Lending on Notes and Deeds of Trust

Get a loan that's secured by a loan

By **Phil Sblendorio,** senior vice president and regional business manager, Farmers & Merchants Bank

Many still consider Shakespeare's famous phrase "neither a borrower nor a lender be" to be sound advice. Sometimes, however, an opposite situation occurs in which a person is both a borrower and a lender. And sometimes, it all relates to the same property.

In most deals, borrowers secure financing to purchase or make improvements on a property that they either own or are in the process of acquiring. Some deals involve procuring financing to build on leased property. Sometimes, though, deals involve borrowing money to purchase an existing loan secured by a deed of trust.

This type of deal involves assigning the borrower's interest in or hypothecating (pledging property as collateral for a debt without transferring title or possession) a note and deed of trust tied to a specific property. This is known as "lending on an assignment of a note and deed of trust."

Uses

The most common scenario for hypothecating is when a property has been sold under seller-financing and the seller later needs cash. The seller can pledge the promissory note and deed of trust as collateral to obtain a loan.

Many commercial real estate investors look for a property in default and try to purchase it at a discount. If these negotiations fail, some savvy investors then arrange for financing to go directly to the current lender on the property (i.e., the beneficiary) and offer to purchase the note at a discount.

If the offer is accepted, two things must happen: The beneficiary must assign interest in the note and deed to the purchaser, and the purchaser must assign interest in the note and deed to the lender.

For example, say your client Jason has had his eye on a retail property. This property — on which the property-owner has a $1.2 million first-trust-deed loan with Bank A — is now in default, and the borrower has filed for bankruptcy protection.

In his preliminary evaluation of the retail center, Jason finds that it has been mismanaged. Maintenance is scarce or nonexistent; the parking lot is in disrepair; the lighting is poor; and most of the in-line tenants are at below-market rents. Accordingly, the fair-market value of the property has decreased to $1 million. The major tenant, however, has remodeled the interior of its store and has good traffic.

Jason realizes there will be upside potential to this retail center if he spends about $100,000 on repairs and updates. Based on his analysis of the property's potential income, he believes that the upgraded property would be worth more than $1.5 million.

He approaches Mark, the property-owner, and offers to buy the property for $1 million. Mark turns down Jason because $1 million is less than the current outstanding note with Bank A. It therefore will not satisfy Mark's financial obligations.

Jason then goes directly to the beneficiary (Bank A) and offers to purchase Mark's $1.2 million promissory note for $1 million, the property's current fair-market value. Bank A accepts the offer because it is eager to get the defaulted loan off its books.

Jason approaches you to obtain financing, which you arrange through Bank B. Before purchasing the note, Jason and Bank B complete their due diligence. In reviewing the documentation, they learn that the major tenant has a nondisturbance clause — a binding agreement stating that in case of foreclosure, the tenant will not be disturbed if it pays rent and performs according to lease terms — recorded against the property. The in-line tenants do not.

Upon Jason's purchase of the note, Bank A assigns its interest in the promissory note and first-trust deed to Jason. He simultaneously assigns his interest to Bank B.

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Now that he is in control of the note, Jason reapproaches Mark and gives a final offer: If Mark will release the property from the bankruptcy and allow the trust-deed sale to complete, Jason will release Mark from any deficiencies on the note.

Mark agrees to Jason's offer, and the property goes to foreclosure. This is important to Jason, because once the trust-deed sale is complete, the leases of the in-line tenants will be wiped out. The new property-owner can increase rents to market value.

The results

When the trust-deed sale takes place, one of three things can happen:

- **Mark brings his loan current** by making all of his payments; the sale is canceled. Jason, as the note-holder, receives the income from the note but will not gain control of the property. Jason now owns a $1.2 million note that he purchased for $1 million, so he will realize a $200,000 gain.
- **One or more buyers come forward** and

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offer to purchase the property for $1.2 million or more. Jason receives the face value of the note ($1.2 million) plus any associated legal expenses and walks away with a $200,000 profit.

- **No buyers make an offer on the property** for $1.2 million or more. Ownership of the property reverts back to the beneficiary (Bank B).

Based on an agreement that would have been made when Jason first obtained financing from Bank B to purchase Mark's note and deed, Jason immediately purchases the property back from Bank B for $1 million, using a new loan secured by a first trust deed. Jason's transaction is complete. Jason now has a retail center, a loan on a property worth $1.5 million (after repair) and an opportunity to renegotiate the in-line tenants' leases.

Deals of this sort often benefit everyone involved. In this example, if Jason ends up owning the shopping center, he would benefit from the center's upside potential; Bank A would be happy to be rid of the defaulted loan; and Bank B would be pleased to have a successful loan. Mark could walk away from a property that he had not properly maintained and a loan on which he had defaulted — without being held liable for any deficiencies. Although they would have to pay higher rents, the in-line tenants would benefit from Jason's commitment to making the center work.

What do lenders seek?

In deciding whether to grant a loan secured by an assignment of a note and deed of trust, a lender will look at a few things.

- **Property value**: The current or potential value of the underlying property (as supported by an appraisal) must be more than the new loan amount.
- **Underlying promissory note's balance due**: Because this is all that is collectable, this must also be more than the loan amount.
- **Interest rate on underlying promissory note**: This must be adequate to support the new loan.
- **Beneficiary statement**: If possible, the borrower on the underlying promissory note must verify that the balance due, interest rate, amount of monthly payment and paid-to date are what the note-holder claims.
- **Title policy**: The lender will want to review a copy of the original title policy that was issued on the original note and obtain an endorsement of that policy (normally called a 104.1 Endorsement) from the original title company.

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A note and deed of trust is an asset. It can be purchased, sold or borrowed against. Lending on assignment of notes and deeds is most commonly used as a way to obtain cash by people who have sold property using seller-financing. Savvy investors, however, use this type of financing to purchase the notes of defaulted properties at a discounted value.

The investor ultimately opts to deal with the drawbacks of such transactions — which can include complications, time expenditures and an investor holding a note rather than owning the property. But the investor gains the possibility to profit from the property's upside potential.