and Regulation Z.

An MLB acting only as an arranger of credit is not generally subject to the disclosure requirements of Regulation Z which are imposed upon creditors (lenders and note holders). However, many MLBs act as both lenders and arrangers or hold themselves out to be lenders and, therefore, may qualify as creditors under this federal law.

Even private parties may qualify as creditors under Regulation Z after a certain volume of loans have been funded or promissory notes have been purchased. While you may not be a creditor by definition, either the MLB or another lender or note holder on a fractionalized deed of trust may be. If so, the borrower should receive a federal disclosure statement and a notice of the right to cancel the transaction within a specified period of time if the Property is the residence of the borrower.

The Truth-in-Lending Act (TILA) was amended in 1994 with respect to loans, other than purchase money loans, secured by the borrower's principal dwelling. The amendment places some restrictions on

creditors, requires them to make additional disclosures, and permits consumers to cancel certain transactions. A creditor is defined for purposes of this amendment as someone who originates, in any 12-month period, more than one loan subject to this amendment or any such loan(s) negotiated through a mortgage broker. Rules to implement the amendment were effective October 1, 1995 and affect all described mortgage transactions having rates or fees above a certain percentage or amount. These mortgage transactions are referred to as "high rate/high fee" or "Section 32" loans. A loan is considered to be a "high rate" loan if the APR exceeds by 8 points or more on a first-lien loan or 10 points or more on a second-lien loan, the yield on Treasury Securities having a similar maturity. A "high fee" loan is one for which the total points and fees exceed the greater of 8% of the loan amount or, as of 1-1-06, \$528.00. (Note that this dollar figure is adjusted annually on January 1 by the annual percentage change in the Consumer Price Index as measured on the preceding June 1.) The TILA regulations are enforced by the Federal Trade Commission (FTC). Persons having any questions regarding "high rate/high fee" loans or Regulation Z should contact the FTC.

California also has a consumer protection law covering high rate/high fee loans. With certain exceptions, loans for consumer purposes that are secured by a borrower's principal residence of 1 to 4 units and are within the current FannieMae single-family conforming loan limit are covered by the law if 1) the APR exceeds by 8 points or more the yield on Treasury Securities having a similar term, or 2) the total points and fees, as defined, payable by the consumer at or before closing exceed 6 percent of the loan amount. The law establishes specified limitations on loan terms and prohibited practices. With the exception of an as-signee that is a holder in due course, a

lender on such a loan may be subject to specified civil remedies that are available to the consumer for willful violations of the law. Also, certain unlawful loan terms, such as balloon payments or prepayment penalties, may be rendered unenforceable. [California Financial Code Sections 4970 through 4979.8]

## **6. Loan servicing provisions, authority and compensation**

In the case of “whole” promissory notes, lenders and note holders may decide whether to handle the loan servicing themselves or authorize by written agreement a servicing agent (i.e., a person licensed as a real estate broker or a person exempt from that license requirement). In contrast, a servicing agent must be retained/authorized for a transaction which falls under the multi-lender law. See Business and Professions Code Section 10238(k).

Loan servicing includes collecting payments from borrowers, disbursing payments to lenders or note holders, mailing appropriate notices, monitoring the status of senior liens and encumbrances, maintaining adequate insurance coverage(s), and coordinating foreclosure proceedings.

A servicing agreement must provide that payments received are to be immediately deposited into a client trust account and forwarded to the lender(s) or note holder(s) within 25 days after the agent receives them. The servicing agreement should identify the person who has the authority to instruct the trustee under the deed of trust to proceed with and record an NOD or an NOS and should further identify whether that authority vests in the servicing agent or is retained by the lenders or note holders. Also, provisions should be included requiring the servicing agent to: record requests for notices of delinquency (if applicable) and requests for



notices of default from senior lienors; notify you within 15 days of recording of any NOD and/or NOS; notify you within 15 days of receipt of any payment equal to or greater than five monthly payments; and notify you within 15 days of the day upon which any installment becomes delinquent for over 30 days. The servicing agent is also required to provide certain accountings to you detailing the principal balance at the end of each year and the collections and disbursements received and made during each year.

Many MLBs will request that the original promissory note and deed of trust be delivered to the servicing agent (who may be the MLB) to be held on behalf of the lenders or note holders during the term of the servicing agreement.

***Note: It is important that the original promissory note and deed of trust together with any applicable assignments or endorsements be delivered first to you or to an independent custodian on your behalf (or on the behalf of all of the note holders) prior to the delivery of these documents to the servicing agent (who should provide you with a written receipt).***

For multi-lender transactions, the servicing agreement must also require that the servicing agent's trust account(s) be inspected at three-month intervals by a CPA (with follow-up reports to the servicing agent and the Real Estate Commissioner) if:

- The total of payments due in any three consecutive months exceeds \$125,000.00; or
- The number of persons entitled to payments exceeds 120.

The servicing agreement should set forth the servicing agent's compensation. Many MLBs who service loans retain a portion of the interest rate being paid by the borrower on promissory notes being serviced. The servicing agreement may

also permit the MLB to retain the late charges and/or prepayment penalties as consideration for loan servicing activities.

Finally, the servicing agreement should describe how and under what circumstances you or the servicing agent may terminate the loan servicing agency. For example, the provision regarding termination should require written notification, a minimum notice period (e.g., 30 days), the signature of all or a majority of the lenders or note holders, and/or the payment of a cancellation fee (**liquidated damages**).

California law does not allow the advancing of funds by an MLB for payments that otherwise should have been paid or tendered by the borrower without a permit from the DOC as part of an issuer's plan. Accordingly, an MLB may not represent nor imply in any way that he or she will advance payments (funds) to you whether or not the borrower has performed, or that the MLB will advance payments to senior lienors to protect your **investment**.

MLBs do have limited authority to make advances to senior lienors to protect your trust deed **investment** provided that you receive written notice within 10 days of the date of the advance and the notice includes the following:

- 1) The date and the amount of payment;
  - 2) The name of the person to whom the payment has been made;
  - 3) The source of the funds used for the payment;
- and
- 4) The reason for making the advance payment. Unless an MLB has received a special permit from the DBO (depending upon the activity being authorized), an MLB may not in any way guarantee your investment or imply that your investment is guaranteed. The risk of the investment is yours.

The servicing agent/licensee must also provide the lender/note holder with annual accountings of the unpaid principal balance and the collections and disbursements for that year.

## **7. Recovering your investment when the borrower fails to pay**

Lenders and note holders are not always anxious to foreclose. As a result, it is not uncommon for loan payments to be several months delinquent prior to the commencement of a foreclosure.

Frequently, the borrower who is delinquent on your loan is also delinquent on senior liens. Even though your loan may be current, **the borrower may fail to maintain the payments on senior liens**, such as taxes, insurance premiums, and/or deeds of trust. A breach of or default in connection with a senior lien by the borrower constitutes a default under your deed of trust. It is, therefore, important that the status of all senior liens be monitored.

**Prior to investing in a junior deed of trust, you should have determined the amount and the debt service (payments) required to maintain the senior lien(s). To protect your investment during any senior lien (loan) foreclosure, it may be necessary for you to maintain the payments (with your own funds) on all senior liens. Curing a senior lien default may not eliminate the need to continue to maintain the payments required by the senior lienor while your junior deed of trust is being foreclosed.**

When you are a junior lienor, you should be prepared to cure senior lien defaults and to pay senior lien delinquencies. In this regard, you should determine if you have adequate resources to cure senior lien(s) in case of default before investing. A delay in paying the delinquencies may

cost you (or other junior lienors, if any) more money to protect your interest in the Property. A prompt commencement and processing of the foreclosure should limit the amount necessary to advance (pay) to cure senior lien defaults and to maintain the senior lien(s) without delinquencies until conclusion of the foreclosure sale.

*Note:* Unless you are prepared to pay the entire amount owed on a senior lien (loan), the due date of your junior lien (loan) must precede the due date of the senior.

If the Property produces income, you may elect to collect the **rents and profits** during the foreclosure process to help maintain senior lien (loan) obligations. As additional security for your loan, you should have received an **assignment of the rents and profits** (usually contained in the deed of trust).

*Note:* Self-help” in collecting the rents is generally not effective. You may need assistance from legal counsel to petition a court for either mortgagee-in- possession or the appointment of a receiver to collect the rents and profits.

In a “fractionalized” **investment**, it is necessary to obtain the concurrence of more than 50% of the lenders or note holders (measured by the amount of ownership interest rather than the number of lenders or note holders) to commence and direct the foreclosure process. The servicing agent should contact each of the other lenders or note holders for you. However, you should be able to directly contact the other lenders or note holders when necessary.

When foreclosing a deed of trust, all sums owing and secured by the deed of trust are **accelerated** and immediately become due regardless of the maturity date identified in the promissory note, provided that an acceleration clause is included in the promissory note and/or deed of trust. Two

methods are used to foreclose deeds of trust: judicial foreclosure and nonjudicial foreclosure.

In certain instances it may be desirable to file a lawsuit in a local superior court to foreclose on the Property (**judicial foreclosure**). When the beneficiary files a lawsuit against the trustor in a local superior court to judicially foreclose, the Property, unless the default is remedied (**cured**), will be ordered sold at a publicly held sale supervised by the court. The judicial action to foreclose is often more costly and will typically take more time to complete than the second method, which is a privately held public sale (**nonjudicial foreclosure**).

In a nonjudicial foreclosure, the trustee (under the **power of sale** clause contained in the deed of trust) may proceed with the foreclosure at your request and, unless the default is cured, sell the Property without court supervision. This privately held public sale procedure will usually take at least four months to complete. If the deed of trust does not contain a power of sale clause, your only option is to foreclose judicially. Most deeds of trust do include a power of sale clause.

*Note:* You should examine the promissory note and deed of trust to ensure that, among other provisions, both acceleration and power of sale clauses are included.

One of the major differences between the two foreclosure methods is your right to obtain a **deficiency judgment**, which is available when the loan is a “**nonpurchase money**” mortgage or deed of trust. If the Property is other than one to four residential units, or if it is one to four residential units and the borrower did not intend to occupy, your loan (as distinct from a **seller “carry-back”**) would be “nonpurchase money.” When your loan is used to finance or refinance the equity of the Property (no sale transaction is involved), the loan is also “nonpurchase money.”

If your loan is “nonpurchase money” and you determine the **protective equity** is insufficient to repay the entire amount owed by the borrower, including all of the fees, costs, and expenses of the foreclosure, you may want to consider a judicial foreclosure. **Deficiency judgments** are not available when the nonjudicial foreclosure method is utilized. However, **collateral actions** (a separate judicial action) for fraud, waste, or malicious destruction of the Property may still be possible.

If the Property is foreclosed by a senior lienor, thus extinguishing your “nonpurchase money” junior lien, you still may collect as a “**sold-out junior lienor**.” You may seek to collect as a sold-out junior lienor when either there is no **overage** or an **inadequate overage** is received (insufficient money received from the foreclosure sale over and above that which is owed to the foreclosing senior lender to pay all or any part of the money owed to you). To enforce collection as a sold-out junior lienor, a judicial action for money damages must be brought pursuant to the terms of the promissory note.

Another remedy available to you (to recover your **investment**) when the borrower defaults (fails to pay) is to negotiate a “**deed in lieu of foreclosure**.” A properly executed and delivered “deed in lieu,” with consideration and when accepted by you, will transfer title of the Property to you without going through a foreclosure. Potential advantages to you are the elimination of foreclosure fees, costs, and expenses and immediate ownership and control of the security Property. The disadvantage to you is that you accept title to the Property subject to all junior liens, unlike a foreclosure, which typically removes junior liens as claims against the Property.

*Note:* You should not accept a “deed in lieu” without securing title insurance coverage against

any title defects and exceptions of record, including junior liens and encumbrances for which you have not agreed to become obligated.

A borrower, in an effort to avoid the sale of the Property by either of the two methods described, may seek the protection of an **automatic stay** (a prohibition against any further foreclosure action) by filing a petition in **bankruptcy** in federal court or bringing an action in state court to restrain the nonjudicial foreclosure sale (**Temporary Restraining Order**).

A bankruptcy petition which is filed in federal bankruptcy court prior to the foreclosure sale of the Property prevents the trustee in a nonjudicial foreclosure, or a state court in a judicial foreclosure, from selling the Property without relief from the automatic stay. A Temporary Restraining Order (**TRO**) will act to delay the trustee's sale until the state court determines whether a preliminary injunction is to be granted until a full hearing or trial can be held on the matter.

You will need the assistance of legal counsel to appear in the bankruptcy court to ask the court to grant **relief from the automatic stay** (a removal of the prohibition against further foreclosure action). The assistance of legal counsel will also be required to respond to a TRO. It is important to act quickly when responding to a borrower's bankruptcy petition or request for a TRO.

*Note:* Your quick response could ensure that sufficient **protective equity** remains to pay the total amount owed to you, including all fees, costs, and expenses incurred in processing the foreclosure and in responding to the federal bankruptcy petition or state court action (e.g., legal fees, costs, and expenses).

You should remember that while acting to recover your **investment** due to the failure of the borrower to pay, you may not receive income from

your trust deed **investment**. The return of the principal you invested and the income you anticipated may be delayed until the foreclosure sale or, in the absence of a successful third-party bid, until the Property is later sold by you (subsequent to foreclosure).



## CONCLUSION

As you can see, reviewing, analyzing, and understanding the seven essential elements of trust deed investments should assist you in evaluating the risk involved.

Trust deed investments can provide an excellent return but remember, the risk of a trust deed investment is yours. Therefore, you may wish to discuss the *investment* with an MLB and/or other qualified professional *before* committing your funds!