THE DANGERS OF FRACTIONALIZED TRUST DEEDS

For years, this company has been warning lenders about the inherent dangers of investing in fractionalized trust deeds. Though this practice is standard throughout the mortgage broker industry, it is definitely not to the lender's advantage.

For the sake of this discussion, assume a mortgage broker is approached by a borrower for a $100,000 second trust deed junior to a $200,000 first trust deed on a $450,000 property. The broker does not have one lender with $100,000, but he does have six separate lenders with various amounts of money totaling $100,000. The broker then places this loan, with each lender receiving a "fraction" of that trust deed. One lender may have a 20% portion, another a 15% portion, etc.

The difference between a 100% investment and a fractionalized investment

Though this dissertation could go on for hundreds of pages, let's keep it as simple as possible. If the lender invests in a trust deed, he/she receives from the broker an original promissory note secured by a trust deed, recorded in the lender's name. He/she also receives a title insurance policy in the lender's name, a fire insurance policy in the lender's name and various other documents completing the lender's package. The broker usually services the loan (collects payments). In the event that the lender is unhappy with the performance of the broker in servicing, the lender merely "fires" the broker and hires another servicing agent. Remember, all original documents are in the lender's possession.

Now let's look at a fractionalized trust deed. With a fractionalized interest, the broker-servicing agent retains ALL ORIGINAL DOCUMENTS. The investors receive a photocopy of the documents and normally the documents are properly designated as to the list of lenders. In other words, the aforementioned insurance policies, notes and deeds of trust do contain the lender's name in list form, showing their percentage interest.

"I have used this broker for years, so what's the big deal?"

Please note in the above that I emphasize the party in possession of the documents and therefore the party in control of the investment; this is the key to the problem. In a 100% investment YOU, the investor, are in 100% control. In a fractionalized investment you are in zero control; the broker is in 100% control. Your broker may be the most wonderful, honest person in the word; in fact the broker may be doing an excellent job of servicing this loan, but you have relinquished total control to the broker. I am writing this in 1995, and many mortgage brokers have failed in the past 2-3 years. This company lived through the 1980-81 fiasco when dozens of other mortgage brokers went out of business. Let's assume, for the sake of discussion, that your broker remains healthy, wealthy and wise. Let's compare two types of trust deeds when the owner of the property has a problem.

"I can't make my payment."

Assuming the hypothetical loan terms on the previous page, the broker discovers that the first trust deed is two payments in arrears, the borrower is unwilling or unable to make any further payments, and the real-estate taxes are unpaid and accruing at 18% interest. The property value has decreased, however there is still sufficient equity in the property to "theoretically" protect the lender's investment.

If the investor has 100% of the note, the investor will probably instruct the broker to immediately file a Notice of Default and immediately cure the delinquencies on the first

trust deed to prevent the first trust deed holder from filing a Notice of Default on their trust deed, adding further foreclosure expenses to the eventual payoff.

With a fractionalized trust deed, the broker will contact the investors and ask for an immediate proportionate influx of cash to cure the first as outlined above. Imagine the situation if one or two of the investors have a change in personal circumstances or are no longer as happy with the broker as you are. All of a sudden you are ready, willing and able to put up your fraction, but two or three of the other investors are talking about attorneys and lawsuits. Obviously, the biggest problem with a fractional investment is that you are in a financial partnership with a bunch of strangers and have absolutely no control over your destiny.

Assuming that the broker is wonderful, you investment will still be hamstrung by the inability of the fractional investors to see and act as one. One or more of the investors will have to advance money on behalf of other investors for the benefit of the group. You have no idea of the animosity that will develop within the group because of the inability of the group to function as one.

"My broker won't return my phone calls"

Unfortunately, the worst possible scenario is very common today. The borrower stopped making payments, the real estate market declined and because of the decline in the market, the broker is in financial trouble. As a result, the broker lays off critical servicing personnel and problems are worse than outlined above because the broker has not been properly servicing the loan. The broker is now receiving calls from 4, 8, or 10 irate investors wanting to know, "Where is my payment?" The broker, with a 500% increase in problem calls and a 50% decrease in staff, WONT EVEN RETURN YOUR PHONE CALL. I liken this scenario to running the Colorado River in a raft with the guide in cardiac arrest – NO FUN.

"Unfortunately, I have a friend in this exact situation – Now what?"

The solution to this "run amuck river raft" is clear. Immediately identify all of the fractions and call a meeting of the fractions. At this critical time it is imperative that the fractions be brought together with a competent advisor, real estate attorney or both present to direct the future course of the group. In effect, the future course of the group is very simple, and that is UNITY OF PURPOSE. The group has to all pull together now to get out of this mess. Squabbling internally will wreck the entire raft.

Conclusion

I have just taken you through a short synopsis of one or two of the differences in being a fractionalized investor rather than a 100% investor. Please note that the solution to a fractionalized trust deed in trouble is to pull the group together and achieve unity of action. Unity of action is, in effect, what I strongly recommend in the first place, I.E. **DON'T INVEST IN A FRACTIONALIZED TRUST DEED.**

The following information was taken from articles written by Peter Rosenthal

From the V.I.P.

Safe trust deed investing

By Peter Rosenthal

Rosenthal is president of V.I.P. Trust Deed Co., V.I.P. Realty and Foothill Conveyance Corp. Questions should be addressed to him at P.O. Box 26 Montrose, CA 91021-0026

Trust deeds can be one of the most secure investments available using actual collateral. Un-secured loans are only as good as the maker (debtor). Automobile loans have the added safety of the lender's possession of the pink slip. Automobiles, however, depreciate rapidly and, in many instances, (with improper insurance), depreciate instantly when meeting a tree at 60 miles per hour. With a properly secured trust deed investment, the reliance on the maker is minimized and the property securing the obligation is the critical factor. The choice of broker and actual delivery of proper paperwork are also critical when making trust deed investments.

Unfortunately, there are crooks in every business and trust deed investing has its share of problems. Last week, I reviewed a situation with a lady who had seemingly been defrauded by a trust deed broker. This lady had spoken to us several years ago, and at that time was an investor with one of the largest, most reputable trust deed brokers in California. My only caution to her at that time was that she was investing in fractionalized trust deeds.

In almost every instance, she owned only a percentage of the note and deed of trust and did not have any original documents. I expressed my personal distaste for fractionalized trust deeds at the time. Now, many years later, this lady apparently has lost a substantial sum of money at the hands of a different broker. If she had stayed with the long-established, reputable company, even with their fractionalized investments, she would have been OK.

So, how does one avoid common pitfalls? As I've said many, many times before, you do not need to invest in only a portion of a trust deed. A trust deed broker can usually find a second trust deed for you for as little as $10,000 to 20,000. You, therefore, do not need to own 10 percent of a $100,000 deed of trust. If you have total ownership, you will hold all of the *original* documents, including the promissory note, the recorded deed of trust, the title insurance policy and the fire insurance policy.

If the loan to value ratio is low enough, the investment is usually very secure. If a default occurred, you could merely call your broker and immediately institute a foreclosure action to either take over the property or force the borrower to repay the debt.

In a fractional investment, the individual fraction owners have very little say in the collection process. They have to rely completely on the broker who is servicing the loan. This can be catastrophic if the broker gets in trouble personally. With an individual trust deed investment, you are not "married" to the broker. In the event of your broker going out of business, dying or moving out of the area, you would merely have some other broker, or even a bank, service the note in the future. This is easy if the note is in your name and you have appropriate documents.

When making a trust deed investment, *please* make certain you have all of the proper documents, including the above-mentioned note, deed of trust, fire insurance policy, title insurance policy and lender/purchaser disclosure statement.

All trust deed brokers are required, by law, to furnish you with an extensive disclosure statement outlining the property, borrower, security, loan history, loan-to-value ratio, appraisal information, etc. If you don't have these documents for each and every investment, there probably is something amiss.

Within the next few weeks, I will touch again one of the other traumatic lending practices, i.e., lending money to friends and relatives.

From the V.I.P.

Learning your fractions

By Peter Rosenthal

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Periodically I devote a column to the dangers of investing in a fractionalized trust deed. Simply stated, a fractionalized trust deed is one in which there are several lenders that have, for instance, a 15 percent, 25 percent, 4 percent or whatever percent of a trust deed that is broken up into pieces.

With normal trust deed investments, the investor has 100 percent of the investment and has, in his possession, the original note, the original trust deed, the original title policy and fire insurance policy. With a fractionalized trust deed, the broker retains all of the documents and the lenders merely receiving photocopies to evidence their ownership.

If problems arise with a regular trust deed investment, the lender merely addresses that problem. Perhaps it is necessary to start a foreclosure or advance payments for taxes or whatever. With a fractionalized trust deed, you are literally hog-tied by the broker and the broker is trying to take directions from all of the fractions instead of one investor. As an example, two of the fractions may have their percent to advance to a senior lien holder, but some of the other fractions may refuse. This failure to act "in unity" impairs everybody's ability to properly protect the fractionalized trust deed. In the worst scenario, the broker gets into financial difficulties or closes down. That leaves the fractions "cast adrift" to fend for themselves with no direction whatsoever.

I received a call the other day from a fractionalized investor who was in such a situation and wished to sell the fraction. Fractionalized trust deeds are salable (at a higher discount than a whole trust deed), however this fractionalized investor was totally in the dark as to the true status of the investment. It appeared that the note was worthless and if so the fraction was worth—less. That is an interesting play on words, if I do say so myself.

This caller had read some of my columns on the subject and even read my "what to do if one is in this situation" column. The first question that I asked was, "Have you had a meeting with the other fractions?" the answer stupefied me. There had been no meetings because the broker claimed that the names of the other investors was "confidential information." Actually nothing could be further from the truth.

If you have a fractionalized trust deed and it has developed problems and you feel that the broker is not being responsive to your questions, then immediately contact the other fractions to call a meeting. In that meeting, one person should be selected to be the liaison of the group and report to the group on the status and progress. If there really is a serious problem, then an attorney should be at that meeting to advise the group and if necessary the group should hire a good real estate attorney to represent them. I have seen numerous cases where the fractions never had a meeting and many of them have individual attorneys, which is a ridiculous waste of attorneys' fees. A group of eight or nine people can easily afford to hire one attorney between them.

I used to say this once a year, but I guess I will say this quarterly now. *Do not invest in a fractionalized trust deed unless you personally know the other fractions.* If you have already invested in a fractionalized trust deed and it is performing properly, fine. This article is NOT intended to imply that fractionalized trust deeds are either immoral, illegal or even fattening. They are, however, less advantageous for the lender from a simple control factor.

If you have a fractionalized truest deed and it is displaying signs of trouble and the broker does not seem responsive, call for a meeting. If the broker refuses to cooperate with names and addresses of the fractions, run – don't walk – to your nearest real estate attorney.

From the V.I.P.

What to do if a fractionalized Trust deed investment goes bad

By Peter Rosenthal

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Q: You will recognize my name as a previous customer. I was attracted to another company because they offered trust deeds at almost 1 percent per annum higher than what was offered by your company. Yes, this was an investment that I share with eight other people and, unfortunately, on of those "people" is a bank that has nine individual IRA accounts involved in their **ONE SHARE.** The company that I purchased through has filed for bankruptcy protection. Can you help me try to unravel my actual situation?

A: The above question is not an actual letter but a combination of three phone calls that we have received within the last 30 days. In each case the investment was in excess of $100,000, and now the investors are grasping for advice.

Yes, I reminded these people about my advice against fractionalized investments in trust deeds. That, of course, doesn't help matters after the fact. Let's call this a "fractionalized trust deed investment repair column."

If you have a fractionalized investment and the serving agent is out of business, in bankruptcy, or just plain lousy, it is time for immediate action. If you held a normal note and trust deed you can merely dismiss the servicing agent and have the note and trust deed collected by a bank or a private company like ours. In this case, you don't have the note and deed of trust but merely photocopies of the original documents and the pieces need to be united to take action.

Somebody is now going to have to do a lot of work and, as usually happens, there will be those that do the work and share their portion of the burden and those fractions that will complain and cry and shirk their responsibilities. It is critical, however, that a meeting be held as soon as possible with, hopefully, all of the fractions in attendance.

The purpose of the first meeting is to meet each other, exchange vital information and plan a future course of action. It is my opinion that a real estate attorney be present to guide the meeting on its proper course. If the servicing agent is in trouble but the loan itself is okay, the fractions merely need to agree on a new servicing agent. This, unfortunately, is rarely the case.

The main purpose of the meeting is to achieve unity of purpose. Until the fractions are brought together, they will each be scurrying around, visiting attorneys, and complaining to all those who will listen. Once brought together (the meeting) it will be generally necessary to hire a real estate attorney or, perhaps, a bankruptcy attorney to resolve the matter. The attorney's fee will be shared by the parties in the proportion of their interest the main problem at this meeting is to get all fractions to agree to hire one attorney, sign necessary retainer agreements, and pay their initial share of the attorney's retainer agreement.

I hosted one of these meetings few weeks ago at my office and I was surprised that five of the six people were present. The sixth share was "represented" by one of the parties present.

The parties all agreed on the fundamentals except for two small details. One of the fractions could not afford the $750 share of initial attorney and appraisal fees. Then, the next day, the fraction who was absent "didn't understand" the situation and couldn't advance money either. Eventually one of the fractions lent some money to the other fraction and the missing fraction was finally convinced to join the group.

It is almost impossible to get a group of dissimilar people to agree on one course of action and that is, in itself, the major problem with fractionalized investment.

At the meeting the investors will want to know whether their investment is at risk. The easiest way to determine that is to put together the following information: A determination must be made as to the conservative *quick sale) value of the property. Then the trust deeds need to be added up to determine the actual loan-to-value ratio. In addition to the trust deeds, other items must be included to correctly assess the situation. Those items include present delinquencies on senior encumbrances, probable future delinquencies, delinquent real estate taxes, probable attorney's fees, etc.

Equity tends to evaporate rapidly when calculating in costs of eventually selling the property. It is important to attend the initial meeting with as many facts as possible. In this way the attorney will be able to handle the most important question, “Is my investment secure?”

There are many reliable trust deed companies that do sell fractionalized investments. Some have been around for 25 or 35 years. Any company that has been around that long knows how to keep their investors out of trouble. All things being equal, however, it is still far safer to own 100 percent of a $20,000 deed of trust than to own 10 percent of a $200,000 deed of trust.

If you have an interest in a fractionalized trust deed at present, so be it. When it pays off however, remember my advice that has been consistent year in and year out: wherever possible, do not invest in a fraction of a trust deed.