Non-mortgage Alternatives to Real Estate Financing

There are a variety of ways to acquire real estate interests without using mortgage financing. With the exception of the real property sales contract, these methods are available only to large financiers, very strong tenants or substantial institutions.

An all-cash purchase is an obvious alternative to mortgage financing. However, it is often difficult for an individual to raise substantial sums of money and protect against unlimited liability.

Syndicate Equity Financing
Syndicates afford small investors opportunities to invest in high-yield real estate. A syndicate offers knowledge of values and the ability to find, organize and manage a successful venture.

Commercial Loan
A straight bank loan can be used to purchase real property. The borrower obtains the loan based on good credit or on some type of collateral (stocks, bonds, personal property) other than the real property.

Bonds or Stocks
Large, well-rated corporations can sell stocks or general obligation bonds in order to purchase real property without using a mortgage.

Long-term Lease
This is a good approach if the property is usable as is. If the lessee is leasing only the land and has to pay for construction of improvements, the overall cash investment will probably be larger than buying improved property with a mortgage.

Advantages to the tenant are:
- Rent may be deductible as an expense. (If property was owned, only the improvements would be depreciable.)
- Money freed for other uses can frequently be used more advantageously.
- Tenant’s total debt load is not increased.

Disadvantages to the landlord are:
- Often cannot find good tenants willing to lease.
- Tenant having a high credit rating at beginning of lease may go “sour” in a few years.
- Tenant may improve property with special purpose development and then go bankrupt.
- Tenant may go bankrupt before completing construction, possibly burdening property with mechanic lien claims leaving landlord with unsaleable and unleasable property.

Exchange
A trade or exchange of properties can be an alternative to mortgage financing, if the difference in valuation between the properties can be reconciled and the trade made without financing difficulties.

Sale-Leaseback
A sale-leaseback is a popular option for companies with excellent credit. Also termed purchase-lease, sale-lease, lease-purchase or leaseback.

Some advantages of sale-leaseback to seller/lessee may be:
1. Property is suited to needs.
2. Working capital not tied up in fixed assets.
3. Since leases are not considered long-term liability, rent may be tax deductible. Lease term is often longer than mortgage. Balance sheet looks better and credit is enhanced.
4. Often more capital can be raised than by borrowing.
5. Tax deduction of lease payments is frequently better than depreciation since the land cannot be depreciated.

6. By selling property at profit after development, seller acquires immediate use of additional cash. Repayment is actually in rent paid over time in constantly inflating dollars.

7. For companies working under government contracts that call for cost plus a fixed fee, rent is an allowable expense item but mortgage interest is not. (This is why many aircraft, electronic, and other defense plants are leased rather than owned.)

Some advantages of sale-leaseback to buyer/lessor may be:

1. Transaction results in a long-term, carefree investment.

2. Property values may appreciate.

3. Lease payments may be higher than the mortgage payments. Lease payments may help pay off the mortgage and lessor will still have title to the property.

4. Investment will not be paid off prematurely, as mortgages often are through refinancing. Investor will not have to seek another good investment to replace the one prematurely paid off.

5. Lease terms often give lessor a claim against other assets of the lessee in the event of a default.

**Sales Contract (Land Contract)**

With certain exceptions, a real property sales contract is an instrument by which the seller (vendor) agrees to convey title to real property after the buyer (vendee) has met certain conditions specified in the contract and does not require conveyance within one year.

This device, variously designated “Installment Sales Contract,” “Agreement to Convey,” “Agreement for Purchase and Sale,” “Land Sale Contract,” or “Land Contract of Sale,” must meet the requirements set forth in Section 2985, et seq. of the California Civil Code.

Historically, the primary advantage of this instrument to a seller was the ease with which seller could eliminate purchaser’s interest in the event of default. This advantage was considerably weakened by the court’s conclusion, in Barkis v. Scott (34 Cal. 2d 116, 208 P. 2d 367), that California Civil Code Section 3275 was a sufficient barrier to harsh and unreasonable foreclosure proceedings. After Barkis v. Scott, other cases have expanded the remedies of defaulting vendees to include even willfully defaulting persons, which has effectively taken away the automatic power of sale.

When selling a parcel of land under a sales contract which is not recorded, the seller is prohibited from otherwise encumbering the parcel to an aggregate amount exceeding the amount due under the contract without the written consent of the purchaser. This may be risky to a buyer with an unscrupulous seller.

A real property sales contract must recite the number of years to complete payment and, if a tax estimate is made, the basis for it.

When selling real property under a real property sales contract, the seller must apply installment payments first to payment(s) due on an obligation(s) secured by the property. The seller must hold in trust payments received for taxes and insurance and use those funds only for those purposes, unless the payor and the holder of an encumbrance on the property agree to some other use of those funds.

A real property sales contract for purchase of real property in a subdivision must clearly set forth the legal description of the property, all the existing encumbrances at the date of the contract and the terms of the contract.

The advantage which a land contract may have held as a security device seems to have dissipated in favor of the use of a deed of trust with power of sale.

**Disadvantages to buyer.** The disadvantages of a sales contract to the buyer are:

1. The contract may include covenants restricting its assignment or transfer.

2. Most financial institutions regard a land contract as poor collateral.
3. Buyer has no assurance that the seller has good title at the time the contract is made. The buyer cannot rescind the contract for this reason.

4. If, prior to full performance by the buyer and conveyance by deed, the seller is:
   - adjudicated a bankrupt;
   - dies, with title passing to heirs; or
   - is adjudicated an incompetent;

   the buyer can expect time-consuming, frustrating, and expensive litigation before obtaining a deed and policy of title insurance.

5. After full performance, the buyer may receive defective title or no title at all, although normally the contract will require delivery of a policy of title insurance. The buyer may have to pay the premium for this.

Many of these disadvantages are largely eliminated by using a contract secured by a deed of trust or a three-party instrument, where a trustee is appointed in the same way as in a deed of trust, coupled with title insurance insuring the equitable title of the vendee and the legal title of vendor.

**Prepayment.** A buyer shall be entitled to prepay all or any part of the balance due on any real property sales contract entered into on or after January 1, 1969 with respect to the sale of land which has been subdivided into a residential lot or lots which contain a dwelling for not more than four families. Provided, however, that the seller, by an agreement in writing with the buyer, may prohibit prepayment for up to a 12-month period following the sale. Any waiver by a buyer of this provision is contrary to public policy and thus unenforceable and void but would not affect the validity of the remainder of the contract.

**SECURITY AGREEMENTS**

**PERSONAL PROPERTY SECURED TRANSACTIONS**

**UNIFORM COMMERCIAL CODE – ARTICLE 9**

Agents in real estate transactions involving both personal and real property must be familiar with the transfer and encumbrance of personal property. Because it is often difficult to determine whether or not a particular item affixed to real property is a fixture, the obligation should be secured by both a trust deed/mortgage and a personal property security instrument (mixed security).

Upon default and foreclosure of real property, Code of Civil Procedure Sections 580(b), 580(d) and 726 prevent or limit a deficiency judgment. Unless expressly stated in a contract between parties, no antideficiency limitation exists in a personal property foreclosure.

**Business opportunities.** Business opportunity brokers are routinely involved in personal property transactions which must fully satisfy the Bulk Sales Law (Uniform Commercial Code, Division 6) and the secured transaction statutes (Uniform Commercial Code, Division 9). Assets of a business are commonly used as collateral to create a security interest in the seller or lender.

Just as a trust deed or mortgage encumbers real property as security for an obligation (debt), a “security agreement” creates a security interest in personal property.

To protect or “perfect” the interest created by a security agreement, as against other security interests and/or lien creditors or subsequent purchasers, a Financing Statement (UCC-l) is usually filed. In most cases, a security interest is *perfected* when it has attached and been properly filed with the appropriate filing officer (the Secretary of State in Sacramento or the appropriate county recorder).

A security interest *attaches* when:
- there is agreement by the parties that it attach;
- value has been given; and
- the debtor has acquired rights in the collateral.

Once *perfected*, the secured party’s interest is protected against the debtor’s other creditors.
The Financing Statement should not be confused with the actual security agreement. The security agreement creates the security interest.

Although a written agreement is not necessary where the collateral is in the possession of the secured party as a pledge, a security interest is usually not enforceable unless there is a written security agreement, signed by the debtor, describing the collateral.

**Uniform Commercial Code (UCC)—Article 9**

Division 9 (entitled “Secured Transactions, Sale of Accounts, Contract Rights and Chattel Paper”) of the Uniform Commercial Code (UCC) contains the unified and comprehensive scheme for regulation and control of the sale, creation and priority of all liens and security interests in personal property. It covers a transaction in any form which is intended to create a security interest in personal property, including goods, documents, installments, chattel paper, accounts or contract rights and similar items. The security interest gives the secured party the right to foreclose and apply the sale proceeds toward the satisfaction of the secured obligation if the debtor defaults.

**Purpose of the UCC.** The basic purpose of the Uniform Commercial Code is to provide a simple and unified structure within which the immense variety of secured financing transactions can be completed.

As amended over the years, the UCC comprises a uniform, clear and easily available set of rules for the conduct of commercial intra- and interstate transactions.

**Filing system.** Under the UCC, a *Financing Statement*, properly filed, perfects a security interest. Absent a filed *Financing Statement*, subsequent purchasers without actual knowledge of the security interest might acquire property free of the prior security interest. On the other hand, a secured party who does file is in most cases protected from the interests of subsequent purchasers. UCC records are indexed by the true name of the debtor.

**Place of filing.** The proper place to file in order to perfect a security interest is as follows:

- When the collateral is consumer goods, in the office of the county recorder in the county of the debtor’s residence or, if the debtor is not a resident of this state, in the office of the recorder of the county in which the goods are kept.
- When the collateral is crops growing or to be grown, timber to be cut or minerals or the like (including oil and gas) or accounts subject to subdivision (5) of Section 9103, in the office where a mortgage on the real estate would be recorded.
- In all other cases, in the office of the Secretary of State.

The proper place to file in order to perfect a security interest in collateral, including fixtures, of a transmitting utility is the office of the Secretary of State. This filing also constitutes a fixture filing as to the collateral described therein which is or is to become fixtures.

For filing purposes, the residence of an organization is its place of business if it has one or its chief executive office if it has more than one place of business.

The proper place to file a financing statement as a fixture filing is in the office where a mortgage on the real estate would be recorded.

Any subsequent filings such as *Statements of Continuation, Termination, Release, Assignment and Amendment* must be filed in the same location as the original *Financing Statement*.

**Erroneous filing.** A filing made in good faith in an improper place or not in all of the places required is nevertheless effective with regard to any collateral as to which the filing complied with the requirements and is also effective with regard to collateral covered by the financing statement against any person who has knowledge of the contents of the financing statement.

**Change in debtor’s/collateral’s location.** A filing which is made in the proper place in this state continues effective even though the debtor’s residence or place of business or the location of the collateral or its use, whichever controlled the original filing, is thereafter changed.
Proper filing. Presentation for filing of a Financing Statement, tender of the filing fee and acceptance of the statement comprise filing under the code.

Duration of filing. A Financing Statement is effective for five years from the date of filing. For extension, the secured party must file a Continuation Statement any time within the six-month period preceding expiration. Succeeding Continuation Statements may thereafter be filed in the same manner to continue the effectiveness of the original Financing Statement.

Filing information. If the Standard Form UCC-1 or UCC-2 is used for filing, the filing officer will note the file number and date and hour of filing and return the acknowledged copy to the person or firm indicated in the box at the bottom of the standard form. If a non-standard form is used, the filing party must request an acknowledgment and send the filing officer a duplicate copy of the form filed, which will be acknowledged and returned.

The Secretary of State will furnish a certificate showing whether there is on file in its office any presently effective Financing Statement, naming the Debtor and, if there is, giving the date and hour of filing of each such statement and the names and addresses of each secured party named therein. This information and copies of the pertinent financing statements may be obtained by filing a Request for Information or Copies form (UCC-3) with the Secretary of State.

Priorities
One purpose of the Uniform Commercial Code Article 9 is to give lien rights to providers and installers of fixtures. A provider’s perfected security interest in fixtures has priority over the conflicting interests of owners and subsequent encumbrancers [Section 9313 (4)].

A secured creditor who is first to make a proper filing has priority, regardless of when his/her claim arose. However, Sections 9301(2) and 9312(4) grant sellers special priority on purchase money security interests when perfected within 10 days of the purchaser’s receiving possession of the collateral.

Section 9312 of the UCC sets forth the basic rules of priority among conflicting security interests in the same collateral and Section 9313 gives the priority rules for liens of a trust deed and other fixture filings.

Failure to File
If a Financing Statement is not filed, subsequent purchasers and secured parties without actual knowledge of it take the property free of the prior security interest. Section 9201 provides, however, that the (unperfected) Security Agreement is still valid between the debtor and secured party.

Escrow - Early Filing
A Financing Statement may be filed before a security agreement is made or before a security interest otherwise attaches. In an escrow for a bulk sales transaction there is often need to promptly perfect a seller’s purchase money security interest to establish priority over other liens which will be perfected when the legal ownership changes. An escrow holder often files a Financing Statement to perfect the seller’s interest before escrow closes. (If escrow fails to close, the escrow holder files a UCC-2 Termination Statement to remove the UCC-l from the record.)

Fixture Filings
Under the UCC, tangible personal property includes “goods” and personal property deemed fixtures under the law, meaning goods which are so related to particular real property that an interest in them arises under real estate law. However, ordinary building materials to be incorporated into a building are not deemed fixtures.

A security interest in fixtures can be created by (1) specific provisions included in a trust deed or mortgage secured by the real property or (2) a fixture filing in the form of a Financing Statement. Both must be recorded in the county where the real property is located.

In either case, to qualify as a fixture filing, the instrument must contain:
1. a description of the goods which are or will become fixtures;
2. a legal description of the real property;
3. a statement that the goods are, or will become, fixtures; and
4. an assertion that the statement will be recorded in the county where the real property is located.
A fixture filing in the form of a Financing Statement is a lien on the fixture for 5 years from the date of filing, unless a Continuation Statement is recorded prior to expiration to extend the Financing Statement/lien an additional 5 years. A fixture filing in the form of a trust deed or mortgage is effective as long as the trust deed or mortgage remain a lien.

As to enforcement, a fixture filing in the form of a Financing Statement is enforced according to the provisions for personal property secured interests in the UCC. If the fixture filing is contained in a trust deed or mortgage, the secured party has the option of proceeding under the UCC to enforce the lien or by foreclosure proceedings under the trust deed/mortgage to enforce the lien on both the real and the personal property.

UCC 9402 provides:
- a Financing Statement form to be used as a fixture filing;
- the formal requisites of a Financial Statement; and
- amendments and contents of a mortgage to be used as a Financing Statement.

A copy of a security agreement signed by the debtor is sufficient as a Financing Statement if it contains all the information required by Section 9402.

Caution
This discussion of the Uniform Commercial Code should not serve as a substitute for:
- statutory analysis when dealing with specific problems;
- consultation with legal counsel on legal matters; or
- proper financial advice on banking or financing problems.