12 Real Estate Finance

BACKGROUND

Finance is the lifeblood of the real estate industry. Developers, contractors, real estate brokers (REBs) and mortgage loan brokers (MLBs) should each understand how real estate is financed.

Traditional sources of loan funds are the financial depository institutions (depository institutions), including savings and loan associations, savings banks, commercial banks, thrift and loans and credit unions. Other non-institutional sources characterized as “non-banks” include mortgage bankers, finance lenders, private individuals and entities, pension funds, mortgage trusts, investment trusts, and hedge funds. Insurance companies are neither depository institutions nor non-banks. These entities collect premiums from policyholders/the insured and invest some of the premium dollars in interests in real property, including equities and mortgage loans.

Brief Overview

Over the past 15 to 20 years, enacted California legislation that characterized certain non-depository institutions or non-banks as institutional and supervised lenders for limited, defined purposes. These include mortgage bankers (licensed under the Residential Mortgage Lending Act), finance lenders (licensed under the California Finance Lender Law), pension funds in excess of $15,000,000 in assets, mortgage trusts, investment trusts, and hedge funds. The expansion of these non-depository institutions or non-banks and their growing share of the residential mortgage market resulted in the development of a secondary market through securitization of mortgage loans in the form of mortgage backed securities. Mortgage backed securities are qualified by registration for intrastate and by coordination for interstate issuance of public offerings. Depending upon the fact situation, these securities may also be qualified by exemption as private placements in accordance with applicable federal and state law.

The secondary mortgage market (investors purchasing real estate loans originated by other lenders through mortgage backed securities) surpassed loan sources which dominated real estate lending prior to the 1990’s. The significant financial collapse and consolidation of the savings and loan and savings bank industry that occurred at the end of the 1980’s and in the early 1990’s contributed to this change. At the beginning of 1980’s, there were approximately 4,022 savings and loans and savings banks in the United States. As of December 31, 2009, approximately 1,158 remain, of which 756 are supervised by the Office of Thrift Supervision (OTS) and 402 are supervised by the Federal Deposit Insurance Corporation (FDIC). During the same period, commercial banks reduced in number from approximately 15,000 to 6,739, of which the Office of the Comptroller of the Currency (OCC) supervises 4,461 and the Federal Reserve Bank (the Fed or FRB) supervises 839.

The FDIC issued a public report at the end of the first quarter of 2010 that indicated 775 banks or more than 10% of remaining U.S. banks were placed on a list of “problem” depository institutions. These problem institutions had a significant portion of non-performing commercial loans on their balance sheets. Non-performing loans are considered to be loans that are at least 3 months past due. According to the FDIC report, the number of non-performing commercial loans continued to increase for the 16th consecutive quarter. The number of problem banks/depository institutions listed by the FDIC increased from 262 at the end of 2008 to 702 at the end of 2009 and to 775 at the end of the first quarter of 2010.

In addition to savings and loans, savings banks, and commercial banks, credit unions have been and remain a significant source of residential financing. In recent years, credit unions have been merging, resulting in some having hundreds of millions of dollars in assets. Currently, approximately 7,244 credit unions control $205 billion in assets, $181 billion in deposits, and $120 billion in loans to their members. Commercial banks control $4.4 trillion in assets, $3.1 trillion in deposits, and $2.7 trillion in loans.

Life and health insurance companies also invest substantial resources in loans secured by real property. The Insurance Information Institute reports that, as a percentage of total investments, the life and health insurance industry continues to invest in mortgage loans from 9.85 to 10.87% of their total assets. As of the end of 2008, this industry reportedly held $327.4 billion in real estate loans. While life and health insurance companies historically invested in residential loans, during the last approximate 30 years the mortgage loans held by this

industry have been other than residential, i.e., income producing properties including apartments, office buildings, shopping centers, malls, strip and freestanding commercial retail, industrial and the like.

Since the 1980's, mortgage loan brokers (MLBs) have become a substantial source of residential mortgage loan origination. The industry-wide use of MLBs to "originate" residential mortgage loans expanded until the mortgage melt down of 2007 and 2008. Depending upon markets, MLBs "originated" from 50 to 70% of residential mortgage loans, i.e., loans secured by 1 to 4 dwelling units.

The term "originate" has historically meant to fund or make the loan and did not include the function of "arranging" a loan on behalf of another or others. Since the late 1980's, mortgage lenders, state legislatures, Congress and various federal and state governmental agencies and departments have redefined the term "originate" to include third parties who arrange loans for lenders to fund and make. These third party "originators" are commonly known as MLBs. Recently, the term "originate" has been extended to employees who act as loan representatives of depository institutions and of licensed lenders. MLBs and lender representatives who solicit and negotiate loans to be secured by 1 to 4 residential units have been re-characterized as Mortgage Loan Originators (MLOs) in the federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the SAFE Act). The Safe Act is briefly explained later in this Chapter.

California MLBs also make and arrange loans relying on funds from private individuals/entities, known as private investors/lenders. Traditionally, these private investors/lenders funded loans secured by 1 to 4 residential units. The majority of these loans were based upon the "equity" in residential properties held by borrowers rather than to finance the purchase of such properties. Beginning with the early 1990's, depository institutions and licensed lenders (non-banks) expanded their loan products to include the quality of loans that previously had been almost an exclusive market for private investors/lenders making loans through MLBs. This almost exclusive market consisted of mortgage loans that relied in large part on the equity in the security property and to a lesser extent on the credit worthiness and financial standing of the borrower.

Private investors/lenders and the MLBs through whom these residential mortgage loans were funded could not effectively compete with the expanded residential loan products that were being offered to the borrowing public by depository institutions and non-banks. However, the historic secondary market would not purchase most of these expanded residential loan products (alternative mortgages or non-traditional loan products). To create the liquidity necessary to continue to fund these expanded residential loan products, a new secondary market was established relying on the issuance of the aforementioned mortgage backed securities.

The residential mortgage loans funded by the historic depository institutions and the more recently constructed non-bank lenders were then packaged, securitized, and sold to foreign and domestic investors in risk/yield based "traunches" through Wall Street investment banks and broker-dealers. These historic depository institutions and more recently constructed non-banks also sold these loan products to each other.

The Wall Street Investment Banks and broker-dealers created a parallel loan "origination" and delivery system outside of the direct regulatory oversight of the Fed and the various federal agencies having supervisory jurisdiction over depository institutions, e.g., FDIC, OCC, and OTS, among others. These federal agencies were responsible for ensuring the safety and soundness of the depository institutions. The new and alternative "origination" delivery system relied primarily on MLBs as third party "originators" of residential mortgage loans, which were often funded through credit facilities made available by mortgage bankers, finance lenders, or hedge funds.

Before Deregulation

Partially because of the unstable market forces prevailing over the last 30 to 35 years, depository institutions such as savings and loan associations, savings banks, commercial banks, credit unions, and thrift and loans experienced reductions in profitability. Largely unregulated non-depository institutions or non-banks drew savings deposits away from regulated depository institutions by paying investors higher rates of interest on financial instruments created for this purpose (e.g., uninsured money market funds, commercial paper, and hedge funds).

During the late 1970's, many depository institutions were holding low-interest loan portfolios that steadily declined in value. At the same time, they were unable to make enough higher-interest rate loans to achieve acceptable profit levels. This happened in part because of the decline in personal savings, appreciating property

values, and increasing interest rates paid to depositors. It was during this period the concept of brokered deposits was first established. Wall Street broker-dealers were delivering deposits from their investor clients to depository institutions looking for those that would pay the highest interest rates. High deposit rates resulted in high mortgage loan interest rates. Many potential home buyers could not qualify for higher-rate mortgage loans and/or were unable to make required down payments.

Across the country, forced postponements of home ownership occurred except for transactions involving transferable (assumable) loans and seller-assisted financing. Subdividers, developers, and builders reduced new home production. By the end of 1980, the prime interest rate imposed by commercial banks reached 21.5%. On September 14, 1981, the interest rate for FHA and VA single-family insured or indemnified home loans reached 17.5%. Tight money, stringent credit underwriting, and high interest rates made mortgage money scarce and expensive. Potential private and government sector borrowers were forced to bid for available loan funds.

Deregulation that Followed

The foregoing mortgage market led to a period of deregulation, the process whereby regulatory restraints upon the financial services industry were reduced or removed. Deregulation extended to California law, and federal legislation was pursued to level the playing field between federally licensed and chartered depository institutions and California licensed and chartered depository institutions. This legislative deregulation included, among others, the federal Depository Institutions Deregulation and Monetary Control Act of 1980, the Depository Institutions Act of 1982 (also known as the Garn - St. Germain Act), and the Alternative Mortgage Lending Act of 1982.

Re-regulation

Re-regulation occurred at the end of the 1980's as a result of substantial losses in the savings and loan and savings bank industry. Re-regulation began with the federal Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). This federal re-regulation continued with a significant number of amendments to both the Real Estate Settlement Procedures Act (RESPA) and the Consumer Credit Act, also known as the Truth-In-Lending Act (TILA).

FIRREA was designed to "bail out" the savings and loan and savings bank industry as the Federal Savings and Loan Insurance Corporation (FSLIC) did not have sufficient reserves to accomplish this objective. FIRREA directly regulated federal depository institutions, and these regulations affected state licensed and chartered depository institutions. The supervision by federal regulators over savings and loans, savings banks and commercial banks increased during the 1990's to include, among other changes, enhanced capital reserve ratios required for loan losses. In addition, the OTS was structured as an office within the Fed or the FRB, replacing the Federal Home Loan Bank Board (FHLBB) that had supervised savings and loans and savings banks since the 1930's. At the same time, the FSLIC was restructured from a separate entity to the Saving Associations Insurance Fund (SAIF) as a subset of the FDIC.

More Deregulation

Following the restructuring of the savings and loan and savings bank industry in the early 1990's and the enhanced federal regulatory supervision that followed, Congress returned to deregulation. An example is the federal Financial Institutions Regulatory Relief Act (FIRRA), also known as the Paper Reduction Act of 1996. Included as part of FIRRA was the termination of SAIF, with its function of insuring deposits held by savings and loans and savings banks being transferred to the Bankers Insurance Fund (BIF). BIF also operated under the FDIC.

In 2006, the Federal Deposit Insurance Act became law. This Reform Act merged BIF and the deposit insurance function of savings and loans, savings banks, and commercial banks into a fund called the Deposit Insurance Fund (DIF). This change was made effective March 31, 2006. The Reform Act also established capital reserve ranges from 1.15 to 1.50% within which the FDIC directors were allowed to set reserves for member institutions, i.e., the Designated Reserve Ratio (DRR).

With this deregulation, the differences once separating the loan products, services, and the purposes of savings and loans, savings banks, and commercial banks were reduced or eliminated. Further, the distinctions in premiums paid to DIF by the various depository institutions were restructured. Savings institutions competed

with commercial banks for business and profits with few governmental restrictions. Some experts in the financial world believed that depository institutions surviving this competition would become larger, more diverse, and more efficient than the depository institutions prior to the 1990's.

The process of diversification and integration of the financial services industry accelerated by the repeal of the Glass-Steagall Act as part of the federal Gramm-Leach-Bliley Act of 1999. The repeal of the Glass-Steagall Act allowed savings and loans, savings banks, and commercial banks to invest funds and integrate investment activities with investment bankers and insurance carriers, including engaging in the issuance of mortgage-backed securities and in the structuring and issuing of unregulated financial instruments referred to as derivatives.

Derivatives have been defined as agreements or contracts that are not based on a real, or a concomitant exchange, i.e., nothing tangible is currently exchanged such as money or a product. For example, a person goes to a department store and exchanges money for merchandise. The money is currency and the merchandise is a commodity. The exchange is concomitant and complete. Each party receives something tangible. If the purchaser had asked the store to hold the merchandise to be delivered at a later date when future payment is made at a predetermined price standard (based upon the movement in the retail price of the product) and the store agrees, then a form of derivative has been created.

Derivatives are agreements derived from proposed future exchanges rather than current and concomitant exchanges of assets, obligations, or liabilities. In financial terms, a derivative is a financial instrument between two parties representing an agreement based on the value of an identified and underlying asset linked to the future price movement of the asset rather than its presumed current value. Some commonplace derivatives, such as swaps, futures, and options have a theoretical face value that can be calculated based on formulas. These derivatives can be traded on open markets before their expiration date as if they were assets.

California Law

Consolidation of the licensing of lenders other than depository institutions has occurred in California. As of July 1, 1995, the Finance Lender Law established a single license, the California Finance Lender (CFL) which replaced three licenses including personal property brokers, consumer finance lenders, and commercial finance lenders. These three licenses were merged into the CFL license.

Effective January 1, 1996, the California Legislature created a new license category for mortgage bankers either originating or servicing residential loans in this state. These licensees are known as residential mortgage lenders (RMLs), each of which is licensed under the Residential Mortgage Lending Act (RMLA). CFLs and RMLs are licensed and regulated by the Department of Corporations (DOC).

Some mortgage bankers remain licensed as real estate brokers (REBs) and continue to operate their non-residential commercial loan business (loans secured by other than 1 to 4 dwelling units) under the regulation of the Department of Real Estate (DRE). RMLs are *not* to use an REB license to make, arrange or to service residential loans.

During 1996, the California Legislature consolidated regulation of depository institutions into a Department of Financial Institutions (DFI). This department replaced the Department of Banking and the Department of Savings and Loans and acquired from the DOC's regulatory oversight the state-chartered thrift and loans (industrial loan companies) and the credit unions.

California industrial loan companies have also experienced significant restructuring. These institutions were legislatively required to switch from a California-based insurance fund to the FDIC. With this switch came more regulatory oversight, including stricter loan underwriting guidelines. Reported diminished profits followed this restructuring and the result was the merger of many of these institutions into larger institutions that were able to profitably function within the regulatory climate and competitive market of the 1990's through the middle of 2007.

Restructuring of the Residential Loan Market

Deregulation and the proliferation of alternative mortgage instruments or non-traditional loan products were each responsible for the restructuring of the housing finance system. These alternative mortgage instruments or non-traditional loan products were responsible for redefining the underwriting guidelines and the standards for

borrower qualifications applied by depository institutions and by non-banks (including licensed lenders). The purpose was to facilitate the expansion of homeownership as a stated public policy and also as a means of pursuing the objectives of the federal Community Reinvestment Act.

As always, the most important issue facing both mortgage lenders and borrowers is the availability and affordability of mortgage funds. As legislators, regulators, lenders, brokers (including MLBs) and consumer interests addressed complex risks, challenges and opportunities, more changes occurred in the lending process. For example, electronic loan originations became readily acceptable to depository institutions and non-banks as well as to the secondary market.

The foregoing changes increased involvement of licensed lenders and brokers, including RMLs, CFLs, and MLBs in residential mortgage loan originations. Since the mortgage meltdown of 2007 (to be discussed later in this Chapter), what remains to be seen is how much consolidation will occur among these licensees, and if not consolidation, how many of these licensees will become subsidiaries of or affiliates horizontally associated with depository institutions. The result of these business relationships will require acknowledgement and disclosure of Affiliated Business Arrangements (ABAs) to be discussed later in this Chapter.

Extensive federal and state re-regulation of lenders and mortgage brokers making and arranging residential mortgage loans (including the SAFE Act) will likely reduce the ability for small independent licensed firms to survive. Accordingly, many of these firms will be forced to merge or, as previously mentioned, may become subsidiaries or affiliates of depository institutions or their holding companies.

Acquisition of state licensed firms may also be considered by federally licensed and chartered savings and loans, savings banks, and commercial banks following a decision of the U.S. Supreme Court issued in April 2007. The decision is Watters, Commissioner, Michigan Office of Insurance and Financial Services v. Wachovia Bank, N.A. et al., No. 05–1342 (argued November 29, 2006, decided April 17, 2007). The U. S. Supreme Court held that subsidiaries of federally licensed and chartered depository institutions or their holding companies did not require licensing under state law. This decision abrogated in part the opinion of the California Attorney General, 84-903, which was issued in October 1985 and had concluded that entities, whether subsidiaries or affiliates, could not rely on exemption from state licensure that extends to the parent or to the employees of the parent entity. The remaining opinions of the Attorney General remain operative.

Essentially, the Attorney General's opinions require separate licensing of entities that fund or make loans, purchase promissory notes, or service loans/promissory notes held by the entities. The U. S. Supreme Court decision will likely facilitate the acquisition of a number of RMLs, CFLs, and MLBs by federally licensed and chartered depository institutions.

THE SAFE MORTGAGE LICENSING ACT

Title V of P.L. 110-289, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), was enacted into federal law on July 30, 2008. This new federal law allowed states to pass state laws to comply with SAFE or in the alternative, HUD would take over the regulation of mortgage loan originators. States had one year to pass legislation requiring the licensure/registration of mortgage loan "originators" (MLOs) according to national standards. This licensure is required in California when MLOs engage in the making or arranging of loans primarily for personal, family, or household use that are secured by deeds of trust or mortgages through a lien on real property when the security property is a dwelling consisting of 1 to 4 residential units. The MLO licensure/registration also applies when the financing arranged is to construct on the security property the intended dwelling of the borrower (Business and Professions Code Section 10166.01(d)).

Since the early part of the 20th century, real estate brokers have been licensed in California and regulated by the DRE. Among the activities that a real estate broker is authorized to pursue is the making and arranging of mortgage loans (as defined) secured directly or collaterally by/through liens on real property (Business and Professions Code Sections 10131(d) and (e), 10131.1 and 10131.3). Such activities of real estate broker licensees have long been characterized as mortgage loan brokerage and these licensees are know as mortgage loan brokers (MLBs).

The SAFE Act established a Nationwide Mortgage Licensing System and Registry (NMLS) in which the states are required to participate. The DRE is a participating state agency in NMLS. The SAFE Act is designed to enhance consumer protection and reduce mortgage loan fraud through the setting of minimum standards for the licensing and registration of state-licensed mortgage loan originators (MLOs). California law was amended to add several sections to the Business and Professions Code expanding the authority of the DRE to participate in the NMLS, including the processing and registering of MLOs. The added California law includes requirements for doing business as an MLO; establishes a one year term for the license endorsement; authorizes application forms; imposes record keeping and transaction fees; and defines violations of the law and the penalties to be imposed (Business and Professions Code 10166.01 et seq.).

Applicable California law requires loan processors and underwriters to either function as employees of the real estate broker (MLB/MLO) or to be separately licensed if providing services as an independent contractor. Each applicant to become licensed or registered as an MLO must undergo a criminal history and related background check. Included as part of the prerequisite requirements for the issuance of the endorsement to act as an MLO, is consideration of previous license discipline, a review of criminal records where the applicant was convicted of a felony, and whether the felony involved fraud, dishonesty, a breach of trust, or money laundering. Further, an applicant for the endorsement to act as an MLO must undergo a qualifying written examination, demonstrate financial responsibility and meet new educational requirements. (Business and Professions Code Sections 10166.03, 10166.04, 10166.05, and 10166.06).

Subsequent to receiving the endorsement required by this law, MLBs/MLOs must file with the DRE business activity reports, additional reports in the form and content required by the NMLS, and documents establishing whether continuing education requirements have been met or satisfied. These reports must be filed annually with the DRE or the NMLS (as appropriate) to renew the MLO endorsement (Business and Professions Code Sections 10166.07, 10166.08, 10166.09, and 10166.10). MLBs/MLOs are required to maintain and to make available for inspection, examination, or audit by the DRE documents and records (as defined). The foregoing inspections, examinations, or audits are substantially broader in authority then to which real estate brokers (MLBs) would otherwise be subject (Business and Professions Code Sections 10166.11 and 101666.12).

Violations of this law include failing to notify the DRE of the activity of the licensee as an MLO, failing to obtain the required endorsement to function as an MLO, and otherwise failing to comply with applicable law (including the Real Estate Law and the SAFE Mortgage Licensing Act). The penalties for violations are assessed at $50.00 per day for each day written notification has not been received by the DRE of activities requiring the endorsement or failing to obtain the endorsement up to and including the 30th day after the first day of the assessment of the penalty and, $100 per day thereafter to a maximum penalty of $10,000 (Business and Professions Code Section 10166.02).

MLOs who work for an insured depository institution or an owned or controlled subsidiary of the institution or its holding company (regulated under federal law by a federal banking agency) or a financial institution regulated by the Farm Credit Administration, are required to register with the NMLS. However, these MLOs do not require licensing under state law and are not required to sit for examination as a prerequisite to licensure. MLOs require licensing by the several states are subject to the regulation of the applicable state licensing agency.

The SAFE Act requires state-licensed MLOs to pass a written qualifying test, to complete pre-licensure education courses and to take annual continuing education courses (as defined). The SAFE Act also requires applicants for status as MLOs to submit fingerprints to the NMLS for submission to the FBI to accomplish the previously mentioned criminal background checks. State-licensed MLOs are required to provide (as part of the examination or review of financial responsibility) authorization for the NMLS to obtain independent credit reports and to examine the credit worthiness and financial standing/responsibility of applicants for and to accomplish renewal as MLOs.

ALTERNATIVE FINANCING

In a stable economic environment (i.e., one involving low inflation and relatively constant market interest rates), the long-term, fixed-rate conventional loan was the typical financing vehicle for the purchase of residential real property. Uncertainty regarding future inflation and interest rates can complicate matters for

both lenders and borrowers. As people continue to build, sell and purchase homes, the terms of home mortgages reflect economic realities and expectations including the periodic reluctance of lenders, investors, and some borrowers to accept long-term, fixed-rate loans.

Loans that involve balloon payments, interest reset options, shared appreciation at resale, etc., have ramifications that are not readily apparent to most people. This section discusses some of the alternatives to the fixed-rate conventional loan that have been offered by lenders to borrowers.

The Fixed-Rate Conventional Loan

The use of alternative financing instruments (non-traditional loan products) authorized under preemptive federal law constituted a major change in the traditional lender-borrower relationship in that the risk of changes in the market rate of interest shifted from lenders to borrowers. However, marketplace competition, including FHA insured or VA indemnified loans, resulted in continued availability of fully amortized, long-term, fixed-interest rate mortgages. The Federal National Mortgage Corporation (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) also contributed and continue to contribute to the availability of fixed interest rate mortgages.

Redesigned Mortgage Instruments

During the 1970's and the early 1980's unstable economic conditions caused Congress, California legislators, consumers, lenders, and real estate and mortgage industry representatives to explore a whole catalog of issues regarding the use of alternative mortgage instruments or non-traditional loan products that were being made available to homeowners and purchasers. In 1970, legislation was passed and regulations adopted in California authorizing the use of variable rate mortgages (VRMs). The interest rate of a VRM changes within a range as increases or decreases in an identified published index occurs. In 1980, California legislation authorized the use of renegotiable rate mortgages (RRMs) in which the borrower has an option to either prepay or renew the residential loan, typically at five year intervals. Generally, renewal of such loans is subject to renegotiation of the interest rate. Lenders were required to offer a fixed-rate mortgage as an option to the RRM.

In 1981, the California Legislature also authorized the use of adjustable rate mortgages (ARMs). These mortgages allowed for the nominal interest rate to adjust periodically by a set margin in relationship to a defined index. Again, lenders were required to offer fixed rate mortgages as an option.

In response to the foregoing California legislation, state depository institutions sought federal legislation to level the playing field among state licensed and chartered and federally licensed and chartered depository institutions. As previously mentioned, the Alternative Mortgage Lending Act was passed by Congress in 1982 to preempt state law to the contrary allowing state licensed and chartered institutions to make residential mortgage loans pursuant to federal law. State depository institutions thereafter followed federal regulations when express preemption of state law was included in federal law. Otherwise, state depository institutions were obligated to follow the more stringent of the applicable state or federal law.

Basically, alternative mortgages also known as non-traditional loan products, resulted in an expansion of the residential mortgage market. These alternative or non-traditional loan products shifted to borrowers some of the risks inherent in market changes to enhance the inflow of funds to lenders during periods of tight money and of high interest rates.

Adjustable Rate Mortgages (ARMs)

As mentioned, an ARM is a mortgage loan that provides for adjustment of its interest rate as market interest rates change. Interest rates are linked to an index (typically representing short term interest rates) which fluctuates as market interest rates change. Following an initial contract period as defined in the loan documents and at predetermined periods (monthly, quarterly, or annually depending upon the terms of the loan); lenders would adjust the interest rates on residential mortgage loans based upon a pre-agreed margin added to an identified current index to arrive at the borrowers' new interest rates for the next period. The new interest rates would remain operative until subsequent adjustments occurred.

Major indices used in ARMs include: the Prime or Reference Rate of major commercial banks, as published in the Wall Street Journal (Prime Rate); the London Interbank Offered Rate (LIBOR), as published in the Wall Street Journal or by Fannie Mae; United States Treasury Securities adjusted to a constant maturity (TCM), as published by the Federal Reserve in its Statistical Release H.15; and the 11th District Cost of Funds (COFI), as

published by the Federal Home Loan Bank of San Francisco. There are many variations in methods of calculation for the aforementioned indices as well as other indices available for different types of ARMs. A Home Equity Line of Credit (HELOC) is a revolving line of credit typically featuring an adjustable rate tied to the Prime Rate of major commercial banks, as published in the Wall Street Journal.

Because ARM interest rates can increase over the term of the loan, ARM borrowers share with lenders the risk that interest rates will increase; therefore, it is important for borrowers to not only fully understand how their loan may react to changes in market conditions, but also to minimize their exposure by selecting loan programs with low margins and reasonable caps or limits on interest rate changes. Selecting a less volatile index is also important to borrowers.

Some ARM products also include an interest rate floor limiting decreases in the promissory note interest rates regardless of the downward movement of the selected index. Typically, interest rate floors have been set at either the start (teaser) or the initial rate. More recently, the difference between the start or teaser rates and the initial rates has diminished.

Lenders benefit from ARMs in that they are able to more closely match the maturities of assets and liabilities and minimize their exposure to the risk of rising interest rates. This results in lower initial rates on ARMs than on fixed rate loans. ARMs that include negative amortization or payment options have proven to be more troubling to borrowers as they often result in loan balances exceeding the then value of the security property (particularly in a declining market) or in borrower payment shock.

Renegotiable Rate Mortgages (RRMs)
An RRM is a long-term mortgage (amortized up to 30 years) comprised of a series of short-term loans. The loans are renewable after specified periods (e.g., every three to five years). Both the interest rates and the monthly payments remain fixed during periods between renegotiation/renewal.

Any change in the interest rate, as limited by law, is based on changes in an identified index. If the borrower declines renewal after any specified period, the remaining balance of the loan including any interest remaining unpaid and accrued thereon becomes due and payable.

Rollover Mortgages (ROMs)
ROMs (used extensively in Canada) are a renegotiated loan wherein the interest rate (and hence, the monthly payment) is renegotiated, typically every five years. Consequently, the mortgage rate is adjusted every five years consistent with the then current or prevailing mortgage rates, although monthly payments are amortized on a 25 or 30-year basis. Monthly payments are calculated in the same manner as conventional mortgage loans, with the term decreasing in increments of five years to permit full payment at maturity date specified at loan origination.

Reverse Mortgages (RMs)
Elderly or retired homeowners often rely on limited or fixed incomes while at the same time owning their homes free and clear or with relatively small mortgage loan balances. For many of these homeowners the choices are limited because of reduced fixed income during retirement years. The choices available to these homeowners include either selling their home to access the equity as a means of supplementing their living expenses or to consider obtaining a reverse mortgage.

The reverse mortgage loan that is available today is known as a Home Equity Conversion Mortgage (HECM), an FHA insured product. Under a HECM reverse mortgage, the homeowner is not required to make loan payments. Instead the homeowner has a choice of receiving monthly income/cash flow from the lender or receiving a lump sum payment at the time the loan is originated. The amount of income/cash flow or the initial lump sum paid to the borrower is determined through an analysis of the current and expected future value of the security property; the current and future expected accruing interest rates to be applied to the principal distributions made to the homeowner during the term of the reverse mortgage (based upon the selection by the lender of one of two HECM authorized adjustable rate programs); and upon the remaining life expectancy of the homeowner.

The analysis considers the amount of any existing mortgage loans encumbering the homeowner's property that must be paid in full at the time of origination of the reverse mortgage loan. This may require the selection of the

option for a lump sum payment at the time of loan origination or that the loan program include both a lump sum payment sufficient to payoff the existing encumbrance(s) and to thereafter provide a monthly income/cash flow to the homeowner. If the amount owing in connection with the existing mortgage loans is in excess of the calculated maximum amount available from the selected HECM loan program, the homeowner may not be entitled to obtain a reverse mortgage.

These homeowners are qualified for a reverse mortgage loan in a maximum amount that can be sustained by the equity in the security property (based upon the analysis previously discussed) and not on their retirement income, or their credit worthiness and financial standing. The homeowner's equity must also sustain the mortgage premiums imposed by HUD/FHA both at the time of origination and throughout the term of the reverse mortgage loan, among other fees, costs, and expenses. The fees, costs, and expenses to originate a reverse mortgage are typically much higher than to originate a conventional loan; therefore, it is ill-advised to consider a reverse mortgage for a short period. The selection of a reverse mortgage loan by a homeowner requires a long-term commitment to occupy the security property.

The FHA insurance coverage protects homeowners by insuring the monthly income/cash flow will continue even if the lender becomes insolvent or subject to a regulatory enforcement action. The insurance coverage also protects the lender and the homeowner in the event the amount owing at the time of the maturity of the reverse mortgage loan exceeds the then market value of the security property. The difference is subject to a claim against the insurance coverage by the reverse mortgage lender thus protecting the estate of the homeowner from any shortfall in principal balance and accrued interest that might otherwise be due.

HECM reverse mortgages are due and payable when then last qualified borrower permanently leaves the property or until a specified event, such as death of the homeowner or a sale of the security property. In effect, a reverse mortgage enables the homeowner to draw on the equity of their home by increasing their loan balance each month. No cash payment of interest is involved, as the increase in the loan balance each month represents the cash advanced, plus interest on the outstanding principal balance.

Shared Appreciation Mortgages (SAMs)

SAMs give the lender the right to an agreed percentage of the appreciation in the market value of the security property in exchange for an initial below market interest rate. These loans are usually unavailable in markets where real property is not appreciating in value.

Graduated Payment Mortgages (GPMs)

GPMs provide for partially deferred payments of principal at the start of the loan term. There are a variety of plans. Usually, after the first five years of the term, the principal and interest payments increase substantially to pay off the loan during the remainder of the term (e.g., 25 years). This loan may be appropriate for borrowers who expect salary or income increases in future years. A GPM may involve negative amortization (i.e., increases in principal) in the early years of the loan, although some GPM products do not provide for negative amortization. If negative amortization is included, the early sale of the home could require the borrower repay more than the original principal amount of the loan. This could be a significant problem if the property has not increased or has even declined in market value.

In Summary

Alternative mortgages also known as non-traditional loan products are not suitable for everyone. It is very important that those who recommend such products, or who contemplate using them personally, have a good understanding of the potential risks and drawbacks as well as the benefits. A temporary solution to a financing problem may turn out to be a long-term detriment to the borrower and/or lender. When the party recommending such products is an MLB/MLO, the understanding of and the explanation regarding the use of alternative mortgages or non-traditional loan products occurs within the context of the fiduciary duties owed to the intended borrower.

Real estate licensees, including MLBs/MLOs should use caution when advocating the use of innovative or creative financing techniques and products in residential loan transactions. These licensees (as agents and fiduciaries) should be prepared to explain the benefits and risks to their clients throughout the anticipated term of the residential mortgage loan when using alternative mortgages or non-traditional loan products. Alternative mortgages or non-traditional loan products are not something that licensees and their principals should learn

together through trial and error. Innovative or creative financing techniques and products generally are to be avoided without the advice of knowledgeable legal counsel.

THE ECONOMY AND MONETARY POLICY

America's economic system has been and is currently a regulated, capitalistic, private enterprise system. Although individuals, partnerships, corporations, limited liability companies, pension funds, investment trusts, and hedge funds, own and control real property and the means of production of goods and services (including the subsequent distribution and allocation of goods and services), the federal government intervenes and influences general economic trends. This intervention is occurring on an ever increasing basis. While often controversial, the stated objective of government intervention is to ensure reasonable competition, to allow for the identification of those who fail to comply with applicable law established for consumer protection, and to achieve and maintain a viable, growing, fair, and equitable economy.

Role of Real Estate in the National Economy

Real estate plays four major roles in the national economy:

Net Worth

Real estate consisting of land and improvements make up a very large portion of and substantially contribute to the total net worth of the United States and of the several states.

Income Flow

As we see on the circular flow chart of our economy (next page), money is paid for the use of real estate (rent) and for the raw materials, labor, capital and management used in construction work of all kinds (the agents of production).

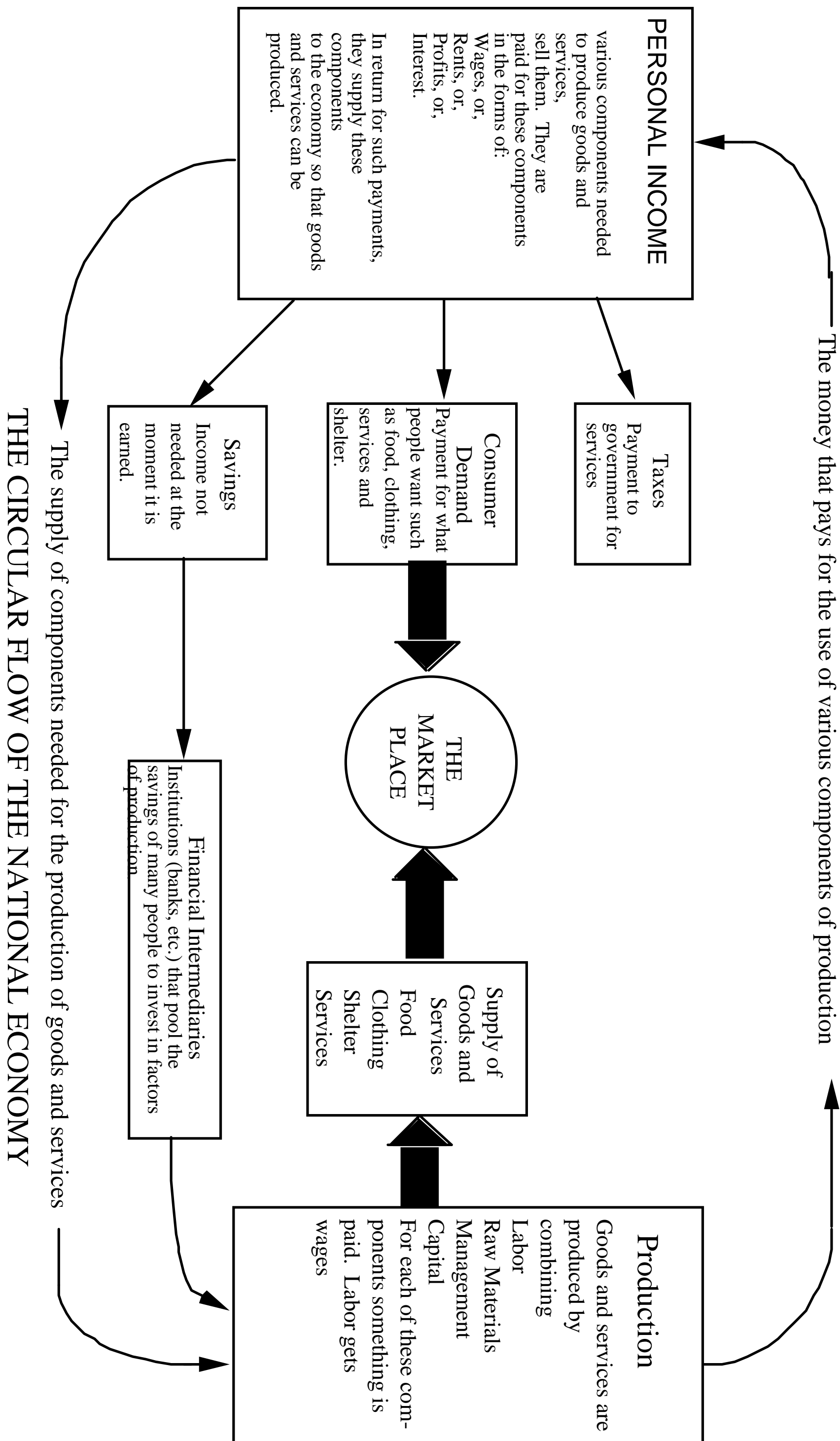
Major Employer

In California, real estate and related industries (e.g. brokerage, construction, design professionals, management, banking, financial services, title, escrow, and appraisal) are major employers and these industries contribute significantly to the gross domestic product in the nation and in this state.

Appreciation, Inflation, and Deflation

After having been in decline for much of the 1990's, residential real estate values stabilized and, in many markets, market values substantially increased through 2005. In some markets, real estate market values continued to increase during 2006 and up to the middle of 2007. Market values of residential real properties then peaked throughout the country and, experienced substantial declines from 20 to 50% (depending on markets, geography, and demographics).

The value of income-producing properties declined following the enactment of the Tax Reform Act of 1986 (TRFA). Depending upon the market and geographic location, market values of these "commercial properties" (income producing properties other than 1 to 4 dwelling units) fell between 25 and 50% from their previous peaks. Commercial properties thereafter increased in market value until they peaked again in 2006. Since 2006, the melt down of the mortgage market and the related affect on the national economy has caused the values of commercial properties to once again decline. Between 2006 and 2010, market values of these properties have fallen by as much as 40 to 50% (depending on markets, location, and security property type).



THE CIRCULAR FLOW OF THE NATIONAL ECONOMY

Federal Reserve Bank System

The Federal Reserve Bank System (the Fed or FRB) is the nation's central bank. The U. S. Congress established the Fed, December 23, 1913, as a Christmas present to then President Woodrow Wilson who had sought the establishment of a central bank authority. The chief responsibility of the Fed is to regulate the flow of money and credit to promote economic growth and stability. The goal is a monetary policy which encourages high employment, stable price levels, and a satisfactory international balance of payments. The Fed's monetary policy attempts to counteract inflation, recession, deflation or any other undesirable shift in the national economy.

The Fed's Board of Governors formulates monetary policy and shares responsibility for its application with the 12 District Federal Reserve Banks throughout the nation. The President of the United States appoints the governors of the FRB for 14-year terms, subject to confirmation by the U. S. Senate. These long terms are intended to insulate the governors from outside pressures. The Chairman and Vice Chairman of the Fed are appointed by the President and confirmed by the Senate for four-year terms. These appointments are often renewed by Presidents of various administrations.

Monitoring the Money Supply

In an effort to avoid the peaks and valleys and "boom or bust" business cycles that spawn liquidity and credit crises, the Fed monitors economic conditions and controls the supply of money and credit. This is a delicate balancing act.

If the Fed makes too little credit available, borrowers may bid against each other for capital/funds that drive up the cost of borrowing. People then buy and borrow less, investments and sales decline, and a recession may follow. On the other hand, too much available credit translates into over stimulation of the national economy and invites inflation, including bubbles in the housing market. When these bubbles burst, deflation often follows.

To accomplish its goals, the Fed currently uses four basic tools:

- Reserve Requirements

  Member banks must set aside and keep as reserves a certain percentage of customer deposits and of the mortgage and other loans held in portfolio or for which servicing and contingent liability is retained. By raising or lowering these capital reserve requirements (based upon risk weight), the Fed increases or decreases the amount of money in circulation. An increase in reserve requirements means banks have less money to lend, mortgage and other loan interest rates will likely increase, and borrowing and spending will slow. Conversely, a lessening of the reserve requirements increases capital/funds to lend and should lead to lower interest rates; borrowing and spending can then be expected to increase.

- Discount and Federal Funds Rates

  The discount rate is the interest rate the Fed charges on money it lends to member banks. The interest rates for federal funds established by the Fed is the rate charged by member banks to each other for overnight or short term liquidity or is the amount a member bank would demand to invest capital/funds with another member bank. These rates are regulated by and subject to changes directed by the Fed. A decrease in the discount rate may encourage bank borrowing, increasing deposits which the bank may loan to businesses and consumers. An increase in the discount rate will have the opposite effect. Increasing the rate for federal funds correspondingly increases the cost of money to member banks, thus reducing the available liquidity for lending. This also would increase the cost of borrowing.

- Open Market Operations

  The Fed also uses open market operations (buying and selling of government securities) to influence the amount of available credit. When the Fed buys government securities, cash is deposited into sellers' bank accounts, increasing reserves and allowing banks to extend more credit to borrowers. If the Fed sells securities, the opposite effect occurs.

- Acquiring Non-Performing Assets

As part of the mortgage melt down, many depository institutions and non-banks (lenders other than historic depository institutions) were holding on their books or in related entities, a significant amount of non-performing assets primarily in the form of mortgage backed securities. These non-performing mortgage backed securities impair the liquidity of depository institutions and non-banks that are required to increase capital reserves in relationship to these non-performing assets. The result of increased capital reserves is the reduction of lending activities. The Fed has been purchasing some of these non-performing mortgage backed securities to reduce the applicable reserve requirements, thereby increasing capital ratios of the depository institutions and the non-banks that were holding these non-performing assets. The purpose of the foregoing Fed acquisitions is to enhance the ability of depository institutions and non-banks to make new loans.

Supervision of Depository Institutions

The Office of Thrift Supervision (OTS) was created pursuant to the restructuring required by FIRREA. The OTS is an office within the Fed that regulates federally licensed and chartered savings and loans and savings banks.

FIRREA also reorganized the Federal Deposit Insurance Corporation (FDIC) into four offices with two sub-agencies. The original four offices consisted of the Deposit Insurance Fund (DIF), the OTS, the Resolution Trust Corporation (RTC), and the Resolution Funding Corporation (RFC). The RTC is no longer operative. DIF currently exists as the insurance fund under FDIC. DIF has subsumed the two insurance funds formerly known as the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

THE MORTGAGE MARKET

Money serves as a medium of exchange. The potential to exchange money for goods and services can be stored. This is called savings. Savings are the primary source of funds for lending.

If the value of money is relatively stable, people are more inclined to save, since their stored capacity to exchange (with interest) is not being eroded by inflation.

Credit

“Credo” is a Latin word which means “I believe.” A lender loans money believing that it will be paid back as agreed; therefore, the lender grants, or extends, “credit” and the term “creditor” is used in federal law to identify lenders for certain defined purposes including applying to the lender in the “creditor/borrower” relationship.

Supply and Demand

The supply of capital is finite. Real estate borrowers must compete with government, business, and other consumers for available capital/funds. If mortgage money is in short supply, mortgage interest rates rise. A cause is the placement of potential capital/mortgage money in other markets that are paying higher interest rates. Another cause is when spending authorized by the U. S. Congress exceeds current tax revenues. The Congress and the President accomplish this spending by borrowing in the capital markets and increasing the direct and indirect national debt that reduces available capital for private investment.

Government Intervention Can Redirect Supply

Between late 1989 and the mid-1990’s, a “credit crunch” occurred in a portion of the real estate market primarily because the federal government, through re-regulation including capital reserve requirements imposed on depository institutions under FIRREA, redirected available capital to residential mortgage lending.

The capital reserves then required for residential mortgage loans secured by 1 to 4 dwelling units ranged from 2% to 4%, depending primarily on whether the loan was insured or indemnified by a federal agency. The reserve requirements for commercial properties jumped to as much as 8%.

Accordingly, lenders rushed to make residential mortgage loans and avoided loans secured by commercial properties, including those that are characterized as industrial or as land loans. Residential income properties were treated more favorably with reduced capital reserve requirements, although higher than the reserves required for residential mortgage loans. The flow of capital to residential mortgages helped cause “refinance

mania" beginning in the mid-1990's and continuing through the middle 2000's. The Fed's policy of holding interest rates at historically low levels also contributed to "refinance mania".

This flow of money mitigated the "credit crunch" that occurred in the early 1990's. In addition, home purchase transactions increased substantially during the period from 1999 through most of 2006, increasing the demand for residential mortgage loans.

The "Mortgage Meltdown"

During the 1990's, with interest rates hovering in the 5 to 6% range and with a strong national economy, a wave of homebuyers entered the market. Housing prices rose significantly in many areas and speculators entered the market in the expectation of "flipping" houses to make a quick profit. Subdividers, developers and builders significantly expanded the housing supply by increasing new housing inventory through residential subdivision development. As prices rose, new and more exotic loan products became popular such as "pay-option" adjustable rate mortgages (ARMs), or "option ARMS", stated income, stated asset, and other alternative mortgages or non-traditional loan products.

With many of these non-traditional loan products, borrowers were not required to prove their income or their ability to pay the mortgage loan debt service. Some loan products were geared to borrowers who could not qualify for conventional loans due to low credit scores, high debt-to-income ratios, limited equity, inadequate down payments, or other factors. But many of these "non-traditional" or "alternative mortgage" loan products were also marketed to and used by conventional borrowers to increase their purchasing power as buyers of residential real properties to allow home purchases that would not have conformed with the standards imposed by conventional loan products, or to allow home purchases at higher prices than previously available to buyers traditionally qualifying to purchase homes.

Many products had very low "start" or "teaser" interest rates, at or below 1%, followed shortly after a period by an initial note rate that remained below market also for a short period. Lenders based the borrowers' ability to pay on the "initial" rate, even if this rate substantially increased pursuant to the contract terms after a relatively short period, e.g., one to three years. The terms of the mortgage loan included the potential for large interest rate increases, resulting in borrower payment shock and, in some cases, negative amortization increasing the principal balance of the loan rather than decreasing the balance through amortization.

100% financing was also a popular loan product. Many of these loans layered risk upon risk, by incorporating no down payment, negative amortization and potential interest rate increases into one mortgage loan transaction. Many homeowners, seeing an opportunity to turn potential growth in equity into cash, refinanced into these types of products from more traditional and safer fully amortizing, 30-year fixed rate loans. These borrowers were lured by the prospect of lower payments and the belief that home values would continue to rise indefinitely. In California, many homeowners failed to realize that when refinancing through "non-traditional" or "alternative mortgage" loan products, the borrower was giving up "purchase money" mortgages (for which no deficiency judgment may be obtained) in exchange for "non-purchase money" mortgages that carried personal liability for the deficiency between the total amount owing the lender and the price received at a properly conducted foreclosure or "short" sale.

By mid-2007, the housing bubble burst when many thousands of homeowners were unable to make their mortgage loan payments that had adjusted and, in many cases, substantially increased. These homeowners had purchased with little or no money down or had refinanced to higher loan balances using alternative mortgages or non-traditional loan products that included adjustable interest rates resulting in monthly mortgage payments rising to unaffordable levels. Housing prices began to fall as effective demand diminished. Homeowners with negative amortization, 100% financing, or both were "upside down" with negative equity in their homes compounded by their inability to make their scheduled mortgage loan payments.

Foreclosures began to skyrocket and many lenders, particularly those that specialized in exotic non-traditional loan products failed. While the primary and secondary markets described in this chapter still exist, most lenders and secondary market purchasers, such as Fannie Mae and Freddie Mac, have substantially tightened their underwriting guidelines and virtually all exotic, alternative mortgage or non-traditional loan products have disappeared from the residential mortgage market. This resulted in constricted effective demand, reduced property sales, and in an over supply of homes on the market. Many of the homes for sale on the market were

subject to negative equities held by homeowners leading to the influx of "short sales", loan modifications, and forbearances or lender foreclosures.

The Primary Mortgage Market

The traditional primary mortgage market consisted of savings and loan associations, savings banks, commercial banks, thrift and loans, credit unions, pension funds and insurance companies, as well as mortgage bankers that originated mortgage loans by lending funds obtained from their own capital or from independent credit lines that appear as debts in their financial statements. The foregoing depository institutions and lenders funded and made loans directly to consumers/borrowers in residential mortgage loan transactions. These participants in the primary mortgage market replenished their capital/funds by selling loans in the secondary mortgage market as described later in this chapter.

Historically, residential mortgage loans sold into the secondary mortgage market were either insured by the Federal Housing Administration (FHA) or guaranteed or indemnified by the Veteran's Administration (VA). Mortgage bankers that originated mortgage loans performed as loan correspondents (agents and authorized representatives) of depository institutions. Those mortgage bankers with sizeable assets at levels acceptable and with the mortgage experience required by government agencies qualified as "approved lenders/mortgagees" by FHA and VA. Since the late 1960's, conventional loans originated by these depository institutions and licensed lenders (subsequently including mortgage bankers) were sold into the secondary mortgage market. Because of federal legislation, the secondary mortgage market for conventional loans included the previously mentioned quasi-government enterprises, Fannie Mae and Freddie Mac.

In addition to the federal agencies discussed, California has established its own residential mortgage loan program for California Veterans, the Department of Veterans Affairs (DVA). However, the DVA does not fund loans to be sold in the secondary market. Rather, it purchases residential or farm properties selected by veterans to be "sold back" to the veterans over time with a land contract of sale authorized by the Military and Veterans Code describing the selected property as the security property. These land contracts of sale are retained by the DVA and are typically not sold into the secondary market.

Federal Housing Administration (FHA)

This agency insures loans made by approved lenders/mortgagees.

Veterans Administration (VA)

This agency currently indemnifies loans made to veterans for housing, farms or businesses by approved lenders/mortgagees.

Department of Veterans Affairs (DVA)

This agency assists qualified California veterans with the purchase of housing and farms.

Mortgage Bankers

Mortgage bankers are privately-owned companies that are often subsidiaries of or affiliated with banks, savings and loans or savings banks, or of their respective holding companies. As previously mentioned, mortgage bankers who generally perform as loan correspondents (authorized agents and representatives of depository institutions and of other lenders) originated from their own capital or independent credit lines conventional loans and FHA or VA insured or indemnified residential mortgage loans. Mortgage bankers have also participated in the more recent structuring of alternative mortgages and non-traditional loan products and ultimately became a significant source of origination of such loans.

As previously described, California mortgage bankers are licensed as either RMLs or CFLs. Many mortgage bankers are licensed as REBs to originate commercial loans (loans secured by other than 1 to 4 dwelling units). However, the REB license is oriented toward the status of an agent arranging a loan on behalf of another or others and not the status of a lender acting as a principal to fund and make loans. Notwithstanding the foregoing, some REBs still rely on their broker's licenses to make loans.

Mortgage bankers may retain servicing of the residential mortgage loans they have sold in the secondary market, may release servicing rights to purchasers of loans (a "whole loan" sale), or they may sell the servicing separately to a licensed and authorized servicer or to a servicer that is lawfully exempt from licensing.

The Secondary Mortgage Market
Lenders originating residential mortgage loans traditionally replenished their capital by selling the loans to U.S. and foreign banks, to investors willing to hold mortgage loans on a long-term basis, or (as aforementioned) to Fannie Mae or Freddie Mac. More recently, the secondary mortgage market expanded to include investment banks and international investors who purchased interests in residential mortgage loans in the form of the previously discussed mortgage backed securities.

Wall Street Investment Bankers packaged residential mortgage loans in securitized pools in the form of mortgage-backed securities for sale to foreign and domestic investors by broker-dealers. Private companies underwrote these mortgage-backed securities, which were then rated by recognized bond rating firms, i.e., Moody's, Standard & Poor's, and Fitch. This expanded secondary mortgage market included participants buying and selling amongst themselves. The Wall Street expansion of the secondary mortgage market was established to facilitate the sale of alternative mortgages or non-traditional loan products that would not have been saleable in the historic secondary market.

Federal National Mortgage Association (FNMA or Fannie Mae)
Fannie Mae initially provided a secondary market for FHA and VA insured or indemnified loans and, since the early 1970's, conventional mortgages originated by approved lenders (seller/servicers). Initially FNMA required that conventional loans were to be insured by a private mortgage insurer to be acceptable for purchase.

Fannie Mae's sources of funds include borrowing; selling long-term notes, mortgage-backed securities (MBS) and debentures in the capital markets; issuing and selling its own common stock; and earning from its mortgage portfolio, including various fees imposed upon seller/servicers.

Fannie Mae purchased graduated payment mortgages (GPMs), conventional fixed-rate first and qualifying second mortgages, and a variety of ARMs, each secured by 1 to 4 family dwellings. Fannie Mae continues to maintain a resale/refinance program whereby approved lenders (seller/servicers) offer borrowers the opportunity to convert ARMs to fixed interest rate loans or to obtain new mortgage loans at competitive interest rates.

Since the early 2000's, Fannie Mae expanded its acceptable loan products to include many of the non-traditional or alternative mortgage loan products being originated by their approved lenders (seller/servicers). FNMA's mortgage-backed securities (MBS) plan included non-traditional or alternative mortgage products. The MBS plan involved approved lenders selling blocks or pools of mortgages in exchange for a like amount of securities that represented undivided interests or participations in a designated pool of loans that may be sold to or retained by qualifying lenders. FNMA provides a 100% guaranty of full and timely payment of interest and principal to the holders of the securities.

While FNMA is the largest investor in the secondary residential mortgage market, it delegates most underwriting and servicing responsibilities to approved lenders (sellers/servicers) in accordance with FNMA's guidelines. FNMA has also played a major role in the development of standardized loan origination documents, including the 1003 loan application form, promissory notes and deeds of trust (with various addendums depending on the residential mortgage loan product), and uniform residential appraisal reports (FNMA guide forms). These guide forms are also approved by the Federal Home loan Mortgage Corporation (FHLMC-Freddie Mac).

Fannie Mae has a 15-member board of directors, 10 elected by shareholders, and 5 appointed by the President of the United States. Until recently FNMA was a government enterprise primarily controlled by its shareholders who were largely approved lenders (seller/servicers). As of this writing, FNMA has been placed into receivership by the federal government to continue its operations through a series of financial "bail outs" as authorized by the U. S. Congress.

Government National Mortgage Association (GNMA or Ginnie Mae)
Ginnie Mae is a government corporation which administers mortgage support programs that could not be carried out in the private market place. Ginnie Mae increases liquidity in the secondary mortgage market and attracts new sources of funds for residential loans. Ginnie Mae does not purchase mortgages. Rather, it adds its guarantee to mortgage-backed securities (MBS) issued by approved lenders (seller/servicers). GNMA's three major activities include:

- Mortgage-backed securities (MBS) Program;
- Special assistance functions; and
- Management and liquidation functions.

Through the MBS Program, GNMA guarantees securities issued by financial intermediaries that are backed by pools of mortgages. Mortgage bankers, savings institutions, commercial banks and other approved types of financial intermediaries are issuers of securities. Holders of these securities receive a pass-through of principal and interest payments on the pool of mortgages, less amounts to cover servicing costs and certain GNMA fees. Ginnie Mae guarantees that the holders of the securities will receive payments of principal and interest as scheduled, as well as unscheduled recoveries of principal due to prepayments. Because of the federal guaranty (pledge of full faith and credit of the U.S. Government), GNMA mortgage-backed securities are considered by many to be as safe, as liquid, and as easy to hold as securities issued directly by the U. S. Treasury.

The MBS programs of FNMA and GNMA have benefited all regions of the country by increasing the flow of capital/funds from the securities market to the residential mortgage loan market and from capital-surplus to capital-short geographical areas.

Under the special assistance functions, GNMA purchases certain types of mortgages to provide support for low-income housing and to counter declines in mortgage lending and in housing construction. Under the management and liquidation functions, GNMA manages and liquidates (sells) portfolios of federally-owned mortgages.

The President of the United States appoints the President of GNMA, who acts under the direction of the Secretary of the Department of Housing and Urban Development (HUD).

Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)
Freddie Mac was established to increase the availability of mortgage credit for the financing of urgently needed housing by developing, expanding and maintaining a nationwide secondary market primarily for conventional loans originated by savings and loans, savings banks, thrift institutions, commercial banks, mortgage bankers and other HUD-approved lenders/mortgagees.

Freddie Mac finances most of its mortgage purchases through the sale of mortgage participation certificates (PCs) that require issuance and acquisition by qualified investment buyers (QIBs).

Through its standard programs, Freddie Mac buys:

- Whole loans and participation interests in conventional 1 to 4 family dwelling loans with both fixed and adjustable rates;
- Home improvement loans; and,
- Multifamily whole loans and participation interests therein.

The mortgages purchased in the standard programs are generally less than one year old. FHLMC underwrites the loans delivered under its purchase commitments and rejects loans that do not meet its underwriting guidelines. Residential mortgage loans secured by 1 to 4 dwelling units with loan-to-value ratios above 80 percent must carry private mortgage insurance coverage.

Freddie Mac's guarantor or "Swap" program gives primary mortgage lenders an added source of liquidity during periods when the yield on mortgage portfolios of predominantly older loans is lower than the lenders' cost of funds. Lenders may thus convert a low yield portfolio into highly liquid securities that can be sold or used as collateral for the lenders' borrowing of funds.

Until recently, Freddie Mac was an independent stock company and functions in direct competition with FNMA. Freddie Mac has an 18-member board of directors, 13 are elected by Freddie Mac's stockholders; and 5 are appointed by the President of the United States. As of this writing, FHLMC was placed into receivership by the United States government to facilitate "bail outs" as authorized by Congress to be able to continue its residential mortgage loan programs.

Secondary Market for Non-Traditional Mortgage Products
As previously discussed in this Chapter, securitization of non-traditional mortgage products into pools underwritten by Wall Street investment bankers were added to the secondary market. These securitized pools consist of alternative mortgages or non-traditional mortgage products. Some industry representatives refer to these products as "subprime" while others define the term "subprime" to mean a specific category within the class of mortgage products identified as alternative or non-traditional loans. These loan products would not have historically qualified for sale to FNMA or FHLMC and still cannot be securitized into mortgage pools guaranteed by GNMA.

Beginning in the early 2000's, FNMA and FHLMC lowered their standards to include alternative mortgages or non-traditional loan products in portfolios owned, participated in, or securitized by each of these government enterprises. This expanded secondary market facilitated much of the growth in alternative mortgages or non-traditional loan products made to residential borrowers that otherwise would be unable to qualify to purchase or refinance their homes. This opened the door for conventional lenders, who traditionally ignored these borrowers, to make and deliver alternative mortgage or non-traditional loan products to FNMA and FHLMC, as well as directly to investment bankers for securitization through Wall Street.

In response to the major increase in the use of exotic alternative mortgages or non-traditional loan products and the consumer protection issues that followed, on November 7, 2006, the Fed and its member agencies, promulgated the "Interagency Guidance on Non-Traditional Mortgage Product Risks." On June 29, 2007, the same agencies issued the "Statement on Subprime Mortgage Lending". These guidelines and standards were adopted and issued to apply to federally related mortgage loans. The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) also adopted these documents to guide state supervised lenders and mortgage brokers (MLBs).

These documents established risk management practices, consumer protection principles, and control systems for lenders and brokers when offering or advertising alternative mortgage and non-traditional loan products. The purpose was to address the particular risks associated with ARMs, stated income, limited documentation and other loan products where the borrowers typically received a low credit score, as defined. The objective was to control borrower payment shock, and limit the use of prepayment penalties and other material loan terms that were anti-consumer. An additional objective wass to ensure that borrowers received full and complete disclosures of all material loan terms.

It is noteworthy that following the publication of the guidelines and standards referred to above, the secondary market for alternative mortgages or non-traditional loan products established by Wall Street froze and, within a short period, became largely inactive. By mid to late summer 2007, delivery systems for alternative mortgages or non-traditional loan products became largely inoperative and the secondary market for these products almost entirely shut down. As of this writing, approximately 390 lenders originating these products have exited the mortgage industry.

Effective January 1, 2008, California law was amended to require the Commissioners of the Department of Real Estate (DRE), Department of Corporations (DOC), and of the Department of Financial Institutions (DFI) to ensure that lenders and brokers were aware of the existence and contents of the 2006 and 2007 federal guidance and statement referred to above. The Legislature authorized the Commissioners of the DRE, DOC, and DFI to adopt regulations to ensure compliance by their respective licensees with these federal mandates. The DRE promulgated regulations in 2008 to require increased disclosure of material loan terms when offering alternative mortgages and non-traditional loan products and to require specific underwriting guidelines for DRE licensed lenders when making these loans. The DOC and DFI also adopted regulations in regard to their licensees.

Private Mortgage Insurance
Private Mortgage Insurance Companies (MICs) provide mortgage insurance for residential conventional mortgage loans, making these loans more attractive in the secondary mortgage market. Private mortgage insurance enables residential borrowers to obtain loans with higher loan-to-value ratios and to purchase homes with smaller down payments. Private mortgage insurance is typically required when loan-to-value ratios exceed 80% in connection with residential mortgage loans. This concept was advanced in the 1960's with the first firm to offer such coverage being Mortgage Guaranty Insurance Corporation (MGIC).

Private mortgage insurance reduces the monetary risk of loss to originating lenders and to subsequent investors. MICs have underwriting standards that conventional lenders must meet to qualify for the insurance coverage. MIC insured loans are typically more saleable in the secondary market.

California and the Mortgage Market

The following characteristics make California attractive to suppliers of mortgage money from foreign and domestic investors:

1. High demand for mortgage money;
2. A large, and usually growing, population;
3. Traditionally wide diversification of industry;
4. Historically high employment and prosperity;
5. Large depository institutions maintaining facilities or branches in California;
6. Experienced and highly efficient mortgage loan correspondents (mortgage bankers);
7. Common usage of title insurance companies and public escrows rather than settlements;
8. Predominant use of trust deeds with power of sale rather than mortgages with or without power of sale as security instruments;
9. The existence of licensed mortgage brokers that package mortgages for funding by authorized lenders and for subsequent sale to investors in the secondary market; and,
10. Numerous qualified and independent fee appraisers licensed or certified by the Office of Real Estate Appraisers (OREA).

PROMISSORY NOTES

The Debt/Loan or Obligations

The promissory note is the evidence of the indebtedness between the borrower and the lender. It is also the contract that represents the borrower's promise to pay the lender in accordance with the agreed upon terms. The promissory note may also evidence future obligations such as in home equity credit line loans or that may occur pursuant to additional advances authorized in the accompanying security instrument (whether a deed of trust or mortgage). The promissory note is the prime instrument and if there are conflicts in the provisions of the note and deed of trust or mortgage, generally the terms of the promissory note are controlling. The deed of trust or mortgage is the security instrument that makes the real property described therein the security (collateral) for the debt/loan or obligations that the promissory note evidences.

Negotiable Instruments

A negotiable instrument is a written unconditional promise or order to pay a certain amount of money at a definite time or on demand. The promissory note, a draft (whether issued by a bank and otherwise), and a check drawn on a bank are examples of negotiable instruments. Each is subject to the promise to pay to the payee or to the order of the holder. Bank checks are the most common type of negotiable instrument;drafts (also known as bills of exchange and trade acceptances) are similar "three-party paper," except these instruments generally do not require a bank with Fed check clearing capacity.

Promissory notes constitute "two-party paper." The maker promises to pay the payee a specified amount of money on a date certain, upon demand, or in accordance with its terms. There are seven basic kinds of promissory notes in general use with a deed of trust or mortgage:

1. A straight note calling for payment of interest only during the term of the note, with the principal sum becoming due and payable on a certain date;

2. An installment note calling for periodic payments on the principal, plus separate periodic payments of interest made as agreed;

3. An installment note demanding periodic payments of fixed amounts, including interest and principal (amortized payments) until the loan is fully paid or to a date certain when the principal amount owing is to be paid in full (a balloon payment);

4. An adjustable rate note with an interest rate that varies depending upon changes in an agreed upon prescribed standard (a recognized index such as the 11th District Cost Of Funds, U. S. Treasury Securities, the published Prime or Reference Rate, or the London Interbank Offered Rate);

5. A variable rate note with an interest rate that increases or decreases pursuant to movements in an identified direction of a prescribed standard (index);

6. A renegotiable note with equal periodic payments of principal and interest being made for a specified term, e.g., five years at which time the debt or loan is due or is subject to renegotiation/recasting at the then prevailing interest rate based upon a preset margin in relationship to a recognized and authorized standard (index); and,

7. A demand note that does not become due until the holder makes demand for its payment.

Negotiable instruments in the form of drafts or checks drawn on a bank are freely transferable in commerce. They are typically accepted as virtual equivalents of cash, yet the hazards of handling large sums of cash are avoided. However, to be regarded as a negotiable instrument, the document must conform strictly to the statutory definition. Thus a negotiable instrument must be:

1. Signed by the maker or drawer;

2. Include an unconditional promise or order to pay a sum certain in U.S. dollars, and no other promise, order, obligation or power is given the maker or drawer;

3. Payable on demand or at a definite time; and

4. Is payable to the holder or bearer.

Every one of the listed elements must be present if the instrument is to qualify as negotiable. If any one is missing, the instrument may still be valuable and transferable (assignable) like an ordinary contract. As such, the transferee or assignee receives no more benefits than held by the transferor. Personal and real defenses that are available to the borrower/debtor against the payee (lender/assignor) are generally good against the transferee/assignee, which affects the holder in due course status.

Negotiation

Negotiation is the transfer of an instrument in such form that the transferee becomes a subsequent holder. If the instrument is payable to order, it is negotiated by delivery and acceptance with any necessary endorsement. If payable to bearer, it is negotiated by delivery and acceptance.

An exception to the requirement of delivery of the instrument is set forth in Section 10233.2 of the Business and Professions Code. A real estate broker (MLB) acting as a servicing agent of the note holder or holders may perfect delivery by retaining possession of the promissory note and the deed of trust or mortgage, including collateral instruments and documents securing the debt/loan or obligations evidenced by the promissory note (provided the deed of trust or mortgage or an assignment or assignments of either and of related collateral documents identifying the lender/beneficiary/mortgagee/assignee is/are recorded in the office of the recorder of

the county in which the security property is located). The promissory note is to be made payable to the lender/holder or to the assignee(s) or endorsee(s) of the lender/holder.

An endorsement must be written by or on behalf of the holder and on the instrument or on a paper so firmly affixed thereto so as to become a part thereof. An endorsement on a paper so affixed shall be valid and effective even though there is sufficient space on the instrument to write the endorsement. When so affixed, the paper is known as an allonge. An endorsement is effective for negotiation when it conveys the entire instrument or any unpaid residue. If it purports to do less, it generally operates (with certain exceptions) as a partial assignment.

There are various types of endorsements, including:

1. Blank: the holder simply signs his or her name on the back of the note (Caution: Such an endorsement should not be made without the advice of legal counsel);

2. Special: the holder executes “pay to the order of (a named transferee)”;

3. Restrictive: the holder restricts future negotiation by inscribing, “pay to the order of ____________________ State Bank, for deposit only to ______ account”; or,

4. Qualified: the holder inscribes the promissory note with the words “without recourse” to the endorsement, which means if the maker refuses to pay, the endorser will not be liable for the amounts owed.

Regarding item 4 above, a qualified endorsement does not eliminate the endorser’s contingent liability concerning certain representations and warrantees included within an agreement between the parties or implied by law. That is, by negotiating a promissory note by delivery or by endorsing the instrument, the transferor, as a matter of law, still represents and warrants that: (a) the instrument is genuine and what it purports to be; (b) the transferor/assignor or endorser has good title to the instrument, that no previous endorsement(s) has or have occurred by the identified transferor, or that no previous assignment(s) of the same interest by the transferor has occurred; (c) all prior parties had capacity to contract; and (d) the transferor neither has notice nor knowledge of any fact or defect that would impair the validity of the instrument or render it valueless.

It is common for the transferor/assignor or endorser of a promissory note to enter into a global agreement with intended assignees or endorsees regarding the future transfer of promissory notes. These agreements typically include representations and warrantees made by the transferor upon whom the transferee relies to perform the representations and warrantees that are distinguishable from an assignment or endorsement without recourse. Accordingly, the duties and obligations of the transferor pursuant to these agreements would remain operative irrespective of whether the promissory notes are assigned or endorsed with or without recourse. With representations and warrantees, it is preferable that the transfer or assignment be made with recourse integrating the agreement between the transferor and the transferee.

When negotiation is by delivery only, the above warrantees extend only in favor of the immediate transferee. Negotiability of a promissory note is neither affected by inclusion of a clause adding court costs and reasonable attorney’s fees in the event litigation becomes necessary to collect nor by inclusion of an acceleration clause which provides that default in one of a series of payments makes the entire principal amount and any interest accrued thereon immediately due and payable. These and similar provisions actually make promissory notes more acceptable to lenders and investors.

Holder in Due Course Defined

A holder in due course is one who has taken a negotiable instrument: (a) for value; (b) in good faith; and (c) without notice or knowledge that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person. A holder in due course may be a person who has taken the instrument through a prior holder in due course, or, for that matter, through a person who was not a holder in due course.

Notice may be obtained in many ways, including defects on the face of the instrument, in the loan documents, through actual knowledge of dishonor or of a defense, or through the operation of law. Recording of an

instrument does not give notice of a defense or claim in recoupment, or of other claims to the instrument to prevent the holder from being in due course (Commercial Code Section 3302).

It is possible in the case of negotiable instruments that the transferee may receive more benefits than held by the transferor. If the holder of the instrument transfers it to a third party who is a bona fide purchaser for value, that third party enjoys a favored position provided the third party takes the note as a *holder in due course* (without notice of defect or dishonor and absent a continual business relationship with the transferor). This holder in due course status facilitates trade and commerce because persons are more willing to accept such instruments without careful investigation or thorough due diligence of the maker's credit worthiness and financial standing and of the circumstances surrounding creation of the debt/loan or obligations evidenced by the promissory note/negotiable instrument.

Holder in due course status is limited if the loan transaction is subject to the federal Truth-In-Lending Act (TILA). Transferees of such loans are liable to the maker if:

- Violation of the Truth-in-Lending Act is apparent on the face of the disclosure statement or in the loan documents (e.g., Regulation Z final disclosures show the amount of the broker's (MLB's) commission to be $2,000.00 and the HUD-1 lists the commission as $5,000.00); or,
- The assignment was voluntary as opposed to involuntary (e.g. court-ordered sale and assignment of the promissory note/negotiable instrument, unless the order expressly states that the assignee is free of any claims including TILA that may be brought by the borrower/debtor).

In addition, loans which are subject to 12 CFR Section 226.32 of Regulation Z (TILA) include a broader assignee liability standard, i.e., assignees of high cost and high fee loans do not benefit from standing as a *good faith purchaser* or as a *holder in due course*.

Holder in due course status may also be limited when private investors/lenders acquire promissory notes through MLBs who are required to function as their agents and fiduciaries. This is a result of the legal theories of imputation of liability and of respondeat superior, i.e., the master must respond for the actions or conduct of the servant performing within the course and scope of the employment, including any applicable notice or knowledge possessed by the servant. This issue would depend upon the facts, including whether any conduct of the MLB as the agent and fiduciary was adverse to the interests of the private investors/lenders, or was deemed to be criminal. Accordingly, legal counsel should be consulted before a conclusion is drawn by practitioners about holder in due course status, particularly when involving private investors/lenders.

FTC "Holder in Due Course Rule"

State law governing the rights of a holder in due course has been limited by the so-called "holder in due course rule" of the Federal Trade Commission (16 Code of Federal Regulations, Part 433, Preservation of Consumer's Claims and Defenses, 1977). Under this rule, any holder of a consumer credit contract is subject to all claims and defenses that the consumer could assert against the seller of goods or services obtained under or with the proceeds from the consumer credit contract.

This rule has limited application in the field of promissory notes secured by deeds of trust or mortgages on real property. It appears to be applicable in the context of a home improvement contract secured by a deed of trust or mortgage on the home of the borrower. A typical example would be a siding contract. The normal promissory note secured by deed of trust or mortgage used to finance the purchase or construction of improvements on residential or other real property is not subject to the FTC holder in due course rule.

Conflict in Terms of Note and Deed of Trust or Mortgage

Where there is a conflict in the provisions of the promissory note and deed of trust or mortgage, the provisions of the note will generally control. A deed of trust or mortgage gives no additional validity to an unenforceable promissory note. However, the assignment or endorsement of the promissory note carries with it the security as described in the deed of trust or mortgage.

The promissory note and deed of trust or mortgage are to be construed together, and if a deed of trust or mortgage contains an acceleration clause, exercising it may cause the promissory note to become due, even though the note contains no such clause. Since July 1, 1972, every California deed of trust or mortgage describing security property containing 1 to 4 dwelling units that includes a provision accelerating the due date

of the debt/loan or obligation upon the sale, conveyance, alienation, lease, succession, assignment or any other transfer of the security property (subject to the deed of trust or mortgage) will not be valid, unless the clause is uniformly set forth in both the promissory note and the deed of trust or mortgage.

DEEDS OF TRUST OR MORTGAGES

Security Interest

"Security interest" is a term designating the interests of the lender/creditor in the property of the borrower/debtor. Certain assets of the borrower/debtor are set aside so that the lender/creditor can reach or sell them if the borrower/debtor defaults on his or her debt or obligations. The document that describes the rights and duties of the lender and the borrower is called a security instrument. Deeds of trust and mortgages are security instruments.

In General

The deed of trust is the security instrument most frequently used in California real estate loan transactions. Early distinctions between the legal and economic effects of the deed of trust and mortgage have diminished considerably. In the early 1930's, the California Supreme Court held in the case, Bank of Italy Nat'l Trust and Savings Ass'n v. Bentley, 217 Cal. 644, 657 (1933), that deeds of trusts and mortgages were functional equivalents. Also, Civil Code Section 2920 was amended in 1986 to provide "…mortgage also means any security device or instrument…that confers a power of sale affecting real property…to be exercised after breach of the obligation so secured…". Now, both security instruments may include a power of sale through which a named or substituted trustee may conduct a trustee's sale as part of the non-judicial foreclosure procedural law (Civil Code Section 2924 et seq.).

Unless indicated otherwise, references to "mortgage", "mortgagor", or "mortgagee" in this discussion include "deed of trust", "trustor", "beneficiary", "lender", or "lender/creditor" and vice versa. Further, references to "debtor" or "borrower" also may mean "trustor" or "mortgagor". Further, the terms creditor/lender and borrower/debtor as used in this Chapter also describe the person or entity funding or making a loan and the person or entity that obtains the loan. These terms are sometimes used interchangeably with other terms describing the same parties and other times used distinguishably when so defined.

Differences Between Deeds of Trust and Mortgages

The historical differences between deeds of trust and mortgages have been largely eliminated. What remains distinguishable are the names of the parties and the terms used to extinguish the deed of trust as compared to the mortgage as a lien against the security property when the debt or loan is paid. The deed of trust is extinguished by a deed of reconveyance while the mortgage is extinguished by a certificate of discharge/satisfaction of indebtedness.

The parties to a mortgage remain identified as the mortgagor (borrower) and the mortgagee (lender or beneficiary). Even here the terms mortgagor/mortgagee are often used to describe the borrower and the beneficiary as in the deed of trust. For example, federal government agencies and enterprises interchange the use of mortgagor and mortgagee with the terms borrower/trustor, and the terms lender/beneficiary/mortgagee with the terms creditor/lender.

When the mortgage instrument is constructed without power of sale, it may only be foreclosed judicially. When judicial foreclosure is the only available foreclosure remedy; the statute of limitations, the pursuit of deficiencies (money claims), and the redemption rights would be distinguishable from a deed of trust that is foreclosed through a power of sale as a function of the procedural law authorizing the named or substituted trustee to conduct such sales. However, when the deed of trust or mortgage each includes a power of sale, distinctions regarding the statute of limitations, deficiencies, and redemption rights no longer exist.

When a power of sale is included in a deed of trust or mortgage, each security instrument is subject to the same anti-deficiency limitations and to the same reinstatement and redemption rights (if a non-judicial foreclosure is the selected remedy). Should judicial foreclosure be the selected remedy, the same rules are generally applicable to both deeds of trusts or mortgages.

The Civil Code was amended in 2006 to make uniform the statute of limitations when a deed of trust or mortgage contains the power of sale. If the final maturity date or the last date fixed for the payment of the debt/loan or performance of the obligations is ascertainable from the recorded evidence of indebtedness, an action for foreclosure may be commenced within 10 years from that date, whether the security device/instrument for the debt/loan or obligations is a deed of trust or mortgage. If the recorded evidence of indebtedness does not fix the maturity date or the last date for the payment of the debt/loan or performance of the obligations, then an action to foreclose may commence within 60 years after the recording of the security device/instrument. It is important to note that the California Legislature and the Law Revision Commission in the context of this legislation have deemed deeds of trust and mortgages to be functional equivalents (Civil Code Section 882.020).

Junior Deeds of Trust or Mortgages

It is often necessary to obtain junior financing (a loan secured by a deed of trust or mortgage recorded after the recordation of or made subordinate to the deed of trust or mortgage securing the senior financing) to complete a transaction where the amount of a first conventional loan (senior financing) plus the trustor's/mortgagor's down payment are not sufficient to pay the purchase price.

It should be noted junior financing may not be employed when the security property is subject to a first conventional loan made by a financial institution or licensed lender at the time of purchase without the approval of the foregoing. When the senior financing is FHA insured or is a VA indemnified loan made at the time of the purchase of the security property, junior financing is most often prohibited. Even to further encumber a security property with junior financing where the senior financing is held by a financial institution or a licensed lender (or when the loan is FHA insured or VA indemnified), may require prior approval from the financial institution, licensed lender, or applicable government agency because the existence of due on further encumbrance clauses or similar provisions.

Packaged or Mixed Collateral Deeds of Trust or Mortgages

A package or mixed collateral deed of trust or mortgage involves a loan on real property that is secured by more than just the land and improvements thereon. It may include fixtures (appliances, carpeting, drapes, and air conditioning units) as well as other items of business or household personal property. As a cautionary note, MLBs are not licensed to make or arrange loans to be funded by private investors/lenders secured by business or household personal property. This restriction does not apply to depository institutions or certain licensed lenders, i.e., the California Finance Lender (CFL).

In California, the license that specifically authorizes making and arranging loans secured by business or household personal properties are issued under the Finance Lender Law to CFLs. In loan transactions where business personal property represents an essential part of the security for the real property loan, MLBs should seek the prior advice of knowledgeable legal counsel prior to proceeding.

Blanket Deeds of Trust or Mortgages

A blanket deed of trust or mortgage is a loan which covers more than just one parcel of property. Usually, the loan contains a "release clause" providing for release of a particular parcel upon the repayment of a specified portion of the loan. Typical use of blanket security instruments is in connection with subdivisions of homes built on speculation.

Initially, one blanket deed of trust covers the entire subdivision or the particularly defined and authorized unit or phase of the subdivision. Releases from the blanket encumbrances may not occur until the developer/subdivider/builder has complied with the requirements imposed pursuant to the Subdivision Map Act and, if a common interest development (as defined), with the requirements of the Subdivided Lands Law. The Subdivision Map Act is found in the Government Code commencing with Section 66411. This law delegates primary responsibility of regulating the development of residential subdivisions to local government (cities and counties). Each condition imposed by local government as a prerequisite to issuing the required entitlements and authorizing the development of a residential subdivision must be met or satisfied in an acceptable manner prior to releasing from the blanket financing any individual lot or parcel within the subdivision, or the authorized unit or phase thereof.

The Subdivided Lands Law is found in the Business and Professions Code commencing with Section 11000. The regulatory and enforcement oversight of this law is the responsibility of the DRE. Prior to releasing any lot or parcel within a subdivision from the blanket financing, compliance with the requirements of the Subdivided Lands Law must occur, including the issuance of the Public Report, or in accordance with an applicable exemption from such required issuance.

It is unlawful to sell, offer to sell, lease or offer to lease, finance or offer to finance any lot or parcel of real property or commence construction of any building for sale or lease (except for model homes), or to allow any occupancy of a lot or parcel within the subdivision until a final map has been recorded in full compliance with the Subdivision Map Act. It is also unlawful to sell or offer to sell, lease or offer to lease, or to finance any lot or parcel in a subdivision subject to the Subdivided Lands Law without compliance with this law (including notice to the Real Estate Commissioner of the provisions of such financing). Further, the issuance of a Public Report or an Amended Public Report by the DRE must first occur prior to offering any lot or parcel for sale or for lease unless an applicable exemption exists for such required issuance (Business and Professions Code Section 11000 et seq.).

The manner in which blanket financing/encumbrances are handled in common interest developments is also subject to the Subdivided Lands Law. The statutory penalties for violating these provisions may result in fines, in jail or prison terms, or both not to mention discipline of the real estate licensee who may be acting in an agent or in a principal capacity (or both) in such transactions (Business and Professions Code Sections 11013 et seq. and 11023).

Open-End Deeds of Trust or Mortgages

An open-end deed of trust or mortgage involves a loan arrangement whereby additional amounts of money may be lent in the future (an advance) without affecting the priority of the security instrument. In California, the law provides that additional advances retain the priority established by the recorded deed of trust or mortgage, if the advances qualify as obligatory as opposed to optional (Civil Code Sections 2882 and 2884).

Construction loan advances made pursuant to construction loan agreements and evidenced by a construction promissory notes and deeds of trust or mortgages are obligatory. For example, a supervised institutional or licensed lender operating under government regulation and with sufficient net worth and reserves may well be able to establish that the draws or voucher payments made during the construction period will retain the priority of the recorded documents and instruments, including the construction loan agreements and deeds of trust or mortgages. If properly documented, the same standards should apply to HELOCs.

MLBs should exercise caution when structuring land acquisition and development, vertical construction loans, or HELOCs to adequately address the obligatory or optional advance issue and to establish under what fact situation such loans may be partially funded or funded in stages by private investors/lenders. Partially funded loans when relying on fractionalized note interests to be held by private investors/lenders pose significant problems, including the loss of priority in connection with mechanic's liens occurring during the staged funding and the possible result of a "Ponzi" scheme (even if inadvertent). The question of advance fees also is at issue when such loans are partially or staged funded. Partial or staged funding of construction or rehabilitation loans are expressly prohibited in transactions subject to Business and Profession Code Section 10238(h)(4), the "multi-lender" statutory "quasi-private placement" exemption from qualification under the Corporate Securities Law of 1968.

Wrap-Around Deeds of Trust or Mortgages (Over-Riding or All-Inclusive Trust Deeds or AITDs)

A word of caution is required before discussing this type of financing. Prior to using this security instrument, it is essential that an analysis of the existing financing (typically a conventional loan) be undertaken to learn whether the deed of trust or mortgage includes due-on-sale or due on further encumbrance clauses. Most loans made by depository institutions or licensed lenders, including FHA insured or VA indemnified loans, contain in their loan documents (promissory notes and security instruments), acceleration provisions that either include or substantively describe due-on-sale or due on encumbrance clauses/provisions. These clauses preclude the transfer of the security property to a new owner or the further encumbrance of the property by the owner holding title without the existing lender's prior approval.

Practitioners should be aware that the full implementation of the Federal Deposit Institutions Act of 1982 (Garn-St. Germain Act) has resulted in federal preemption of state law that restricted the right of lenders to accelerate the maturity date of loans secured by real property (regardless of the maturity date set forth in the loan documents) in the event the borrower either transferred the title to or further encumbered the security property, as defined. This includes AITDs and real property sales contracts.

When the security property is an owner-occupied residence, certain exemptions from the exercise of this right were included in the Garn-St. Germain Act. This preemption has limited the ability to lawfully use AITDs and real property sales contracts. Implementing an AITD and a real property sales contract in violation of a due-on-sale or due on further encumbrance clause may result in an allegation of fraud upon the existing creditor/lender and/or professional negligence, including a breach of fiduciary duty. Accordingly, the advice of knowledgeable legal counsel is recommended to ensure the transaction is being conducted lawfully and each party is receiving what they intended and for which they bargained.

During periods of credit shortages and/or “tight-money,” it is may be impossible for some potential buyers to qualify for conventional loans and for other borrowers to refinance existing loans secured by commercial real estate (as defined) held for the production of income or for investment. Often the purpose for refinancing is to raise additional capital or to improve the rate and terms of the financing. The opportunity to refinance may be severely limited. For example, the existing loan may be “locked” precluding prepayment for a prescribed period. Further, the existing loan may not be locked but may include a substantial prepayment penalty or include a yield maintenance agreement that imposes substantial costs for the owner of the property at the time of refinance or prepayment of the existing loan. In addition, loan-to-value ratios established by depository institutions and licensed lenders may limit the ability to refinance. In such circumstances (among others), these owners and their agents may elect to use an AITD as a means of further encumbering or selling the security property.

An AITD, like a junior deed of trust or mortgage, should not disturb the existing loan, yet the debtor is able to borrow an additional amount against the security property to obtain cash or to permit the sale of the property. After the AITD has been arranged, the new lender typically assumes payment of the existing loan while funding a new loan in an increased principal amount at a higher interest rate. The increased principal amount of the AITD includes the unpaid principal balance of the existing loan plus the loan funds advanced (or the AITD reflects the amount of the purchase price being “carried back” by the owner as the seller of the security property).

The borrower makes payment on the AITD to the new creditor/lender that in turn makes payment to the holder of the existing loan, which remains the senior encumbrance against the security property. Although the AITD “wraps around” the existing loan, it is in effect a junior encumbrance that secures the repayment of the debt/loan representing the difference between the unpaid balance of the existing loan and the principal loan amount secured by the AITD. This method has also been used to finance a sale of real estate where the purchaser has only a small down payment. In the case of a seller “carry back”, the AITD evidences the time differential payment of the purchase price. The buyer/borrower executes an AITD to the seller who will collect a larger loan payment from buyer/borrower, and the seller will continue to make payments on the existing loan. The interest rate spread between the amount required under the AITD and the nominal rate on the underlying promissory note evidencing the debt/loan results in an expected profit for the creditor/lender.

Pledged Savings Account Deeds of Trust or Mortgages

Under the pledged savings account loan, also known as the flexible loan insurance program mortgage, or FLIP, part of the borrower’s down payment is used to fund a pledged savings account. The savings account is maintained as cash collateral for the creditor/lender and a source of supplementary payments for the borrower during the first (usually two) years of the loan. Interest on the account is typically paid to the borrower.

Pledged savings account loans are used by depository institutions as additional collateral to reduce otherwise required equity or down payment for residential as well as commercial loans. Pledged savings accounts may also appear in construction loans made by depository institutions as additional collateral to cover performance of obligations that may include the payment of interest during construction.

ADDITIONAL CHARACTERISTICS OF PROMISSORY NOTES AND DEEDS OF TRUST OR MORTGAGES

In General

The parties and the property must be adequately identified in the instruments, and the instruments must be signed by, delivered to and accepted by the appropriate parties. The parties should be named in the security instrument in the same manner they are named in the promissory note, unless additional parties have been added as co-signors or have provided additional or separate collateral secured by separate security instruments.

Further, in spousal circumstances where title is held in joint tenancy or as tenants in common, it is possible for the name of one spouse who is the borrower to appear on the promissory note and the deed of trust or mortgage, or for one borrower to appear on the promissory note and both to appear on the deed of trust or mortgage. Needless to say, the foregoing deviations from the customary practice of the same parties being identified in both the promissory note and deed of trust or mortgage should be reviewed by knowledgeable legal counsel in advance of their use.

Notary acknowledgment of the security instrument is necessary for recording purposes. Subsequent to acknowledgement, no changes may be made to the parties of the instruments without a subsequent acknowledgement.

A valid deed of trust or mortgage must have a valid underlying debt/loan or obligation (whether present or future), otherwise the security instrument secures nothing. Without a debt/loan or an obligation to secure, the security instrument has no meaning and no lien attaches to the intended security property.

One security instrument can secure several debts/loans or obligations (whether present or future), and one debt or obligation can be secured by several security instruments on several parcels of land. Further, a single security instrument may describe several parcels of land as the security for the debt/loan or obligations the promissory note evidenced.

Unless prohibited by law, fractional interests in the fee title to real property as well as the entire fee interest may be hypothecated or pledged, but lenders/creditors or beneficiaries/mortgagees are generally reluctant to lend on partial estates. No requirement exists that the trustor/mortgagor be the debtor. One person may give a deed of trust or a mortgage to secure the debt/loan or obligations of another, or as a surety or guarantor. As previously discussed, the debtor/trustor/mortgagor is usually the same person.

A transaction which is a “hidden security device” (a mortgage transaction disguised to appear otherwise) established by the use of a grant deed as a “deed absolute” to secure a debt/loan or the performance of an obligation will typically be characterized as a mortgage without power of sale subject to judicial foreclosure, including the reinstatement, redemption, and anti-deficiency rules discussed in this Chapter (Civil Code Sections 2925 and 2950). Such transactions are not to be structured by MLBs. Hidden security devices are for legal counsel to consider, if at all appropriate for the fact situation.

A beneficiary/lender/mortgagee of a security instrument with power of sale will usually prefer the publicly held, privately conducted foreclosure sale (trustee’s sale) if the real property is valuable enough to satisfy the debt/loan and expenses of the sale. Since the power of sale eliminates subsequent to the sale the debtor’s/trustor’s/mortgagor’s right of redemption, the trustee’s sale is generally absolute. If the security property’s sale is expected to be insufficient to satisfy the debt/loan, the beneficiary/lender/mortgagee will generally initiate a judicial sale and seek a deficiency judgment following such foreclosure sale when the security instrument is a non-purchase money deed of trust or mortgage. The election of the remedy is the choice of the lender/creditor or beneficiary/mortgagee. This election of remedy is to be made with the advice of knowledgeable legal counsel before proceeding.

Interest-Only Promissory Notes

As previously indicated, an interest-only promissory note is characterized as a straight note in which the monthly payments cover the accruing interest. The unpaid principal balance, which remains constant, is due and payable on an agreed date in the form of a balloon payment. Balloon payments are discussed further in this Chapter.

Depending upon the facts, balloon payments in loans secured by 1 to 4 dwelling units are typically required at the end of periods as short as one to as long as seven years. Most commonly, the balloon payment will be due at the end of a five year period. Shorter periods should be limited to bridge loans such as construction loans or loans where a reasonable method of repayment has been established and assuming the short period for the maturity date does not violate applicable federal or state law.

Balloon Payment Loans

In California, when a private investor/lender makes or funds a loan or when a seller extends credit to the buyer (a "carry back") in the form of a purchase money note and junior deed of trust or mortgage, often the monthly payments to service the debt are either interest only or do not fully amortize the loan or extension of credit. These transactions are typically subject to a due date, e.g., three to five years, at which time payment in full of the principal amount owing plus any interest accrued thereon is required (the "maturity date"). This last payment is called a balloon payment, and the amount owing is generally substantial.

Section 2924i of the Civil Code requires the holder of a balloon payment loan or forbearance with a term in excess of one year secured by an owner-occupied dwelling of four or fewer units to give 90 to 150 days notice in advance of the due date of the balloon payment. Seller "carry backs" are subject to a similar advance balloon payment notice pursuant to 2966 of the Civil Code. Foreclosure of the loan or forbearance or seller "carry back" may not commence without the required balloon payment notice being first given.

Real property loans negotiated by MLBs, junior loans under $20,000, or first loans under $30,000 ("sheltered" loans) are subject to specific controls on broker compensation and to prohibited loan terms, as defined. For example, loans or forbearances secured by non-owner-occupied real property with a term of less than three years require substantially equal installment payments over the period of the loan with the final payment due at the maturity date (the balloon payment). This means the balloon payment may not occur before the 36th month of the loan term. During the period of the loan, no installment shall be greater than twice the amount of the smallest installment.

If the loan or forbearance is secured by owner-occupied real property, the term of the loan must be more than six years to include a balloon payment. Loans or forbearances for six years and less (when the security property is owner-occupied) are subject to limitations regarding the installment payments, whether providing for interest and principal or for interest only. No installment payment during the loan term may be in amount greater than twice the amount of the smallest installment, i.e., no balloon payment until the final payment is to be no sooner than the 73rd month.

The balloon payments that may occur when the loan is "sheltered" must be disclosed in accordance with Business and Professions Code Section 10241.4. The notice is also to contain a statement whether any refinancing, renegotiation or extension of the loan term has been agreed to by the parties, or whether the MLB has undertaken to use his or her best efforts to obtain a future refinancing, renegotiation or extension of the loan described in the disclosure. The outcome of such efforts may well be limited by market conditions operative at the time and to the then credit worthiness and financial standing of the borrower.

A further discussion of the balloon payments described above are included in this Chapter in the Section regarding Article 7 of the Business and Professions Code. The foregoing requirements do not apply to a purchase money note given back to a seller for part payment of the purchase price, a seller "carry back".

Piggybacks or Combo Financing

Piggyback or combo financing is a financing arrangement whereby two conventional loans, one secured by a first deed of trust or mortgage and a second secured by a junior deed of trust or mortgage, are made by the same creditor/lender or by two different lenders to purchase or refinance a residential security property. In a typical scenario, the first conventional loan may provide sufficient funds up to 80% of the purchase price or appraised value of the security property (whichever is less), and the junior loan funds up to an additional 10% for a combined loan-to-value ratio (CLTV) of 90%. Typically, depository institutions and licensed lenders will reduce the LTV or the CLTV for commercial security properties, i.e., other than residential property consisting of 1 to 4 dwelling units.

Since mortgage insurance is normally only required by creditors/lenders on first conventional loans exceeding 80% LTV, piggyback financing has the advantage of avoiding the (non-tax deductible) cost of mortgage insurance in favor of (tax deductible) interest expense on the junior deed of trust or mortgage.

Swing or Bridge Loans
In residential loan transactions, a swing or bridge loan is a temporary loan made against the equity in the borrower's home (which is to be sold), or against the equity in both the present and the "contemplated" home (which is being purchased). The loan funds are used for the down payment on the contemplated residence. In addition, swing or bridge loans are used to finance the construction of the borrower's intended residence.

Where the security property is or is intended to become the residence of the borrower (owner-occupied), the use of swing or bridge loans requires special consideration. For example, a bridge loan for the purposes of applicable California law is defined as a temporary loan having a maturity of one year or less for the purpose of acquisition or the construction of a dwelling intended to become the consumer's (borrower's) principal dwelling (Financial Code Section 4970(d)). Because loans with short maturity dates are subject to extensive regulation, these products should not be offered to private investors/lenders by MLBs without the advice of knowledgeable legal counsel prior to proceeding with such loan transactions.

LOAN PURPOSE

Purchase Loan
A purchase loan is made to finance a portion of the purchase price of the security property. The intended occupancy of the borrower/buyer should be determined at the outset. This status will affect the type of loan product available for the transaction. Owner-occupied conventional purchase loans typically require a down payment of from 5 to 25%. The greater the down payment, the better the rates and terms will be. Minimum down payments and loan-to-value ratios in excess of 80% will generally require mortgage insurance. FHA insured and VA indemnified loans are often used in purchase transactions.

Refinance Loan
A refinance loan is one made to replace an existing loan to borrowers who hold title to the security property. In most cases:

- It occurs for the borrower to obtain more attractive interest rates and loan terms (the interest rate is adjusted to more closely reflect the current market and to achieve a new schedule of payments);
- Some additional credit may be extended ("cash-out"); and,
- The lender and borrower may desire to substitute a basically different kind of loan (e.g., a conventional fixed rate loan to replace an adjustable rate or a negatively amortizing loan).

(Note: As previously discussed, the character of the loan and the deed of trust or mortgage against the security property may be changed through refinancing from that of a purchase money mortgage to a non-purchase money mortgage resulting in personal liability for the borrower and a possibility of a money judgment for deficiencies against the borrower.)

SELLER EXTENDING CREDIT

Structuring the "Carry Back"
A seller who receives a substantial portion of the purchase price from the proceeds of a conventional loan recorded as the senior or first deed of trust or mortgage, plus a down payment from the buyer/borrower that is acceptable to the conventional lender, may be willing to extend credit to assist in completing the purchase price. Generally, the buyer/borrower as the trustor/mortgagor of the conventional loan is required by the beneficiary/lender/mortgagee to pay a down payment equal to at least 5% or as much as 10% of the purchase price, plus the recurring closing costs or pre-paid expenses.

A seller would typically demand and receive an interest rate higher than that of the first conventional loan. However, the terms of the seller's junior loan, including debt service and maturity date, would be subject to the approval of the beneficiary/lender/mortgagee of the first conventional loan.

When a seller "carries the paper," the extension of credit is *a time differential payment of the purchase price and not a loan or forbearance*. The seller imposes and interest rate/yield as compensation for the delay in payment. By definition a seller "carry back" is a "purchase money" deed of trust or mortgage. This financing method may also be used when a seller wants to receive an income spread over a designated period instead of receiving the entire difference between the balance owing on an existing loan to be assumed and the purchase price.

Seller "carry backs" are often used in periods of tight money where buyers/borrowers are unable to make the entire required down payment, whether in the context of financing the purchase through a new conventional loan or through an assumption of an existing conventional loan. "Carry backs" by sellers are evidenced by promissory notes secured by deeds of trusts or mortgages recorded in a junior position that may either be held or sold by assignment or endorsement to a permanent investor/lender, either directly or through use of the services of a mortgage broker.

These promissory notes may be sold subject to a discount depending upon the risk involved and the material terms of the transaction. The material loan terms include due date, principal amount, interest rate, borrower character (including credit worthiness, stability of repayment source, and financial standing), and the market value of the security property. In addition, clauses and provisions to be considered include due-on-sale, due on further encumbrance, late charges, prepayment penalty provisions, or customary acceleration clauses. The foregoing material loan terms, clauses, and provisions will control the amount of discount demanded in the market place by purchasers of promissory notes evidencing seller "carry backs".

Disclosures Required

Since July 1, 1983, in transactions that involve a purchase money deed of trust or mortgage secured by 1 to 4 dwelling units with the seller extending credit in the form of a "carry back", specific disclosures are required to be given to the seller and the buyer by the "arranger of credit". An arranger of credit is typically a real estate broker who has negotiated the sale transaction and the seller's extension of credit. Certain specific disclosures must be made by the arranger of credit to both the seller and buyer, including:

- The identification and a description of the promissory note or other credit documents or security instruments which are the security for the transaction, including the terms, clauses, and provisions of each (or a copy of each document or instrument);
- The terms, conditions, clauses and provisions of each encumbrance which constitutes an existing or intended lien (whether a deed of trust, mortgage, or otherwise) upon the security property that is or will be recorded senior to the seller financing being arranged;
- A warning that if refinancing would be required as a result of the lack of full amortization of the amounts owing of any existing or proposed liens (deeds of trusts, mortgages, or otherwise), such refinancing might be difficult or impossible to obtain at that time in the conventional mortgage market;
- If negative amortization is possible, or the senior loan or the financing being arranged is variable or adjustable, a disclosure of this fact and an explanation of its potential effect must be given;
- If the senior loan or the financing being arranged includes a balloon payment or a right of the lender/creditor/mortgagee or of the seller to require a prepayment of the principal balance (at or after a stipulated date or on the occurrence of a stipulated event), a disclosure of the date and the amount of the balloon payment or of the amount that would be due on the exercise of such right must be given in accordance with Section 2966 of the Civil Code (including no assurance is offered that new financing, loan extension, or forbearance will be available);
- A disclosure of the identity, occupation, employment, income and credit data about the prospective buyer as represented by the arranger of credit or that no representation has been made by the buyer or the arranger regarding credit worthiness and financial standing, which disclosure is to include that

Section 580b of the Code Of Civil Procedure may limit (in the event of foreclosure) any recovery by the vendor to the net proceeds of the security property;

- A statement must be included that the loss payee endorsement has been added to the property insurance coverage to protect the seller's interest or instructions have been given to the escrow holder to accomplish this objective;
- A statement advising the seller that a request for notice of default under Section 2924b and a request for notice of delinquency under Section 2924e of the Civil Code has been made and recorded, or that neither request will be completed or recorded;
- A statement that an appropriate policy of title insurance has been obtained insuring the interest of the seller, or that the seller and buyer should consider obtaining such coverage as well as entering into a tax service contract to be informed if the property taxes and assessments have been timely paid;
- A disclosure whether the security instruments have been or will be recorded pursuant to Section 27280 of the Government Code, or a statement that the security property may be subject to intervening liens that may occur after the promissory note has been executed and before any resort to the security property occurs for payment of the debt/extension of credit (if the security documents or instruments have not been recorded); and,
- If the seller financing involves the use of an all-inclusive deed of trust, then a substantial number of additional disclosures must be given to the seller and buyer. (An all-inclusive deed of trust should not be used by practitioners without the prior advice of knowledgeable legal counsel.)

The arranger of credit is defined to include the real estate broker representing the buyer in residential transactions consisting of 1 to 4 units when the seller extends credit in the form of a "carry back". The arranger of credit is a fiduciary of the buyer and owes duties to the seller whether performing as a dual agent or in conjunction with a separate real estate broker representing the seller (Civil Code Section 2957(a)).

PRIVATE INVESTORS/LENDERS

Private Money Loan Transactions

Loans funded by private investors/lenders and arranged by MLBs that are secured directly or collaterally by liens on real property (deeds of trust or mortgages) have been historically referred to as "hard money" loans. Whether the proceeds of the loan funded by private investors/lenders are for the purchase of the intended security property or used to further encumber or refinance existing encumbrances (including the payment of additional net proceeds to the borrower known as an "equity loan"), the term "hard money" has been historically applied to such transactions.

The term "hard money" has also been applied to loan transactions funded by depository institutions and licensed lenders when the loan proceeds are used to refinance existing encumbrances or to further encumber the security property (including loan transactions where additional net proceeds are paid to the borrower known in this setting as a "cash-out refinance"). The discussion in this Section is intended to apply to loan transactions made or arranged by MLBs with the capital/funds of private investors/lenders.

MLBs also make and arrange loans relying on capital/funds from private investors/lenders where the loan proceeds are used to purchase, develop, or improve the intended security property (land acquisition and development or vertical construction loans). In addition, loans made or arranged by MLBs may be secured by either senior or junior deeds of trust or mortgages.

Many practitioners have redefined making and arranging loans with the capital/funds of private investors/lenders as "private money" transactions. Investment bankers and broker-dealers refer to the use of funds from private investors/lenders as "private equity capital". The traditional term "hard money" has given way to industry use of the terms "private money" or "private equity capital". As a cautionary note, the use of "private money" in a loan transaction does not excuse MLBs from following applicable federal and state law,

including (among others) standards imposed regarding the appraisal of the intended security property and the underwriting of the borrower's credit worthiness and financial standing.

As agents and fiduciaries, MLBs remain subject to the responsibility of ensuring that a reasonable method of repayment of the debt/loan has been established and that the borrower is capable of paying the required mortgage debt service throughout the term of the loan, i.e., the proposed loan transaction is suitable for the borrower. Equally, MLBs must assess whether the intended loan transaction is suitable for the private investors/lenders whose capital/funds are being relied upon to make or arrange the loan. (Business and Professions Code Sections 10131(d) and (e), 10131.1, 10131.3, 10176, 10177, 10232.4, .5 and .6, 10238(h)(3) and (4), 10240 et seq., including 10241.3 and 11302(b), among others).

Transactions with Private Investors/Lenders are Securities

When relying on capital/funds obtained from private investors/lenders for loans secured directly or collaterally by liens on real property (deeds of trusts or mortgages), MLBs must be aware they are performing in three roles under the Real Estate Law and the Corporate Securities Law of 1968 and the respective Commissioners' Regulations pertaining to each. The three roles include issuer, real estate broker acting within the course and scope of his or her license as an agent and fiduciary, and de-facto broker/dealer (Business and Professions Code Sections 10131.3, 10177.6, 10177(q), 10230 et seq., and 10240 et seq., and 10CCR, Chapter 6, Section 2840 et seq. among others; Civil Code Sections 2295 et seq. and 2923.1; Corporations Code Sections 25019, 25100(e), 25206, and 10CCR, Chapter 3, Sections 260.115 and 260.204.1, among others).

If the loan is evidenced by promissory notes issued in series secured by the same deed of trust or mortgage, secured by more than one deed of trust or mortgage of equal priority, or "fractionalized" interests in the promissory notes are sold to private investors/lenders (in "multi-lender" transactions), the loan or the purchase of the promissory notes or interests therein *must* occur through MLBs (Business and Professions Code Sections 10131.3, 10177(n) and 10237 et seq.; and Corporations Code Sections 25100(e), 25102(e), 25102(f), 25102(n), 25102.5 and 25206, and 10CCR, Chapter 3, Sections 260.115 and 260.204.1, among others).

These private investors/lenders are usually persons desiring higher returns on the capital/funds invested in exchange for higher risks than might occur in other forms of investment vehicles. It is possible investments in promissory notes and deeds of trusts may result in lower risks than some alternative investment vehicles. Individual private investors/lenders acting for their own account in "whole note" loan transactions without the loan being arranged by MLBs must still operate within applicable federal and state law governing lending and usury.

Disclosures Required

Private investors/lenders making loans through MLBs must receive disclosures pursuant to Sections 10176, 10177, 10232.4, 10232.5, 10232.6, and 10237 et seq. of the Business and Professions Code, and 10CCR, Chapter 6, Section 2846, among others, including any additional disclosures regarding material facts and investment risks required under the Corporate Securities Law of 1968 and the Corporations Commissioner's Regulations pertaining thereto (Corporations Code Section 25000 et seq. and 10CCR, Chapter 6, Section 260.100 et seq.). These disclosures must be made to private investors/lenders prior to the MLB committing the private investor/lender's capital/funds to loan transactions or to the purchase of interests in promissory notes and deeds of trusts or mortgages.

Borrowers must receive disclosures from MLBs pursuant to Sections 10176, 10177 and 10240 et seq. of the Business and Professions Code and 10CCR, Chapter 6, Section 2840 et seq., among others, prior to becoming obligated to complete the loan transaction.

Whether required to be delivered to private investors/lenders or to borrowers, the objective of these disclosures is to ensure that in either residential or commercial loan transactions (as defined), the principals are making informed and considered decisions to extend credit or to borrow the money, and the proposed loan transactions are suitable for the intended private investors/lenders and the borrowers.

Usury

Private investors/lenders may loan money directly or they may benefit from the usury exemption by lending the funds through an MLB. In California, the passage of Proposition 2 in 1979 made significant changes to the constitutional provisions defining and controlling usury. Thereafter, loans secured directly or collaterally by

liens on real property in the form of deeds of trusts or mortgages made or arranged by licensed real estate brokers (acting as MLBs) became exempt from the usury law.

The California Legislature has applied the usury exemption to loans or forbearances made or arranged by licensed real estate brokers (whether acting as MLBs or as brokers in connection with a related real property transaction) that are directly or collaterally (in whole or in part) secured by liens (deeds of trusts or mortgages) on real property (Civil Code Section 1916.1). The usury exemption extended to real estate brokers (MLBs) applies regardless of the nature of the intended security real property.

Whether a loan made or arranged by a real estate broker (MLB) may be secured "… in whole or in part by liens on real property …" is controversial in the real estate and mortgage industries and among some members of the legal community (Civil Code Section 1916.1). Some observers believe this phrase authorizes MLBs to make or arrange loans secured in part by business or other forms of personal property (including the pledging as additional collateral of other non-real property security interests) even though the real estate license authority for such brokers does not extend beyond loans secured directly or collaterally by liens on real property.

Other observers believe the language was intended to preserve the usury exemption when real estate brokers (MLBs) made or arranged part of the loan within the course and scope of their license authority with the remaining part of the loan being made or arranged by other lenders acting within their license authority. A further interpretation has been applied in narrow circumstances, i.e., when the loan is made in part directly by a principal (person or entity) without the benefit of a license.

A principal acting directly raises additional questions involving the Securities Law and the applicable license law, e.g., a real estate broker's license is required when performing as a mortgage broker (MLB) to issue "multi-lender" promissory notes (Business and Professions Code Sections 10131.3 and 10237; Corporations Code Section 25102.5 and 10CCR, Chapter 3, Sections 260.115 and 260.204.1). Regardless of interpretation, MLBs are unable to include other than the real property security when establishing loan-to-value ratios required pursuant to Business and Professions Code Section 10238(h)(1) and (2).

A real estate broker arranged extension, forbearance, or refinancing of a loan secured in whole or in part by a lien on real property (deed of trust or mortgage) in which the broker had originally been compensated (even though not being specifically compensated for arranging the new credit terms) is also exempt from the usury law. As previously mentioned, private investors/lenders making loans or engaging in such transactions involving new credit terms without having the transaction arranged by a real estate broker are controlled by and subject to the usury law (Article 15, Section 1 of the California Constitution; Civil Code Section 1916.1; Gibbo v. Berger (2004) 123 Cal.App. 4th 396, and In re Lara, 731 F.2d 1455, 1459 (9th Cir. 1984)).

"Multi-Lender" Promissory Notes

Notes in series which are secured by a single deed of trust or more than one deed of trust of equal priority, or notes providing fractionalized interests to no more than 10 investors/lenders (as defined) are securities requiring issuance pursuant to the "quasi-private placement" exemption (as defined) set forth in Business and Professions Code Section 10237 et seq., and in Corporations Code Section 25102.5. The phrase "quasi-private placement" as used in this discussion means a "private placement", which unlike any other such offering allows the issuer to market to private investors/lenders through media and to accept funds from the foregoing even though no preexisting business relationship exists with the issuer.

When private investors/lenders fund or make loans evidenced by promissory notes or purchase interests in promissory notes, the issuance of securities must be addressed to ensure compliance with the Corporate Securities Law of 1968 and the Corporations Commissioner's Regulations pertaining thereto, particularly Corporations Code Sections 25019, 25102 et seq., and 25110 et seq. The "quasi-private placement" exemption is structured to allow "multi-lender" promissory notes to be issued without requiring the issuers to otherwise qualify the offering by "exemption" (a private placement) or by "registration".

The offering of securities must either be qualified pursuant to Sections 25110, 25120, or 25130 of the Corporations Code, i.e., "registered" with and permitted by the DOC, or the securities must meet an exempt "issuer" or "nonissuer" status, arise from an exempt "issuer" or "nonissuer" transaction, or from a transaction exempt through issuance to a "qualified purchaser" (Corporations Code Section 25100 et seq.). The foregoing

"exemptions" must meet each of the standards and requirements imposed pursuant to the Corporate Securities Law of 1968 and the Commissioner's Regulations pertaining thereto.

If the issuer fails to meet each of the standards and requirements imposed to issue an offering pursuant to an applicable "exemption", the offering would be issued in violation of the Securities Law. Accordingly, the issuer may be subject to an enforcement action for securities fraud due to the failure (among other violations) to appropriately qualify the offering with the DOC, i.e., "registering" with and obtaining a permit from the DOC. There are no exemptions from the Corporate Securities Law of 1968 and the Corporations Commissioner's regulations pertaining thereto for fraud or misrepresentation. Furthermore, the failure to comply with the standards and requirements imposed for the applicable "exemption" negates the "exemption", and the burden of proving "…an exemption or an exception from a definition is upon the person claiming it" (Corporations Code Section 25163).

For the purposes of this discussion, offerings of securities that meet the exempt "issuer" or "nonissuer" status, arise from an exempt "issuer" or "nonissuer" transaction, or from a transaction exempt through issuance to a "qualified purchaser" will be referred to as securities qualified by "exemption". Offerings qualified with the DOC and for which a permit has been issued will be referred to as securities qualified by "registration". Accordingly, the offering of securities must be qualified either by "exemption" or by "registration" with the DOC (if the securities are to be issued intrastate) and qualified by coordination with the Securities and Exchange Commission (SEC) when the securities are to be issued both intra and interstate.

Coordination with the SEC is also required if the issuer is unable to qualify the securities under the exemption extended through Regulation D of the Securities Exchange Act of 1933, Section 18(b)(4), and as authorized in 17CFR Section 239.500. Among the standards imposed to qualify by exemption through Regulation D is the requirement that 100 percent of the private investors/lenders and 80 percent of the business of the issuer must be within the same state (Rule 147 promulgated by the SEC).

The issuance of securities by MLBs to private investors/lenders is a very complex matter requiring a practical understanding (at a minimum) of an extensive body of law, including the Corporate Securities law of 1968 and the Corporations Commissioner's Regulations pertaining thereto (Corporations Code Section 25000 et seq. and 10 CCR, Chapter 3, commencing with Section 260.100). A further discussion is included later in this Chapter regarding "multi-lender" transactions authorized by Article 6 of the Business and Professions Code (as noted, a "quasi-private placement").

Subdivision Projects

In recent years, MLBs have arranged loans funded by private investors/lenders secured by raw land for which entitlements were to be obtained, entitled land for purposes of development of offsite (including backbone) and onsite improvements, or for financing vertical construction of building improvements. These loans were made or arranged in connection with subdivision projects. The term "backbone" when describing offsite improvements refers to improvements required by a local political subdivision as part of the necessary public infrastructure to accommodate the development/subdivision.

These loan products are subject to high although diminishing risks depending upon the stage of the project. The highest risk is when the security property is raw land and the loans are made in advance of receiving entitlements. The second level of risk is associated with loans to finance post entitlement land development of offsite (including backbone) and onsite improvements. The third level of risk is the financing of the vertical construction representing the improvements to be built upon the land. Each of the foregoing represent loans for speculative objectives and, therefore, is an example of loans funded with "risk capital".

In each case, the financing obtained from private investors/lenders represents "risk capital" which must be distinguished from other forms of loan transactions in the securities offerings made to the public or pursuant to an authorized exemption (private placement). The "quasi-private placement" authorized pursuant to Article 6 of the Business and Professions Code, commencing with Section 10237 and pursuant to Corporations Code Section 25102.5, is a securities specific exemption from otherwise qualifying by exemption or registration with the DOC (and by coordination with the SEC, if applicable). This exemption is known as the "multi-lender statutory exemption".

MLBs as issuers, real estate broker agents and fiduciaries, and as de-facto broker-dealers must carefully follow without deviation the provisions of the statutory “multi-lender” exemption and the related requirements of the Real Estate Law. It is strongly recommended that MLBs not engage in the financing of land intended for subdivision development, in the financing of offsite (including backbone) and onsite improvements, or in the financing of vertical construction (including rehabilitation loans) without first obtaining the advice of knowledgeable construction and securities legal counsel.

Whether a vertical construction loan is intended to finance a single spot loan for an identified borrower or is intended to finance the construction of homes on a speculative basis within a subdivision project, permanent or “take out” financing should be considered by the borrower and the private investors/lenders. MLBs acting as agents of the private investors/lenders must undertake to underwrite adequately the borrower and the subdivision project to determine whether a reasonable expectation exists to obtain permanent financing to pay off the development or construction loan upon completion of the improvements.

It should be clear that engaging in the issuance of securities (whether in the form of a “multi-lender” transaction authorized by Article 6 of the Business and Professions Code, through an offering otherwise meeting the standards and requirements for exemption, or an offering qualified by registration) is a matter involving a significant amount of complexity. Practitioners should not engage in the issuance of securities (whether the investment vehicle is an equitable or fee interest in the title to or a mortgage interest in real property) without the prior advice of knowledgeable securities legal counsel.

Article 5 – Private Investors/Lenders

The Real Estate Law imposes certain duties and restrictions on real estate brokers (MLBs) who make or arrange mortgage loans directly or collaterally secured by liens on real property (deeds of trust or mortgages). MLBs may act in the secured transaction as either a principal making the loan with the broker’s own funds or with funds the broker controls (as defined), or as an agent of the private investors/lenders or of the borrower, or both.

MLBs may also act as agents of the principals for the purpose of buying, selling, or exchanging existing promissory notes secured directly or collaterally by liens on real property (deeds of trust or mortgages). When MLBs are selling and assigning interests to private investors/lenders in mortgage loans they have funded with their own capital or through independent credit lines they have obtained for this purpose, MLBs are required (pursuant to the Corporate Securities Law of 1968 and the Corporations Commissioner’s Regulations pertaining thereto) to act as the agent and fiduciary of the private investors/lenders.

Real property sales contracts are marketing agreements and security devices/instruments rolled up into one document. While such contracts are authorized under California law, federal law has preempted applicable state law thus prohibiting the use of real property sales contracts when the property described therein is encumbered by deed(s) of trust or mortgage(s) that include due-on-sale or due on further encumbrance clauses (the Federal Depository Intuitions Act of 1982 also know as the Garn-St. Germain Act.) Further, real property sales contracts are subject to significant issues regarding the remedies available to the seller/vendor in the event of a breach or default by the buyer/vendee. For the foregoing reasons, this Chapter focuses on promissory notes and deeds of trust or mortgages rather than on real property sales contracts. Practitioners should not engage in the use of real property sales contracts without the prior advice of knowledgeable legal counsel.

Application of Article 5

The passage of Proposition 2 in November 1979 eliminated interest rate limits on real property secured loans “made or arranged” by real estate brokers (MLBs). The Legislature responded in 1981 and 1982 by extensive additions to the Real Estate Law, specifically to Articles 5 (governing transactions in deeds of trust primarily with private investors/lenders) and to Article 7 (governing real property loans in connection with the duties and obligations owed to borrowers).

Article 5 (Sections 10230 - 10236.6 of the Business and Professions Code) is applicable to arranging the funding of mortgage loans by private investors/lenders who are non-institutional (other than depository institutions) and are not themselves licensed as lenders. Article 5 is also applicable to the buying, selling or exchanging of promissory notes and deeds of trust or mortgages (including interests therein) on behalf of private investors/lenders.

The provisions of Article 5 also apply to real estate brokers (MLBs) who engage in secured transactions as principals in buying from, selling to, or exchanging promissory notes and deeds of trust or mortgages with the public and to MLBs who make agreements with the public for the collection of payments or the performance of services in connection with promissory notes and deeds of trust or mortgages. The Securities Law integrates with Article 5 and alters the principal-only role of the MLB when selling to or exchanging promissory notes and deeds of trust or mortgages with private investors/lenders. As previously mentioned, MLBs engaging in such transactions are required to be the agents and fiduciaries of the private investors/lenders (Business and Professions Code Section 10131.3, Corporations Code Sections 25100(e) and 25206, and 10CCR, Chapter 3, Sections 260.115 and 260.204.1, among others).

Pooling of Loan Funds

Pooling of funds from private investors/lenders' is prohibited except as authorized through qualification by exemption or registration of the offering issued through a permit obtained pursuant to the provisions of the Corporate Securities Law of 1968 and the Corporation Commissioner's Regulations pertaining thereto. As previously mentioned, the Securities Law is administered by the DOC. Capital/funds of private investors/lenders may be accepted for the funding/making of a *specific loan* or the *purchase of a specific promissory note or interests therein*; unless the capital/funds were received through an offering qualified either by exemption or by registration with the DOC that authorizes such pooling of funds (Business and Professions Code, Section 10231 and Corporations Code Sections 25019, 25100, 25102, 25102.5 and 25110 et seq., among others).

When the DOC processes an offering qualified by registration and the applicable requirements have been satisfied, a permit is issued by the DOC (Corporations Code Section 25110 et seq.). Should the offering be qualified by exemption, then the DOC is to be noticed pursuant to Corporations Code Section 25102.1 and in accordance with the related regulations of the Corporations Commissioner. While it is important to comply with the notice provisions of the Securities Law, the failure to notice the DOC may not in and of itself disqualify the offering. However, practitioners should be aware that offerings qualified by exemption, pursuant to Corporations Code Section 25102(f) may be limited to not more than one such offering during a 6-month period before the start of an additional offering to be qualified under this exemption, i.e., not more than two per year (10CCR, Chapter 3, Section 260.102.12).

"Multi-lender" or "fractionalized loans" and promissory notes are subject to the Securities Law (as defined). Article 6 of the Real Estate Law, commencing with Section 10237 of the Business and Professions Code (discussed later in this Chapter) is qualified by statutory exemption (as defined). MLBs who make or arrange loans or who engage in the buying, selling, or exchanging of promissory notes with "fractionalized" interests are issuing securities pursuant to Section 10237 et seq. of the Business and Professions Code and in accordance with Corporations Code Section 25102.5.

Prior to making or arranging "multi-lender" loans or engaging in the buying, selling or exchanging promissory notes or "fractionalized" interests therein, the MLB should obtain the advice of knowledgeable securities legal counsel. Legal advice should also be obtained prior to engaging in any form of pooling of private investor/lender funds.

A further word of caution should be added - while the buying, selling, or exchanging of promissory notes with the public is authorized under the Real Estate Law, these activities are subject to the Securities Law and the MLB's participation therein may be limited or prohibited when relying on the "multi-lender" statutory exemption, or in offerings qualified by exemption (Corporations Code Section 25104(a)).

"Threshold" Criteria

Except as otherwise provided in the Real Estate Law, a real estate broker (MLB) pursuant to Business and Professions Code Section 10232(a) meets the "threshold" criteria if he/she intends or expects in any 12-month period to perform or provide services regarding any of the following:

"(1.) Negotiate any combination of 10 or more of the following transactions pursuant to subdivision (d) or (e) of Business and Professions Code, Section 10131 or Section 10131.1 in an aggregate amount of more than $1,000,000:

(A.) Loans secured directly or collaterally by liens on real property or on business opportunities as an agent for another or others;

(B.) Sales or exchanges of real property sales contracts or promissory notes secured directly or collaterally by liens on real property or business opportunities as an agent for another or others; or

(C.) Sales or exchanges of real property sales contracts or promissory notes secured directly or collaterally by liens on real property as the owner of those notes or contracts.

(2.) Make collections of payments in an aggregate amount of $250,000 or more on behalf of owners of promissory notes secured directly or collaterally by liens on real property, owners of real property sales contracts, or both.

(3.) Make collections of payments in an aggregate amount of $250,000 or more on behalf of obligors of promissory notes secured directly or collaterally by liens on real property, lenders (holders) of real property sales contracts, or both. Persons under common management, direction, or control in conducting the activities enumerated above shall be considered as one person for the purpose of applying the above criteria."

If the lender or promissory note purchaser is a depository institution or a licensed lender (as defined), loans or sales negotiated in connection therewith by a broker (MLB) or for which the broker (MLB) collects payments, are not counted in determining whether the broker (MLB) meets the threshold criteria. Further, if the loan or promissory note transaction occurs under the authority of a securities permit issued by the DOC, such transactions are also not counted to determine threshold broker status. Pension trusts having a net worth of not less than $15 million are also excluded from the count to determine threshold broker status. Generally, real estate brokers (MLBs) dealing with private investors/lenders (whether as individuals or organized as members or partners of a lawfully authorized entity) and small pension trusts are transactions to be counted to establish threshold status (Business and Professions Code Section 10232 et seq.).

A threshold broker must notify the DRE in writing within 30 days of satisfying the criteria described in Business and Professions Code Section 10232 (a) or (b). The notice is intended to advise the DRE the broker (MLB) meets the threshold criteria and is performing as a threshold broker. Failure to timely inform the DRE in writing is subject to a penalty of $50 per day up to and including the 30th day after the first day of the assessment of the penalty and $100 per day thereafter up to a maximum fine of $10,000. The failure to timely notice the DRE may result in the suspension or revocation of the license of the real estate broker (MLB).

A broker (MLB) who meets the threshold criteria must file with the DRE two annual reports within 90 days after the end of the broker's fiscal year and a quarterly trust fund status report within 30 days after each of the broker's first three fiscal quarters. The two annual reports are the Annual Report of a Review of Trust Fund Financial Statements (TAR) and the Mortgage Loan/Trust Deed Annual Report (Business Activities). An extension for filing the TAR is provided upon request, if the broker's fiscal year ends between November 30 and the last day of February of the following year.

These required reports are filed under the penalty of perjury, and, if the broker (MLB) fails to timely file the reports, the Commissioner may cause an examination and report of the MLB's applicable books and records and may charge the broker one and one-half times the cost of making the examination and completing the report. If the broker (MLB) fails to pay the fee as billed, the Commissioner may suspend or deny the renewal of the MLB's license (Business and Professions Code Section 10232.2, 10232.25, and 10236.2).

Disclosure Statements

Business Professions Code Sections 10232.4 and 10232.5 require a real estate broker (MLB) to complete and deliver to private investors/lenders (as defined), or pension trusts that are otherwise not exempt, a disclosure statement known as the Lender/Purchaser Disclosure Statement setting forth, at a minimum:

1. The terms of the loan or of the promissory note;

2. Pertinent information about the borrower (identity, occupation, income, credit data, as represented to the broker by the prospective borrower, or as a result of a separate inquiry of the broker, or through an inquiry of or a report(s) received from a third party, such as a credit reporting agency);
3. Pertinent information about the intended security property, including the address or other means of identification, fair market value, age, size, type of construction and description of improvements obtained from preliminary "title" and appraisal reports;
4. Provisions for loan servicing, including disposition/payment of late charges and prepayment penalty fees;
5. Pertinent information concerning encumbrances which are currently liens against the security property or of which the borrower has knowledge or notice and prospective/contemplated liens which the borrower discloses or are known to the MLB to encumber the security property presently or subsequent to the completion of the transaction;
6. Detailed information concerning any proposed arrangement under which the prospective lender (private investor/lender or the trustee of a pension trust or plan, including when the plan is self directed) will be joint beneficiaries or obligees, along with persons not associated with the private investors/lenders or the trustees (e.g., engaged with other persons in "multi-lender" transactions); and,
7. Whether the solicitation is subject to Business and Professions Code Section 10231.2, and if so, a detailed description of the intended use of the funds being distributed including an explanation of the nature and extent of the benefits to be directly or indirectly derived by the broker (MLB), described as self-dealing (Business and Professions Code Section 10238 (e)).

The Lender/Purchaser Disclosure Statement must be delivered before the private investor/lender or purchaser of a promissory note (or of interests in either the loan or promissory note), as well as a trustee of a pension trust or a plan (including a self-directed plan) becomes obligated to complete the loan or promissory note purchase transaction. When the MLB is engaged in self-dealing, this statement must be delivered to the DRE at least 24 hours in advance of receiving the funds from the private investor/lender (as defined above). Further, the issue of self-dealing by an MLB is subject to the Securities Law and MLBs should not participate in such transactions without the prior advice of knowledgeable securities legal counsel.

A real estate broker (MLB) who advertises for or solicits capital/funds from the public used for the broker's direct or indirect benefit must submit the format of the advertisement and of the disclosure statement to the DRE for approval prior to such solicitation. Each Lender/Purchaser Disclosure Statement to be issued to the private investors/lenders (as defined) when the broker (MLB) is self-dealing, must be submitted to the DRE in advance of receipt of such funds as described above (Business and Professions Code Section 10231.2). The advertising must also meet the requirements imposed pursuant to the regulations of the Real Estate and Corporations Commissioners (10CCR, Chapter 6, Section 2848 and 10CCR, Chapter 3, Section 260.302).

The reference in this section to the use of funds from pension trusts or plans is not intended to suggest these sources may be relied upon by MLBs for the funding of loans or the purchase of promissory notes (or "fractionalized" interests in either) without the prior advice of knowledgeable legal counsel. Transactions with ERISA regulated pension plans or with IRAs or SEP-IRAs may be prohibited and subject to significant penalties imposed by applicable federal law.

Disbursing Funds

Unless a lender has given written instructions knowingly authorizing the broker (MLB) to proceed, the broker may not disburse loan funds until after recording the deed of trust or mortgage which conveys technical legal title to the security property to a trustee as a principal source of the repayment of the loan. If the lender has given the broker (MLB) authority to release funds prior to recordation, the securing deed of trust or mortgage must be recorded, or delivered to the lender with a written recommendation for immediate recordation within ten days following disbursement of loan funds (Business and Professions Code Sections 10233.2, 10234, 10234.5 and 10 CCR, Chapter 6, Section 2841.5).

The broker (MLB) is similarly responsible for the execution and recordation of the assignment of a deed of trust or mortgage when the transaction has been negotiated by the broker (MLB). In addition, the broker is required to deliver or cause to be delivered conformed copies of the deed of trust or mortgage to the investor or lender within a reasonable amount of time from the date of recording. MLBs may delegate this responsibility (subject to written confirmation) to the escrow holder or title insurer escrowing or insuring the loan transaction (Business and Professions Code Section 10234.5). When the investor or lender is a private investor/lender or a group of private investors/lenders (as defined), the broker (MLB) should not proceed to disburse funds before recordation of the security instrument/device.

Table Funding

Table funding by a real estate broker (MLB) is unauthorized and in violation of applicable law (Business and Professions Code Sections 10233.2, 10234, 10234.5 and 10 CCR, Chapter 6, Section 2841.5). The only exemption to the table funding prohibition is found in Section 10234(d). This exemption applies when the lender is a depository institution or a licensed lender (as defined) and when the security property is other than a dwelling (i.e., a single family unit in a condominium or cooperative, or any parcel containing residential units numbering four or less). In addition, if the security property is unimproved, no exemption applies.

Generally, a real estate broker (MLB) *may not table fund any residential mortgage loan or a loan secured by unimproved property* regardless of the status of the lender. Commercial loans (other than a residential mortgage or unimproved land) may be table funded with a lender that either is a depository institution or appropriately licensed under and pursuant to applicable California law.

The concept of table funding has been driven by depository institutions and licensed lenders as a means of reducing capital reserves (among other objectives) to support the loans in their portfolio that have been funded and delivered by MLBs (now also known as MLOs). These institutions and lenders are also concerned about the contingent liability they incur when selling these loans to the secondary market under terms that include an obligation to repurchase (in the event of breaches of specified representations and warrantees), and in connection with servicing agreements when the institutions or lenders retain servicing. Loans delivered by MLBs to depository institutions and licensed lenders that were table funded were characterized as secondary market transactions to allow different treatment when disclosing the compensation paid to MLBs/MLOs and to support how the loan is "booked" as an asset in the records of the depository institutions and of the licensed lenders. While this concept may function in other states, table funding is contrary to applicable California law.

The Real Estate Law (as well as the Finance Lender Law and the Residential Mortgage Lending Act) prohibits table funding in California with narrow limited exemptions (Business and Professions Code Sections 10233.2, 10234, 10234.5 and 10 CCR, Chapter 6, Section 2841.5; 10CCR, Chapter 3, Section 1460; and Financial Code Section 50003 (o) and (t)). When an MLB negotiates a loan secured by a deed of trust or mortgage on real property, the broker is to record or cause to be recorded the security instrument/device in the name of the beneficiary/lender/mortgagee (or an authorized nominee thereof) who shall *not* be the licensee or the licensee's nominee. This also applies when the MLB sells, endorses, or assigns the promissory note and assigns the deed of trust or mortgage securing the loan, i.e., the assignee *cannot* be the licensee or the licensee's nominee (Business and Professions Code Sections 10234 and 10234.5 and 10 CCR, Chapter 6, 2841.5).

To avoid unauthorized table funding, the originator of the loan (e.g., an MLB/MLO) must use its "own funds", as defined. Further, the originator must approve the loan and must be the named payee on the promissory note and identified in the deed of trust or mortgage as the named beneficiary/lender/mortgagee. Delegation of underwriting the loan transaction to a lawfully authorized person is acceptable; however, the creditor/lender must approve the loan transaction, which approval cannot be delegated under applicable law.

California law generally defines "own funds" to mean the capital of the broker (MLB) or of the creditor/lender or funds obtained from an independent line of credit as long as the obligations of the line appear as a debt on the financial statement of the broker (MLB) or of the creditor/lender. The use of "own funds" (as defined) is required to perform as a creditor/lender in the loan transaction. It is brokering, not lending, to fund loans relying on the advance commitment to or the actual purchase of the loan at the close of the loan escrow by a creditor/lender (including when the funds are drawn down for each loan on an individual or loan-by-loan basis). The use of "own funds" (as defined), loan approval, and naming the creditor/lender as the initial payee in the promissory note and as the beneficiary/lender/mortgagee in the deed of trust or mortgage will collectively

constitute evidence of the identity of the actual lender (Business and Professions Code Sections 10131.1, 10233.2, 10234, 10234.5 and 10 CCR, Chapter 6, Section 2841.5; 10CCR, Chapter 3, Section 1460; Financial Code Section 50003 (o) and (t); and 24CFR Parts 3500 et seq.).

Servicing - Broker Advances

A real estate broker (MLB) servicing a promissory note may advance his or her own funds to authorized third parties to protect the security of the loan being serviced, including an advance to pay debt service on a senior promissory note and deed of trust or mortgage secured by the same real property. If the MLB does advance funds for taxes, hazard insurance, or debt service on a senior loan secured by the same real property, the broker must, within ten (10) days, provide written notice of the advance to the beneficiary/holder of the promissory note/loan being serviced (Business and Professions Code Section 10233.1).

Retention of Funds

If a broker receives funds from the obligor/borrower in payment of a promissory note, as is ordinarily the case when servicing the promissory note, the broker may not retain the funds for more than 25 days without written authorization from the obligee/lender to whom the funds are to be disbursed. The authorization from the obligee/lender may not provide for payment of interest to the broker on funds retained by the broker (MLB). Moreover, the agreement between the real estate broker (MLB) and the obligee/lender or obligor/borrower authorizing the broker to service the instrument must be in writing. This 25 day distribution period also applies to the receipt of payoff funds due to private investors/lenders (Business and Professions Code Section 10231.1).

As previously mentioned, an MLB may not accept loan funds except for a specific loan transaction or for the purchase of a specific promissory note or of "fractionalized" interests in either, unless authorized through a qualified and registered offering resulting in a permit being issued by the DOC (Business and Professions Code Section 10231 and Corporations Code Section 25000 et seq.).

Advertising

Business and Professions Code Section 10235 describes as unlawful false, misleading, or deceptive advertising by a real estate licensees (MLBs) engaged in the business of brokering loans or in the sale or assignment of existing promissory notes and deeds of trust or mortgages. These limitations apply whether the advertising occurs through printing, display, publishing, or otherwise distributing through print or electronic media; or telecasting or broadcasting, or in any other manner. An advertisement cannot imply a yield or return on promissory notes different from the interest rates set forth in the notes themselves, unless the advertisement sets forth both the actual interest rates and the differences (discounts) between the outstanding principal balance of the promissory notes and the price at which the notes are being offered for sale.

Article 5 also prohibits real estate licensees (MLBs) from offering or advertising any premium, gift, or other inducement to a prospective promissory note purchaser or lender (private investors/lenders). The Real Estate Law was amended to allow for inducements made available to prospective borrowers, provided the inducements are not intended to steer or direct the perspective consumer/borrower to an unsuitable loan product. No costs or fees may be added or increased to allow for the inducements (Business and Professions Code Section 10236.1).

Real estate licensees (MLBs) are not to place an advertisement to be disseminated primarily in this state for loan transactions or for the sale of promissory notes and deeds of trust or mortgages, unless disclosed within the printed or oral text is the license number of the licensee under which the loan is to be made or arranged or the promissory note is to be sold, endorsed, or assigned (Business and Professions Code Section 10235.5).

The Real Estate Commissioner's Regulations implement the statutory provision against false, misleading or deceptive advertising in areas of mortgage loan brokerage and in the marketing of promissory notes and deeds of trust or mortgages. As previously mentioned in this Chapter, MLBs must disclose their license status and the identity of the regulatory agency in advertisements (regardless of media) concerning contemplated loan transactions or for the intended purchase and sale or assignments of promissory notes and deeds of trust or mortgages.

A disclosure of "Real Estate Broker, CA. Dept. of Real Estate" in mortgage loan advertising complies with applicable law (10CCR, Chapter 6, Sections 2847.3 and 2848). The broker (MLB) license identification number must also be included in the advertisement (Business and Professions Code Section 10236.4(a) and

(b)). When MLBs engage in transactions subject to the Corporate Securities Law of 1968 and the Corporations Commissioner's Regulations pertaining thereto, the advertising regulations of this law must be complied with (Corporations Code Section 25300, 25301, and 25302, and 10CCR, Chapter 3, Section 260.302).

Commissioner's Regulations

Real estate licensees active in the mortgage loan business (MLBs) should be familiar with the Real Estate Commissioner's Regulations set forth in 10CCR, Chapter 6, commencing with Section 2725. Among the most important are Sections 2830.1 et seq. (trust fund accounts/handling); 2840 et seq. (approved borrower disclosure statements and related loan disclosure requirements); 2844 (lending practices for non-traditional mortgage products); 2845 (interpretative opinion request); 2846 (approved lender/purchaser disclosure statements); 2846.5 (report of annual trust fund accounts review); 2846.7 and 2846.8 (filing of annual trust account and quarterly trust fund reports); 2847, 2847.3 and 2848 (advertising requirements, including voluntary submissions); 2849.01, 2849.1 (annual Business Activities Report format and reporting transactions pending at close of the MLB's fiscal year); and 2970 and 2972 (advance fee agreements and related accounting requirements).

Article 6 – "Multi-Lender" Loans

Claim of Qualification by Exemption Rather than Qualifying by Registration of Securities

For the purposes of this section, the term "purchaser" is intended to identify persons who fund loans (typically private investors/lenders, as defined) secured directly by real property or "fractionalized" interests therein or who purchase promissory notes or fractionalized interests therein. The rules discussed under "Article 5" generally apply to promissory notes secured by deeds of trust or mortgages on real property where the beneficiary/lender mortgagee is a private investor/lender or promissory note purchaser. However, when the loan is funded or the promissory note is purchased (including "fractionalized" interests in either) by more than one private investor/lender (as defined), the loan transaction is known as "multi-lender" which describes the use of funds from multiple beneficiaries/lenders/mortgagees.

As previously described in this Chapter, these transactions are known as "multi-lender", "fractionalized" loans, or "fractionalized" promissory notes. By way of review, Corporations Code Section 25019 describes notes as securities (unless subject to a specific exemption pursuant to applicable law, including a statutory/regulatory scheme established for this purpose). "Multi-lender" notes are securities regulated under the Real Estate Law and the Corporate Securities Law of 1968 and the respective Commissioners' regulations pertaining thereto.

To offer interests in a loan or a promissory note to more than one private investor/lender (as defined), the broker (MLB) must either qualify the offering through an exemption or by registration resulting in the receipt of a permit from the DOC, as defined (Corporations Code Sections 25019, 25100(p), 25102(e), 25102(f), 25102(n), 25102.5, and 25110 et seq. (among others). As previously discussed, the *securities specific* exemption for "multi-lender" loan transactions and promissory notes is set forth in Article 6 of the Business and Professions Code, commencing with Section 10237 and in accordance with Corporations Code Section 25102.5.

Notification to the Department of Real Estate

The real estate broker (MLB) must notify the DRE within 30 days after the first "multi-lender" transaction and within 30 days of any material change, as defined in applicable law (Business and Professions Code Section 10238(a) and 10CCR, Chapter 6, Section 2846.1). The purpose of the notification is to inform the Real Estate Commissioner that the broker (MLB) is engaging in "multi-lender" transactions and to inform the Commissioner of various material facts regarding such broker's business plan/model.

A broker (MLB) or other person (including entities) lawfully entitled to become the servicing agent for holders of "fractionalized" promissory notes originated, sold, endorsed, or assigned pursuant to Article 6 must also provide the DRE with notification no later than 30 days after achieving certain requirements pursuant to applicable law. These requirements include, servicing loans for which payments are *due* during any period of three consecutive months in the aggregate that exceeds $125,000 *or* the number of private investors/lenders (including all persons) entitled to receive payments exceeds 120 (Business and Professions Code Section 10238(b)).

Advertising for Private Investors/Lenders
As previously discussed, all advertising soliciting private investors/lenders, note purchasers, or borrowers must comply with the Real Estate Law and the Corporate Securities Law of 1968 and the respective Commissioner's Regulations pertaining thereto (Business and Professions Code 10238(c); 10CCR, Chapter 6, Section 2848; and 10CCR, Chapter 3, Section 260.302).

No expression or implication can be included or made in an advertisement that a contemplated transaction subject to Article 6 of the Real Estate Law has received any approval by the DRE or the DOC. The same standard applies to any offering of securities issued by a real estate broker (MLB), whether qualified by exemption or registration, as defined.

Property Securing the Loan
The real property securing the loan must be located in California and "fractionalized" promissory notes and deeds of trust or mortgages cannot by their terms be subject to subordination to any subsequently created deed of trust or mortgage against the same security property. Further, the "fractionalized" promissory notes and deeds of trust and mortgages may *not be promotional notes*, as defined (Business and Professions Code Section 10238, 10238(d)(1) and (d)(2) and Corporations Code Section 25000 et seq. and Corporations Commissioner's regulations pertaining thereto).

Promotional notes are secured by liens (deeds of trusts or mortgages) on separate parcels of real property in one subdivision or in contiguous subdivisions (or in units or phases of either). Promotional notes are defined to mean promissory notes secured by liens on real property executed on unimproved real property, or executed after construction of an improvement on the security real property, but before the first purchase of the property as so improved, or executed as a means of financing the first purchase of the property as so improved; that is subordinate (or by its terms may become subordinate) to any other deed of trust or mortgage on the security property (as defined).

Real estate brokers (MLBs) may not issue promotional notes, as defined (in a subdivision or contiguous subdivisions, or in phases or units thereof) without qualifying the offering with the DOC, i.e., registering when obtaining a permit from the DOC, unless an exclusion from the definition of promotional notes applies to the transaction. Pursuant to Business and Professions Code Section 10238(d)(1)(2),the definition of promotional notes does not include:

1. A promissory note and deed of trust or mortgage that was executed in excess of three years prior to being offered for sale; or,

2. A promissory note secured by a first deed of trust or mortgage on real property in a subdivision (as defined) that evidences a bona fide loan made in connection with the financing of the usual cost of the development of a residential, commercial or industrial building, or of buildings to be constructed on the security property under a written agreement providing for the disbursement of the loan funds as costs are incurred or in relation to the progress of the work; and further providing, for title insurance "ensuring" (insuring) the priority of the security instrument/device against mechanics' and materialmen's liens, or regarding the final disbursement of at least 10% of the loan funds after the expiration of the period for the filing of mechanics' or materialmen's liens.

It should be noted that the second exclusion does not extend to security property consisting of unimproved land or land that is improved with offsite (including backbone) or onsite improvements. The second exclusion contemplates vertical construction with construction loan agreements entered into describing the manner in which disbursements are to occur and with title insurance coverage insuring the continued priority of the deeds of trust or mortgages (security devices/instruments) against mechanic's and materialmen's liens (Business and Professions Code Section 10238(d)(1) and(2) and Corporations Code Section 25000 et seq.; and the respective Commissioners' regulations pertaining thereto).

"Fractionalized" promissory notes and deeds of trust or mortgages must be secured directly by real property. *No collateral assignments (hypothecations) of "fractionalized" promissory notes and security devices/instruments are allowed*, i.e., hypothecation through collateral assignments of "fractionalized" notes would cause the loss of the "quasi-private placement" exemption from qualification of the securities by registration. This and other

deviations from the standards required in the securities specific statutory and regulatory scheme would be violations of the "quasi-private placement" exemption (Business and Professions Code Section 10237 et seq. and Corporations Code Section 25102.5).

Practitioners should not engage in promotional notes (as defined) or in hypothecations through collateral assignments of promissory notes and deeds of trust or mortgages (whether or not "fractionalized") without the prior advice of knowledgeable securities legal counsel.

The Broker as Issuer and Related Self-Dealing Limitations

The securities represented by "fractionalized" promissory notes and deeds of trusts or mortgages must be issued by and sold through a licensed real estate broker (MLB) who is acting in the capacity of an agent or of a principal in the secured transaction and in the three roles previously described in this Chapter in the context of the securities being issued (Business and Professions Code Sections 10131.3, 10237 and 10238(e), and the Real Estate Commissioner's regulations pertaining thereto; Corporations Code Sections 25019, 25100(e) and 25206, and the Corporations Commissioner's regulations pertaining thereto, including 10 CCR, Chapter 3, Section 260.115 and 260.204.1, among others).

No self-dealing (as described in Business and Professions Code Section 10231.2) is allowed, except under two fact situations described in applicable law, provided the interests of the broker (MLB) or the affiliate of the broker (if any) is first disclosed to the private investors/lenders, and the disclosure includes under what circumstances the MLB or the affiliates acquired their interests in the contemplated transaction. The two exclusions are generally described below:

A transaction in which the broker (MLB) or an affiliate of the broker is acquiring the promissory note and security devices/instruments or the security property that are under foreclosure (including at the foreclosure trustee's sale) of a deed of trust or mortgage for which the broker (MLB) is the servicing agent, or the loan being foreclosed is evidenced by a promissory note and deed of trust or mortgage that was sold, endorsed, assigned, or exchanged to the present holder(s) thereof by or through the MLB; or,

A transaction in which the broker or an affiliate of the broker (MLB) is re-selling from inventory the real property acquired by the holder or holders through foreclosure, provided that the broker (MLB) is the servicing agent of the loan that was foreclosed or the promissory note and deed of trust or mortgage evidencing and securing the foreclosed loan was sold, endorsed, assigned, or exchanged by or through the MLB to the holder or holders thereof.

Applying the language of the two exclusions describing when a broker (MLB) may self-deal in the context of a "multi-lender" transaction or in any other offering of securities (whether qualified by exemption or registration) requires the advice of knowledgeable securities legal counsel.

The Purchasers

The note cannot be sold to more than 10 persons, as defined, who must meet certain income or net worth requirements, i.e., the private investors/lenders must be suitable for the contemplated transaction. The investment cannot exceed 10% of the net worth of the private investors/lenders (the purchaser's net worth), exclusive of home, furnishings, and automobile; or the investment cannot exceed 10% of the adjusted gross income of the private investors/lenders (the purchaser's adjusted gross income).

The foregoing thresholds of 10% of the net worth or 10% of the adjusted gross income apply whether the investment arises from the funding of a "fractionalized" interest in the promissory note and deed of trust or mortgage, or from the purchase of the promissory note or interests therein as an existing asset. The suitability of the private investors/lenders must be considered for the specific transaction and the "thresholds" may not be exclusively relied upon for this purpose (Business and Professions Code Section 10238(f) and the Corporate Securities Law of 1968 and the Corporations Commissioner's regulations pertaining thereto).

The Interests

The interests of each private investor/lender (purchaser) in a "fractionalized" loan or promissory note must be identical in the underlying terms. The terms of the investment representing a "fractionalized" interest in a loan or promissory note directly secured by a deed of trust or mortgage on real property must be the same among the

private investors/lenders. This includes the interest rate, the servicing fees, and how and to whom the late charges and prepayment penalty fees are to be distributed, among others.

Notwithstanding the foregoing, private investors/lenders may invest distinguishable amounts resulting in different percentages of undivided or "fractionalized" interests received in the promissory note and deed of trust or mortgage (security device/instrument). No stripping of principal or interest amounts (including but not limited to income streams or yield spreads) may occur and a private investor/lender may not receive any of the benefits inuring to the beneficiary/lender/mortgagee identified as the initial payee/lender or the endorsee or assignee thereof in the promissory note and deed of trust or mortgage without receiving and holding a ratable "fractionalized" interest as the evidence of ownership as the holder or an undivided interest in a promissory note and deed of trust or mortgage.

Private investors/lenders acquiring interests in promissory notes and deeds of trust or mortgages through mortgage brokers (MLBs) may not evidence such interests through participation certificates or other forms of agreements or contracts. Rather, the interest must be evidence by ratable "fractionalized" assignments in the promissory notes and deeds of trust or mortgages (Corporations Code Section 25100(s).

When a private investor/lender purchases a "fractionalized" interest in an existing promissory note and deed of trust or mortgage from the holder of the interest, the acquisition price may vary to reflect the market price of the interest purchased at the time of purchase. This means the benefits inuring to the purchasing private investor/lender must be identical to the other holders of interests in the "fractionalized" promissory note and deed of trust or mortgage predicated on a ratable assignment of the undivided interest purchased. For example, when considering the purchase of an interest in an existing "fractionalized" promissory note and deed of trust or mortgage, the interest rate of the promissory note, the disposition of late payment charges and prepayment penalty fees, and the servicing fees must be identical among the private investors/lenders who are the holders subject to ratable assignment of the foregoing based upon the undivided interests of each holder. The prohibition regarding principal and interest amounts described in the previous paragraph will still apply (Business and Professions Code Section 10238(g)).

The applicable law controlling the benefits inuring to private investor/lenders holding "fractionalized" interests in promissory notes and deeds of trust or mortgage is similar to the meaning applied by the depository institutions and licensed lenders to the term "pari passu". However, the distinction between the use of this term by depository institutions and licensed lenders as compared to MLBs issuing securities to private investors/lenders is that private investors/lenders do not qualify as investors in transactions where the interests purchased are participations in the form of certificates or otherwise by agreement or contract in pools of mortgage loans.

Such investments are limited to depository institutions and other qualified investment buyers (QIBs) who must meet the predicate qualifications required under Regulation A of Section 4(2) of the Securities and Exchange Act of 1933 in addition to the Corporate Securities Law of 1968 and the Corporations Commissioner's regulations pertaining thereto (15 USC, Chapter 2A, Section 77d and 17 CFR, Chapter II, Section 230.114A, among others; and Corporations Code Section 25100(s)).

Loan-to-Value Ratios, Appraisals, and Construction and Rehabilitation Loans

Article 6 imposes certain loan-to-value limitations on "fractionalized" loan transactions depending on the type of the security real property. In some limited circumstances, the statutory loan-to-value limits may be exceeded if the broker (MLB) deems it to be reasonable and prudent. In such event, the broker (MLB) must include within the transaction file the written justification for and the evidence in support to exceed the statutory loan-to-value ratio limits.

Notwithstanding the foregoing, the loan-to-value ratios may not exceed (together with the unpaid principal balance of any other encumbrance on the security property that is senior to the subject loan) 80% of the current fair market value of the security real property, as improved, or 50% of the current fair market value of the unimproved security real property. When the security property is a single family residentially zoned lot or parcel that has installed offsite improvements (including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the local political subdivision having jurisdiction over the lot or parcel), the maximum

loan-to-value ratio is 65% of the current fair market value (Business and Professions Code Section 10238(h)(1)(2)).

The broker (MLB) must advise the private investors/lenders or promissory note purchasers of their right to receive a copy of an independent appraisal report completed by a qualified appraiser, or the MLB's evaluation of the fair market value of the security real property (if the private investors/lenders have first expressly waived in writing on a case-by-case basis the independent appraisal report). The evaluation of the MLB may not be delegated to another broker and must include the objective data upon which the MLB relied in offering an opinion of value, i.e., no "bald" assertions. Further, the MLB must be qualified by knowledge, experience and training to undertake the valuation of the specific security real property at issue (Business and Professions Code Sections 10232.4, 10232.5, 10232.6, 10238(h)(3), 10241.3, 11302(b) and 11423).

For vertical construction or rehabilitation loans as authorized by Article 6, the fair market value of the intended security property must be estimated by an independent appraiser who is properly qualified for the assignment pursuant to a license or certification issued by the Office of Real Estate Appraisers (OREA). The appraisal report must be completed in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP). These standards generally include an "as is" (current) and an "as completed" (future) estimate of fair market value for the intended security real property.

When the loan being made or arranged relies on a loan-to-value ratio based on the "as completed" or future value of the security real property, a significant number of safe guards must be operative in the contemplated loan transaction, including the aforementioned appraisal standards incorporating USPAP and the use of an appraiser appropriately qualified by license or certification through OREA. Guidance describing the appraisal process to be accomplished, including the approaches, methods and techniques to be applied by the appraiser in arriving at an "as completed" or future value is available in the text published by the Appraisal Institute entitled, "*The Appraisal of Real Estate*" (13th Edition). The safe guards otherwise include:

1. An independent neutral escrow holder to be used for all deposits and disbursements (e.g., a joint control agent authorized pursuant to Financial Code Section 17005.1);

2. The loan is to be fully funded, with the entire loan amount deposited in any neutral escrow prior to recording the deed or deeds of trust or mortgage or mortgages;

3. A comprehensive, detailed, draw schedule is to be used to ensure proper and timely disbursements to allow for the completion of the project;

4. The disbursement draws from the escrow account are based on inspections by an independent qualified person who certifies that the work completed to the date of the draw meets the related codes and applicable standards and that the draws were made in accordance with the construction contract, including the agreed upon draw schedule incorporated in the Construction Loan Agreement;

5. The independent qualified person authorized to make inspections and certified the work completed may not be a person who is an employee, agent or affiliate of the broker (MLB) and is to be licensed as an architect, a structural engineer, or general contractor, or an active local building inspector performing in his or her official capacity to make such inspections (as authorized by the local building official);

6. The loan transaction is properly documented, including the holders of the beneficial interests in the promissory notes and deeds of trust or mortgages evidencing the debt and securing the construction or rehabilitation loan, agreeing to be governed for actions taken by Civil Code Section 2941.9, and the documentation shall include a detailed description of the actions that may be taken in event of failure to complete the project (whether as a result of default, insufficiency of funds or other causes); and,

7. The entire amount of the loan does not exceed $2,500,000 (Business and Professions Code Section 10230(h)(4)).

If the loan is secured by more than one real property, the maximum loan-to-value percentages of each type of property must be met in accordance with the statutory limits imposed (Business and Professions Code Section 10238(h)(1)(2) and (5)). "Multi-lender" notes if secured by more than one real property in a subdivision (as defined) require the use of one promissory note and deed of trust or mortgage recorded as a blanket encumbrance with appropriate release clauses.

Terms of Default and Foreclosure
As previously discussed, the documentation of the transaction must require:

1. A default upon any interest in or in connection with a promissory note and deed of trust or mortgage is a default on all interests or promissory notes and deeds of trust or mortgages evidencing and securing the debt(s) or loan(s) for the subject transactions; and,

2. The holders of more than 50% of the beneficial interests (as defined) are entitled to govern the actions binding all of the holders of the interests in the promissory notes and deeds of trust or mortgages in accordance with applicable law in the event of default, the pursuit of a foreclosure (whether judicial or non-judicial), or for other matters that may require direction or approval of the holders.

The majority action standard to be accomplished in what has been described as a majority action affidavit specifically excludes the real estate broker (MLB) or any affiliate of the broker who has issued or is servicing the loan transaction for determining the majority (defined to be more than 50% of the holders). This exclusion extends to an MLB who is servicing the loan who may not be an affiliate of the real estate broker (MLB) that issued the security (Business and Professions Code Section 10238(i), Civil Code Section 2941.9, and Corporations Code Section 25013).

Receipt of Funds, Disclosures, Trust Accounts and CPA Review
As previously discussed, the broker (MLB) must present to private investors/lenders a specific loan transaction or a specific promissory note in which the requested deed of trust or mortgage investment will be made. Prior to accepting funds from private investors/lenders for a specific transaction (as defined), the MLB must disclose the relevant material facts and investment risks in connection with the contemplated investment. These disclosures typically begin with a summary of the terms of the specific loan transaction or of the promissory note and deed of trust or mortgage in which the funds of the private investors/lenders will be invested.

Should these private investors/lenders express interest in the summarized and described deed of trust or mortgage investment opportunity (whether to fund a loan or to purchase a promissory note or an interest therein), a lender/purchaser disclosure statement (as previously discussed in this Chapter) must be completed and delivered by the MLB before accepting any investment capital/funds. The DRE publishes four lender/purchaser disclosure statements for use by MLBs for carrying out the disclosure objective. MLBs are not entitled to construct their own disclosure forms and are required to request permission from the DRE to rely on forms other than the specific published forms. The request must be made on behalf of at least 25 real estate brokers (MLBs) who have qualified as "threshold" brokers in accordance with applicable law (Business and Professions Code Section 10232(e) and 10232.5(a)(b); and 10CCR, Chapter 6, Section 2846).

The Lender/Purchaser Disclosure Statements published by the DRE are intended for use in distinguishable transactions (as defined) and are numbered 851A, 851B, 851C and 851D. Form 851A is for loan origination (whether funded by a single private investor or "fractionalized"); form 851B is for the sale of an existing promissory note and deed of trust or mortgage or a "fractionalized" interest therein that was not originated by or through the MLB; form 851C is for hypothecations of an existing promissory note and deed of trust or mortgage (which are prohibited in "multi-lender" transactions); and, 851D is when the deed of trust or mortgage describes as security for the repayment of the loan more than one real property (cross-collateralization or blanket encumbrances). The MLB may add addendums to these required Lender/Purchaser Disclosure Statements to ensure the relevant material facts and investment risks are disclosed fully. If more than one real property secures the loan, the broker must disclose to the private investors/lenders the risks associated when securing the loan by multiple properties to the lender or note purchaser (Business and Professions Code Section 10238(l) and form 851D).

All funds received from private investors/lenders are trust funds and must be handled in accordance with Business and Professions Code Sections 10145 and the Commissioner's applicable regulations, 10CCR, Chapter 6, Section 2830.1 et seq. The MLB who issued the securities or who is performing as the servicing agent in "multi-lender" transactions must file CPA-prepared quarterly and annual reports (if the payments *due* in any 3-month period exceed $125,000 or the number of persons entitled to the payments exceeds 120).

The Article 6 reporting criteria for "multi-lender" transactions differs from the Article 5 reporting criteria when reporting loan-servicing activities. The Article 6 criteria applies to payments *due* and the Article 5 criteria applies to payments *collected*. The broker (MLB) engaged in "multi-lender" transactions must also submit an annual report of business activities to the DRE (Business and Professions Code Sections 10238(j), (o), (p)).

Loan Servicing

To service a loan on behalf of the holder or holders, a written servicing agreement is required (Business and Professions Code Section 10233 and 10238(k)). The servicing agreement is a component of the investment contract relationship among the private investors/lenders and the MLB. This investment contract relationship is applicable whether the loans or promissory notes and deeds of trust or mortgages being serviced are "whole notes" (Corporations Code Section 25100(p)), "multi-lender" notes (Business and Professions Code Section 10237 et seq., and Corporations Code Section 25102.5), an offering qualified by exemption (Corporations Code Sections 25102(e), (f), (i) or (n)), or an offering qualified by registration (Corporations Code Section 25110 et seq.).

The tests to apply for the purposes of establishing an "investment contract" include:

1. An investment of money due to;
2. An expectation of profits arising from;
3. A common enterprise; and,
4. Which depends solely on the essential management efforts of a promoter or third party.

The MLB is the promoter or third party whose management efforts are essential in each of the scenarios described above, unless the "whole note" (loans made by one private investor/lender, as defined) is neither underwritten nor serviced by the MLB (Securities and Exchange Comm. v. W. J. Howey Co., 328 U.S. 293 (1946) and Securities and Exchange Comm. v. Glenn W. Turner Enterprises, Inc., et al., No., 474 F.2d 476(9th Cir.1973)). Under the Real Estate Law, loan servicing on behalf of another or others for compensation or expectation of compensation (regardless of form or time of payment), requires a real estate broker's license unless the person or entity is exempt from such licensure (Business and Professions Code Sections 10131(d), 10133, and 10133.1).

The payments received on the promissory notes and deeds of trusts or mortgages or interests therein must be transmitted pro-rata to the owners or holders of the promissory notes (i.e., ratably according to their respective interests) within 25 days of receipt of the payments by the servicing agent. The loan-servicing agent (MLB) must file a request for a notice of default upon any prior encumbrances and promptly notify the promissory note owners (holders) of any notice of default (Business and Professions Code Sections 10233 and 10238(k)).

Identities of the Purchasers

Upon request, the broker (MLB) as the issuer or the servicing agent must give private investors/lenders (whether holders of "fractionalized" interests in loans evidenced by promissory notes and secured by deeds of trust or mortgages or purchasers of promissory notes or interests in either), the names and addresses of the purchasers of the interests (Business and Professions Code Section 10238(m)). The MLB must keep accurate records of the names and addresses and other relevant information on private investors/lenders whether participating in a "multi-lender" transaction (a "quasi-private placement"), another form of private placement through an offering qualified by exemption, or an offering qualified by registration.

No Option to Purchase
The broker (MLB) cannot have any option right or an agreement that grants a future right to acquire (including re-purchase) the "fractionalized" interests of the private investors/lenders or to acquire the security real property, except as authorized by applicable law (Business and Professions Code Section 10238(n)). As previously discussed, the broker (MLB) may acquire the interests of the private investors/lenders in the context of a foreclosure or in connection with the security real property after the foreclosure has occurred (Business and Professions Code Section 10238(e)).

The MLB may acquire the interests of private investors/lenders (as the issuer of the securities or as the servicing agent), provided the concurrent consent of the private investor/lender is obtained. Pursuant to the foregoing, the MLB may acquire such interests whether the interests are in "fractionalized" promissory notes and deeds of trust or mortgages or in the security real property held by the private investor/lender subsequent to a foreclosure. When the "fractionalized" promissory note and deed of trust or mortgage represents securities issued pursuant to the "multi-lender" statutory exemption, or is issued through an offering qualified by exemption (as defined), the interests acquired by the MLB may not be re-sold in violation of applicable law (Business and Professions Code Section 10238(n) and Corporation Code Section 25104(a)).

Conclusion
Brokers (MLBs) must use an abundance of caution when engaging in "multi-lender" transactions, a statutory "quasi-private placement" exemption from qualification of the securities granted pursuant to the Real Estate Law and the Real Estate Commissioner's Regulations pertaining thereto, and the Corporate Securities Law of 1968 and the Corporations Commissioners regulations pertaining thereto (Business and Professions Code Section 10237 et seq. and Corporations Code Section 25102.5, among others).

This exemption is securities specific and any violation of the provisions of the exemption from otherwise qualifying by registration may result in a violation of the Real Estate Law and in a violation of the Corporate Securities Law of 1968, including the respective Commissioners' Regulations pertaining to each (Business and Professions Code Sections 10131.3, 10177(n) and 10237 et seq., and the applicable regulations of the Real Estate Commissioner, among others; and Corporations Code Sections 25019, 25102.5 and 25206, and the applicable Regulations of the Corporations Commissioner's, among others).

Violations of the securities law are subject to criminal prosecution. Therefore, it is prudent and recommended that MLBs seek the advice of knowledgeable securities legal counsel prior to engaging in "multi-lender" transactions qualified by statutory exemption, or transactions involving interests in real property (whether equitable or fee or a mortgage interest) otherwise qualified by exemption or qualified by registration.

EFFECTS OF SECURED TRANSACTIONS

As previously indicated in this Chapter, the terms "debtor", "borrower", "trustor", and "mortgagor" may be used together, separately, or in some combination. Unless specifically noted, they are interchangeable terms describing the person or entity who has borrowed money, the repayment of which is secured by real property. Further, the terms "creditor", "lender", "beneficiary", or "mortgagee" may be used together, separately, or in some combination. Unless specifically noted, they are interchangeable and are intended to describe the person or entity that has loaned money, the repayment of which is secured by real property.

Having subjected property to the lien of a deed of trust or mortgage, the debtor/borrower/trustor/mortgagor should be aware of some of the effects of these security instruments. Among the more important effects are:

1. Assignment of the debt by the creditor;

2. Transfer of the property by the borrower;

3. Acceleration due to breaches and default (including due-on-sale and due on further encumbrance);

4. Offset/Estoppels Statements and Certificates;

5. Lien priorities; and,

6. Purchase Money vs. Non-Purchase Money Deeds of Trust or Mortgages.

Assignment of Debt by the Creditor

The assignment of a debt secured by a mortgage carries with it the security. An attempted assignment of the mortgage without the note transfers nothing to the assignee, but a transfer of the note without the mortgage gives the assignee the right to the security (Civil Code Section 2936).

An assignment of a deed of trust or mortgage may be recorded and recordation gives constructive notice to all persons (Civil Code Section 2934). After the promissory note has been transferred (assigned or endorsed) and the assignment of the deed of trust or mortgage has been recorded, the debtor is not protected if he continues making payment to the original lender/creditor. Failing to record the assignment would prevent constructive notice being transmitted to all persons regardless of notice of transfer of loan servicing. Recent amendments to federal and state law require notice to the debtor/trustor/mortgagor of any transfer of servicing agent (Civil Code Section 2937 and 24 CFR Section 3500.21).

Business and Professions Code Sections 10233.2, 10234, 10234.5 and 10 CCR, Chapter 6, Section 2841.5 require every licensee negotiating a loan secured by a deed of trust or mortgage, or where the promissory note or interests therein are being sold or assigned, to cause the deed of trust or mortgage or the assignment thereof to be recorded. When delivering these instruments to the lender or assignee (including private investors/lenders), the licensee is to in writing recommend that the deed of trust or mortgage or the assignment thereof be immediately recorded, if the licensee has not already recorded such instruments on behalf of the lender or assignee thereof.

Should the licensee be acting as an MLB and be servicing the loan secured by real property, the MLB may retain the original promissory note and deed of trust or mortgage but perfect delivery to the lender and/or the assignee or assignees thereof by recording the required instruments in the office of the County recorder in which the security property is located. A conformed copy of the promissory note and deed of trust or mortgage should be delivered by the MLB to the lender (or to each of the private investors/lenders). The ability of the MLB acting as a servicing agent under a written agreement with the lender (including private investors/lenders) or assignees thereof to retain the promissory notes and security instruments is authorized in applicable law (Business and Professions Code Sections 10233.2, 10234, and 10234.5).

Transfer of the Security Property by Borrowers

When encumbered real property is transferred, the buyer either obtains new financing (and the existing loan is paid off), buys the property “subject to” the existing loan, or “assumes” the loan. Buyers may not take title to the security property “subject to” and existing loan when the deed of trust or mortgage securing the loan includes a due-on-sale clause. Taking title “subject to” the existing loan may result in no personal liability to the buyer; however, the advice of knowledgeable legal counsel should be obtained prior to proceeding with such transactions.

Despite the transfer to the buyer of the security property, the seller will (except in purchase money mortgage fact situations) remain personally liable to the lender for the loan repayment. Even in purchase money fact situations, the seller may remain liable to the lender to the extent of collateral actions that may be pursued by the lender, including actions for fraud. Further, the credit worthiness and financial standing of the seller remains at issue if the buyer fails to timely perform each of the obligations set forth in the promissory note or mortgage. The purchase money exception limits the availability of pursuing a money claim that results from a deficiency judgment. The lender would be required to look only to a sale of the security property to recover the amount of the debt/loan.

If the loan terms do not include a due-on-sale clause and as long as the buyer makes the loan payments in a timely manner and holds, keeps, and performs each and every obligation set forth in the promissory note and deed of trust or mortgage (e.g., cultivates, irrigates, fumigates, and otherwise keeps and maintains the security property in good and tenable condition), no problem should occur for the original maker of the loan and trustor/mortgagor. If the buyer defaults and the loan is not a purchase money loan, the lender can look to the seller/original maker for payment, even years after the transfer was made. The seller may also suffer a loss of

credit status due to the purchaser's failure to timely make the payments or perform each of the obligations required of the maker.

Under a loan assumption, the buyer becomes the principal debtor and the seller either may remain liable to the lender as a continuing maker, or may become liable to the lender as surety for any deficiency resulting after the sale of the property. The safest arrangement for the seller is to ask the lender for a substitution of liability, releasing the seller of all liability in consideration for assumption of the debt/loan and of each and every obligation thereof by the buyer. In such circumstances, the buyer must qualify as though they were the maker of the loan.

Acceleration Due to Breaches and Defaults

Deeds of trust and mortgages generally contain clauses giving the lender the right to declare the full amount of debt/loan due and payable upon defined breaches and default, including the failure to timely pay debt service, property taxes when due, or the happening of a certain event such as failure to maintain the security property or to proceed with an unauthorized transfer or further encumbrance of the security property, i.e., due–on-sale and due on further encumbrance clauses.

"Due-on-sale" and due on further encumbrance clauses, are forms of an acceleration clause. These clauses give the lender the right or option to insist the loan be paid off or renegotiated when the title to the security property is transferred or further encumbered. When loan funds are available at acceptable interest rates, buyers ordinarily obtain new financing and the seller pays off the existing loan as part of the terms of the purchase and sale transaction. In times of scarce money, escalating interest rates, enhanced loan underwriting standards, or declining property values; buyers may prefer (as previously discussed) to assume or take "subject to" the existing mortgage. Lenders generally do not want to be "locked" into long-term, lower-than-market-rate loans. Often, lenders will argue that they must not only watch the value of their existing loans decline, but also are forced to pay higher interest rates to depositors who otherwise would withdraw funds and seek higher returns in other investments.

The issue of a lender's right to automatically enforce a "due-on-sale" provision upon transfer of the mortgaged property has been resolved in favor of the lender, as a result of the 1982 United States Supreme Court decision, Fidelity Federal Savings and Loan Association v. de la Cuesta (1982 458 US 141), and the 1982 federal legislation to which this Chapter has previously referred, the Federal Deposit Institutions Act of 1982 (also known as the Garn- St. Germain Act). These amendments to the law provide for specified exemptions when the security property is a single family owner-occupied residence. Of course, loan documents containing no due-on-sale clause are not affected by the operative changes in applicable law.

Brief Overview of Due-On-Sale and Due On Further Encumbrance Clauses

The California Supreme Court ruled in Wellenkamp v. Bank of America (1978) 21 Cal. 3d 943, that a state-chartered institutional lender could not automatically enforce a due-on-sale provision in its loan documents to accelerate payment of a loan when residential property securing the loan is sold by the borrower. Under this ruling an institutional lender had to demonstrate that enforcement was necessary to protect against impairment of its security or the risk of default (character and credit considerations).

In its opinion, the court reviewed prior decisions, particularly La Sala v. American Savings and Loan Association (1971) 5 Cal. 3d 864, and Tucker v. Lassen Savings and Loan Association (1974) 12 Cal. 3d 629. In La Sala, further encumbering of real property through a second loan in the form of a junior deed of trust or mortgage was found to be insufficient justification for acceleration of the maturity date. In Tucker, sale of the property under a real property sales contract (installment contract) was held to be insufficient justification.

A flurry of California court cases followed Wellenkamp addressing issues it left unresolved, such as the applicability of Wellenkamp to private lenders, commercial as well as residential property, and federal regulations preempting state laws on due-on-sale and due on further encumbrance provisions. The Wellenkamp rule was found applicable to California real property and real property secured transactions.

However, federally-chartered banks and savings and loan associations successfully asserted that the validity and automatic exercise of due-on-sale or due on further encumbrance provisions is applicable to them notwithstanding state law to the contrary. As previously mentioned, this contention was upheld by the United States Supreme Court in Fidelity Federal Savings and Loan Association v. De La Cuesta (1982) 458 US 141.

On October 15, 1982, the Federal Depository Institutions Act of 1982 (the Garn-St. Germain Act) became effective. As mentioned previously with certain limited exceptions, the law makes due-on-sale or due on further encumbrance provisions in real property secured loans automatically enforceable by all types of lenders, including non-institutional private investors/lenders.

These amendments to federal law preempted state laws and judicial decisions which restrict enforceability of due-on-sale or due on further encumbrance provisions in promissory notes and security instruments. In addition, FHA and VA have since implemented rules and regulations restricting the transferability of the loans they insure or indemnify.

Enforceability

The following concerns the automatic enforceability of due-on-sale and due on further encumbrance provisions in loan instruments:

1. Federally-chartered savings and loan associations may automatically enforce due-on-sale and due on further encumbrance clauses in promissory notes and deeds of trust that they originated while federally chartered;

2. With certain exceptions of limited application, all loans originated after October 15, 1982 may be accelerated, upon transfer of the property securing the loan, if the security instrument includes a due-on-sale clause; and,

3. As of October 15, 1985 with very few exceptions, loan transfers or further encumbrances of the security property without the consent of the existing lender are no longer possible in California.

Other Exceptions

Where the security is the owner-occupied residence of the borrower, notable exceptions to automatic enforceability of due-on-sale or due on further encumbrance clauses enumerated under the law include, among others, the following:

1. Creation of a junior deed of trust or mortgage (liens) on the security property which are not related to a transfer of the rights of occupancy;

2. Transfer of the property by one joint tenant to another joint tenant;

3. Transfer to a relative or descendent of a borrower resulting from the death of the borrower; and,

4. Transfer into a revocable inter-vivos trust of which the borrower is the settlor and beneficiary, if it does not relate to a transfer of rights of occupancy of the security property.

Special Provision

As previously discussed in this Chapter, a clause in any deed of trust or mortgage that provides for acceleration of the due/maturity date upon sale, conveyance, alienation, lease, succession, assignment or other transfer of property (containing four or fewer residential units) subject to a deed of trust or mortgage is invalid unless the clause is printed, in its entirety, in both the security instrument and the promissory note or other document evidencing the debt/loan and the obligations (Civil Code Section 2924.5).

Caution Regarding Due-On-Sale and Due On Further Encumbrance

Proposed loan transfers, whether as the result of assumptions or taking title “subject-to”, must be very carefully considered in light of the Supreme Court ruling allowing the nation’s federal lenders to automatically enforce due-on-sale provisions in their loans and the effects of the Garn-St. Germain or Federal Depository Institutions Act of 1982. This federal law limited, and in California by 1985 eliminated, except in certain fact situations (regarding single- family owneroccupied security properties), automatic transfers of loans or further encumbrances of the security property secured by real property with due-on-sale or due on further encumbrance clauses within the security instruments. Covert transfers, no matter how structured, are not an acceptable

practice and are to be avoided by real estate licensees. Again, the advice of legal counsel is recommended before proceeding with transfers of the security property while leaving an existing loan in place.

Offset/Estoppel Statements and Certificates

In transactions involving an assignment of an existing mortgage or deed of trust or mortgage to an investor, an offset statement is customarily obtained for the benefit of the investor. The information included in the offset statement (often referred to an estoppel certificate) is typically the unpaid balance of the promissory note, the date to which interest is paid, the interest rate, the payment amount and due date, the maturity date of loan, the existence of due-on-sale or due on further encumbrance clauses, as well as other forms of acceleration clauses that are of interest to an assignee or endorsee, and whether the property owner has any claims which do not appear in the promissory notes and security instruments being purchased by the investor. The offset/estoppel statement/certificate is in addition to the beneficiary statement of current loan status from the lender. Together the offset/estoppel and beneficiary statements/certificates confirm to the person/investor purchasing the existing loan the nature of the obligations of the property owner (trustor/mortgagor) that will inure to the benefit of the new holder of the deed of trust or mortgage (assignee).

Lien Priorities

Ordinarily, different liens or encumbrances upon the same security property have priority according to the time of their recordation. Notice is an important element in the determination of priority. Notice may be actual or it may be constructive from recordation, thus giving notice of the lien or encumbrance to subsequent buyers and encumbrancers for value (including junior lien holders such as deeds of trust or mortgages). Actual notice will be imparted through an investigation of the occupancy of the security property, including other manners of receiving specific notice of the liens or encumbrances in question. For example, an occupant of an intended security property under a lease with an option right, pursuant to a land contract of sale, or in accordance with an executory purchase and sale agreement, would impart actual notice of the equitable interest in the title that arises from any one of the foregoing documents/instruments and the equitable interest would be prior to any subsequently recorded deed of trust or mortgage.

County and municipal property taxes and authorized assessments are “super liens” and retain priority over deeds of trust and mortgages no matter when recorded. Where there are special assessments affecting the security property, such assessments impart notice to all persons when recorded. These assessments, whether bonds or otherwise, are subordinate to all fixed assessment liens previously imposed on the property. These special assessments would retain priority over all fixed assessment liens that are subsequently recorded against the same property.

Generally, special assessments are coequal to and independent of the lien for general property taxes, except as otherwise provided for by applicable law. Special and ad valorem assessments have the same priority as property taxes, including each installment due as required by the terms of the foregoing. They each retain super lien status over deeds of trusts or mortgages and other liens and encumbrances no matter when recorded (Government Code Section 53930 et seq.)

Purchase Money vs. Non-Purchase Money Deeds of Trust or Mortgages

Purchase money mortgages are described in California law to include deeds of trust or mortgages. Two distinct definitions of purchase money debt exist under applicable law. One definition applies to the issue of priority over all other liens created against and brought with the buyer to the property, subject to the operation of the recording laws when the deed of trust or mortgage is given for the price of the security real property. In such event, the liens created against the purchaser are junior or subordinate to the purchase money deed of trust or mortgage. This rule protects even third persons who furnished money, but only when it is loaned for the express purpose of acquiring the security property (Civil Code Section 2898).

For purposes of establishing whether a deficiency judgment may be obtained against the debtor/borrower, the deed of trust or mortgage must be given to the seller/vendor to secure the payment of the balance of the purchase price of the security real property. When given to a third party lender to secure repayment of a debt/loan or obligation, the proceeds of the debt/loan must have been used to acquire the security property and the borrower must intend to occupy entirely or in part as his/her residence. The security property must consist of 1 to 4 dwelling units. Third party financing of the purchase of 1 to 4 dwelling units for the purpose of investment or the production of income does not qualify the deed of trust or mortgage as purchase money.

When the loan is secured by a purchase money deed of trust or mortgage, as defined, and the borrower fails to pay the debt/loan according to its terms, the lender/creditor/beneficiary can generally look only to the security property or to the proceeds of sale from the property for payment.

This limitation applies whether the security property is sold through judicial or a non-judicial foreclosure. The inability to obtain a deficiency judgment may not preclude the lender/creditor/beneficiary from proceeding against the borrower under a collateral action theory, including an action for fraud (Code of Civil Procedure Sections 580b, 580d, and 726 et seq.; and Financial Code Section 7460).

Under current applicable law, refinancing the owner-occupied security property alters the character of the security instrument from a purchase money to a non-purchase money deed of trust or mortgage. Further, if the security property for the loan is other than 1 to 4 dwelling units (e.g., commercial, income producing property, or land) and the lender is a third party (the extender of credit was other than the seller/vendor), the deed of trust or mortgage is characterized as a non-purchase money security instrument.

With a non-purchase money deed of trust or mortgage, the lender/creditor/beneficiary may generally proceed through the security property and obtain a money judgment for the difference between the amount received at a judicial foreclosure sale and the total amount of debt/loan owing (including authorized fees, costs, and expenses). The court may order a fair value hearing to ensure the property is sold at the foreclosure sale in an amount consistent with its appraised value or as expressly ordered by the court (Code of Civil Procedure Section 580a).

LENDER'S REMEDIES IN CASE OF DEFAULT

Foreclosures Generally

Foreclosure is a procedure used to terminate the right, title, and interest of a trustor/mortgagor in the security real property by selling the encumbered property and using the sale proceeds in an effort to satisfy the debt/loan of the lender/creditor.

A mortgage without a *power of sale* can only be foreclosed judicially (i.e., by court proceeding) pursuant to the Code of Civil Procedure, commencing with Section 695.010, "The Enforcement of Money Judgments". A deed of trust or mortgage that contains a *power of sale* may be foreclosed nonjudicially by trustee's sale in accordance with the procedural law provided for in Civil Code Section 2924 et seq. Most security instruments utilized in California expressly provide for *power of sale,* thus offering a choice to the lender/creditor of electing a non-judicial or judicial foreclosure sale.

As previously discussed in this Chapter, where anti-deficiency judgments are sought and permitted by law, the foreclosure must be accomplished judicially. The lender/creditor may proceed in the same court action to foreclose, quiet title, and to eject the trustor/mortgagor, and to then proceed through the sale of the security property (should the proceeds prove to be insufficient to fully pay the debt/loan) to obtain a money judgment as ordered by the court. Money judgments are evidenced by an abstract of judgment which may be enforced against the assets of the borrower/debtor through a writ of execution. The entire proceeding constitutes one form of action comprised of respective parts (Code of Civil Procedures 726 et seq.).

As a general rule, procedural requirements in effect at the time the judicial foreclosure is begun will govern, even if the requirements change (Code of Civil Procedure Section 725a et seq.). However, when amendments occur to the non-judicial foreclosure procedural law, careful reading of the amendments is required to learn the operative dates of each amendment and the effect the amendments may have on non-judicial foreclosures in process (Civil Code 2924 et seq.).

"One-Action" Rule

Under California law, the "one-action" rule applies for recovery of any debt or enforcement of any right secured by a deed of trust or mortgage on real property (Code of Civil Procedure Section 726).

The "one-action" rule requires the beneficiary/lender/mortgagee to first foreclose the security property before seeking a personal money judgment against the maker/trustor/mortgagor. The personal money judgment represents the deficiency between the amount of debt/loan (including any related authorized fees, costs and expenses), and the amount received for the property at the judicial foreclosure sale.

The foregoing assumes this second part of the action is permitted under the anti-deficiency rules. Only after the security has been exhausted may the unpaid lender/creditor seek a personal money judgment against the maker/trustor/mortgagor. However, this stepped judicial procedure may not apply to guarantors. It should be noted that a maker/trustor/mortgagor cannot guaranty his or her own debt. Depending upon the facts, limited exceptions to the "one-action" rule may be available, e.g., the security becomes worthless due to the act or negligence of the maker/trustor/mortgagor.

If a property is ''legally" worthless (i. e., nonexistent or not actually owned by the maker/trustor/mortgagor, or in a situation in which foreclosure would be meaningless because the security has been destroyed or has become valueless not from any action of the creditor/lender) or where fraud is involved, the creditor/lender is not limited to the "one-action" rule. Under such circumstances, the creditor/lender may sue directly on the promissory note and need not first judicially foreclose.

California Financial Code Section 7460 authorizes depository institutions and their affiliates (as defined) to seek damages for alleged fraud from the maker/trustor/mortgagor in an amount not to exceed 50% of the actual damages, unless the security property is the owneroccupied residence of the borrower and the amount of the loan is $150,000 or less (this amount being adjusted annually, commencing January 1, 1987, in accordance with the Consumer Price Index published by the United States Department of Labor).

"Worthless security" does not include a loss in property or security value due to marketplace or economic declines. Unless expressly authorized in the security instrument to occur with prior notice during the loan term, the creditor/lender must generally first foreclose to have the court determine "economic worthlessness" in the form of an opinion of value of the security property (an appraisal) and whether a writ of attachment may be granted in connection therewith.

Status of "Sold Out" Junior Lien Holders

A first deed of trust or mortgage is a security instrument that achieves in the records of the county where the security property is located first priority as the result of the date and time of recordation or through an express subordination of a previously recorded security instrument. First deeds of trust or mortgages take precedent and have priority over junior deeds of trusts or mortgages, i. e., security instruments that are either recorded subsequent to or expressly subordinated to the prior recorded deed of trust or mortgage. A foreclosure by the holder of a first deed of trust or mortgage will extinguish junior deeds of trust and mortgages and other liens that are recorded subsequent to the prior recorded deed of trust or mortgage (as defined) except for super liens, e. g., property taxes or certain bonds and assessments. This is known as lien cleansing.

A holder of a junior deed of trust or mortgage or other lien holders in such circumstances are "sold out" juniors. Should the junior lien be a purchase money deed of trust or mortgage, the holder cannot proceed with a suit for a money judgment for the amounts owed in accordance with the terms of the promissory note. However, if the junior lien is a non-purchase money deed of trust or mortgage, the holder is not barred from proceeding with such a suit.

As to the Parties

When the deed of trust or mortgage includes a power of sale, there are three parties to the security instrument. In a deed of trust the three parties are: the trustor (borrower), the trustee (third party), and the beneficiary (creditor/lender). In a mortgage with power of sale, the three parties are the mortgagor (borrower), the trustee (third party), the mortgagee (creditor/lender). The trustor/mortgagor conveys technical title to the trustee to hold until the trustor/mortgagor performs or defaults under the terms of the promissory note and deed of trust or mortgage.

California is a lien theory not a title theory state. Accordingly, the technical title conveyed does not carry with it limitations on the exercise of the "Bundle of Rights" extended to property owners under our constitutional system, including the rights of possession and use of the security property. Therefore, the conveyance of technical title is to accomplish a hypothecation or pledging of the security property as collateral for the repayment of the debt/loan or the performance of an obligation without giving up the right to use and further encumber the security property.

In the deed of trust or mortgage, the trustee's function is to reconvey or release the technical title received by the trustee to the security property back to the trustor/mortgagor when the debt/loan is paid in full. The trustee

also is authorized to proceed with the power of sale to nonjudicially foreclose and sell the security property to pay the debt/loan, should the trustor/borrower breach the terms of the promissory note and deed of trust or mortgage. The third power or authority conveyed to the trustee is to execute any instruments as directed by the beneficiary/creditor/lender to reform the description of or any other provision of the deed of trust or mortgage.

The trustee in a mortgage with power of sale performs much the same functions as under the deed of trust. In a mortgage, the manner through which to evidence the repayment of the debt/loan is historically known as a certificate of discharge/satisfaction of mortgage. However, a mortgage with power of sale should be treated by the trustee in the same manner as a deed of trust with a power of sale for this purpose, i. e., a deed of reconveyance may be used.

As to Reinstatement

Under a deed of trust or mortgage, the trustor/mortgagor and certain other persons, including successors in interest and subordinate lien holders listed in Civil Code Section 2924c, may reinstate the loan by curing the default at any time in a non-judicial foreclosure proceeding up to five days prior to the date of the scheduled trustee's sale or the date of the postponed trustee's sale.

In a judicial foreclosure proceeding, the same parties may reinstate before the sale is conducted as ordered by the court. Reinstatement is accomplished by paying all delinquencies, including advances made by the lender to a senior lien holder , plus all authorized fees, costs and expenses incurred because of the foreclosure action.

Under either security instrument, the lender's right to accelerate payment of the debt/loan in the event of a breach or default is limited by the statutory right of reinstatement. This right is intended to provide the trustor/mortgagor with an opportunity to cure the breach or default (assuming it is curable) within a defined period prior to the trustee's sale or prior to the court ordered judicial sale. An example of a non-curable default is a breach of the due-on-sale or due on further encumbrance provisions.

As to Redemption

Code of Civil Procedure Section 729.020 provides that property sold subject to the right of redemption may be redeemed after the sale only by the judgment debtor or his successor in interest (i.e., the trustor/mortgagor). Liens are money claims and include, among others, deeds of trust and mortgages. Junior lien holders are no longer entitled to redeem the debt or loan represented by a senior lien. The junior lien (including deed of trust or mortgage) cannot reattach unless pursuant to an order by a court of competent jurisdiction.

Accordingly, a junior lien holder must proceed with a lawsuit in the form of an action for a money claim for amounts remaining owed to secure an abstract of judgment as an unsecured creditor. As indicated, liens are money claims and also are encumbrances against the title of the security property; however, all encumbrances are not liens. An example of an encumbrance that is not a lien is an easement.

The redemption period is three months after the judicial sale date, if the sale proceeds are sufficient to pay the secured indebtedness (debt/loan) plus interest and costs of foreclosure. The redemption period is one year after the judicial sale date, if the sale proceeds do not satisfy the amount of the debt/loan plus interest, authorized fees, costs, and expenses. However, if the beneficiary/lender/mortgagee waives or is prohibited from obtaining a deficiency judgment (e.g., a non-purchase money loan subject to a non-recourse agreement), there no longer would be any right of redemption according to Code of Civil Procedure Section 726 (the "one-action" rule).

Under a deed of trust or a mortgage with power of sale, the trustor/mortgagor in most cases has a statutory right of reinstatement after the notice of default up to five business days prior to the date of the trustee's sale or the date of any postponed sale and a right of redemption thereafter up to the time that the trustee or the agent of the trustee cries the sale. No right of redemption applies following the trustee's sale. The sale is absolute unless otherwise ordered by a court of competent jurisdiction in a subsequent proceeding brought to set aside the sale.

As to Deficiency Judgments

A deficiency judgment is a personal judgment against a debtor/borrower for the difference between the unpaid balance of the secured debt/loan (plus interest, authorized fees, costs, and expenses of sale) and the amount of the actual proceeds of the sale. Depending upon the language used in establishing prepayment or yield maintenance provisions (and assuming these provisions have not been imposed inconsistent with applicable law), the additional amount due will increase the unpaid balance of the secured debt/loan.

Anti-deficiency Rules
Where a beneficiary or mortgagee elects to foreclose the security by *power of sale* (non-judicial foreclosure) rather than by judicial foreclosure, a deficiency judgment is automatically barred under Code of Civil Procedure Section 580d. Section 726 et seq. of the same code sets certain limits for a deficiency judgment; and Section 580b prohibits deficiency judgments when specified purchase money secured loans are involved (as previously discussed in this Chapter).

A seller/vendor extending purchase money credit generally cannot obtain a deficiency judgment if the trustor/mortgagor breaches or defaults and a foreclosure sale fails to bring sufficient proceeds to pay off the entire amount owing under the promissory note. An exception to this rule exists in the sale of a property to a developer for land development or vertical construction and the seller/vendor subordinates his or her purchase money lien to the deed of trust or mortgage evidencing the land development or construction loan. Upon default by the purchaser/developer, the seller/vendor would typically lose his or her security interest after a foreclosure sale under the senior lien. However, Code of Civil Procedure Section 580b will not be applied to bar recovery by the subordinating junior seller/vendor of the unpaid balance of the purchase price of the security property when the senior deed of trust or mortgage is a land development or vertical construction loan (Spangler v. Memel (1972) 7Cal. 3rd 603).

As previously discussed, if the proceeds of the court ordered sale pursuant to a judicial foreclosure were adequate to satisfy the entire amount owing, the redemption right extended to the debtor/borrower would be limited to three months. Should the proceeds from the court ordered sale of the security property be insufficient to pay the entire amount owing (as defined), the lender/creditor may elect to sue the debtor/trustor/mortgagor for the residual balance owing pursuant to the terms of the promissory note. When a deficiency judgment is permitted following a judicial foreclosure and the court ordered sale of the security property, the redemption right extended to the debtor/trustor/mortgagor is for one year following the sale.

Purchase money anti-deficiency provisions also apply to installment land contracts, and to instruments determined to be, in fact, security devices (disguised mortgages such as equitable liens or, as previously mentioned, hidden security devices). Disguised mortgages of whatever nature are not to be pursued by MLBs without the involvement of and advice from knowledgeable legal counsel.

To determine whether a deficiency judgment will be allowed where third-party lenders are involved, secured transactions falling outside the provisions of Code of Civil Procedure Section 580b (i.e., non-purchase money transactions) depend upon a "purpose" scrutiny and a security property and related analysis by a court of competent jurisdiction.

A borrower/trustor/mortgagor generally cannot waive at the time of executing the security instruments and related loan documents the anti-deficiency protections granted by applicable law. These protections are generally deemed to be a non-waiveable public policy (Civil Code Section 1667). In narrow fact situations, it may be possible for the borrower/trustor/mortgagor to execute a waiver of rights concerning the protections granted against deficiency judgments or the "one-action" rule. However, such waiver attempts should not be accomplished without the prior advice of knowledgeable legal counsel.

Short Sales
Finally, legislation effective January 1, 2011 altered the anti-deficiency rules with respect to short sales. Senate Bill 931 amended Section 580e of the Code of Civil Procedure stating that a lender holding a first deed of trust secured by a dwelling consisting of not more than 4 units cannot obtain a deficiency judgment in a short sale transaction if the lender agrees in writing that they will accept the sale proceeds as payment in full for the amount owed. However, if the borrower commits fraud in the transaction or commits waste with respect to the property, the lender can seek damages against the borrower.

As to Guarantors
When the deed of trust or mortgage is guaranteed by a third party other than the maker/trustor/mortgagor, the surety or guarantor may waive rights of subrogation, reimbursement, indemnification, or contribution and any other rights and defenses that are or may become available to the surety or guarantor by reason of applicable law. This would include, among others, any rights or defenses the surety or guarantor may have by reason of an

election of remedies by the lender/creditor or that the promissory note or other obligations are secured by real property.

In the context of the repayment of the debt/loan or performance of the obligation being secured by real property, the rights or defenses the surety or guarantor may have include, but are not limited to, any rights or defenses pursuant to sections 580a, 580b, 580d, or 726 et seq. of the Code of Civil Procedure. As a predicate to the waiver of the foregoing rights and defenses, the surety or guarantor must affirmatively waive these rights and defenses in the manner described and with the language required pursuant to Civil Code Section 2856, commonly known as the Gradsky waiver.

As to Satisfaction of Mortgages

When any mortgage has been satisfied, the mortgagee or the assignee of the mortgagee must initiate the discharge procedure by executing a certificate of the discharge/satisfaction, as provided in Civil Code Section 2939. This provision applies to mortgages without the *power of sale*. The mortgagee is to within 30 days of satisfaction, record or cause to be recorded (except as limited by applicable law) such certificate of discharge/satisfaction in the office of the county recorder in which the mortgage is recorded. Upon written request of the mortgagor, the mortgagee shall then deliver the original promissory note marked paid in full and the mortgage instrument to the person entitled to make such request and to receive these instruments (Civil Code Section 2941).

When the debt/loan or the obligations secured by any deed of trust or mortgage with *power of sale* has been paid in full or satisfied, the beneficiary or mortgagee or the assignee of either shall deliver to the trustee the original note and deed of trust or mortgage together with a request for a full reconveyance or for a certificate of discharge/satisfaction with such other documents as may be necessary to reconvey and extinguish the deed of trust or mortgage from the title of the security property.

Within 21 calendar days after receipt of all necessary documents, instructions and authorized fees, costs, and expenses, the trustee is to execute and record or cause to be recorded (except as limited by applicable law), a full reconveyance or a certificate of discharge/satisfaction in the office of the county recorder in which the deed of trust or mortgage is recorded. Upon the written request of the trustor/mortgagor, the trustee shall then deliver the original note marked paid in full and the deed of trust or mortgage to the person entitled to make such request and receive such instruments. A copy of the reconveyance or discharge shall be delivered to the lender/beneficiary/mortgagee, its successor in interest, or its servicing agent, if known (Civil Code Section 2941).

Limitations to Recording of Reconveyance or Certificate of Discharge/Satisfaction

Pursuant to Civil Code Section 2941 and other applicable law, the trustee under a deed of trust or a mortgage with *power of sale* (or a mortgagee of a mortgage without *power of sale)* are not to record or cause the deed of reconveyance or the certificate of discharge/satisfaction to be recorded when any of the following circumstances exist:

1. The trustee or mortgagee has received written instructions to the contrary from the trustor or mortgagor, from the current owner of the land, or from the lender/mortgagee of the debt/loan or obligations secured by the deed of trust or mortgage (or from the lender's/mortgagee's servicing agent, if known), or from the escrow holder designated for this purpose;
2. The deed of full reconveyance or certificate of discharge/satisfaction is to be delivered to the mortgagor or trustor, or to the current owner of the land, through an escrow (as requested by the escrow holder) to which the mortgagor, trustor, or current owner of the land is a principal or a party; and,
3. When personal delivery is requested in writing by the mortgagor or trustor, or by the current owner of the land, or by the authorized agent of either (with the understanding the reconveyance or discharge is to be recorded by said parties).

Required Timely Recording of the Deed of Full Reconveyance or Certificate of Discharge/Satisfaction

If a deed of full reconveyance (or certificate of discharge/satisfaction) is not issued and recorded within 60 calendar days of the payment in full of the debt/loan, or release of or the performance of the obligations, and upon receipt of a written request by the trustor/mortgagor or the trustor's/mortgagor's heirs, successors in

interest (including assignees), or by an authorized agent of the foregoing, the beneficiary/lender/mortgagee may execute and acknowledge a document substituting another as trustee to issue a deed of full reconveyance or a certificate of discharge/satisfaction (Civil Code Sections 2934a, 2939 and 2941).

It is clear deeds of trust and mortgages have been deemed to be functional equivalents under applicable California law and that each security instrument may include a *power of sale.* What remains unclear as of this writing is whether the mortgagee of a mortgage with *power of sale* will issue or cause to be issued a certificate of discharge/satisfaction or whether the trustee will be instructed to issue such certificate. In any event, the trustee's interest in a mortgage with *power of sale* must also be extinguished at the time of payment in full of the debt/loan or performance of the obligations.

If a deed of full reconveyance (or as applicable, a certificate of discharge/satisfaction) is not executed and recorded in accordance with the previous paragraphs or within 21 days of the trustee's receipt of all required documents, instruments, instructions and authorized fees, costs, and expenses necessary to effect the reconveyance or discharge, then within 75 calendar days of payment in full or satisfaction of the debt/loan or release of or performance of the obligations, a title insurance company may elect to prepare and record a release of the debt/loan or of the obligations. The release shall be deemed, when recorded, to be the equivalent of a reconveyance of the deed of trust (or as applicable, the discharge/satisfaction of the mortgage).

However, at least 10 days prior to issuance and recording of a full release pursuant to this paragraph, the title insurance company shall mail by U. S. Mail, first-class with postage prepaid, to the trustee, trustor/mortgagor, and beneficiary/mortgagee (beneficiary/lender/creditor) of record, or their successors in interest, at the last known address for each party the intention to release the debt/loan or the obligations.

The release shall set forth:

1. The name of the beneficiary/lender/mortgagee;
2. The name of the trustor/mortgagor;
3. The recording reference to the deed of trust or mortgage;
4. A recital that the debt/loan or obligations secured by the deed of trust or mortgagee have been paid in full; released or performed; and,
5. The date and amount of payment, release or performance.

Sanctions and Penalties

Failure to comply with Civil Code Section 2941 makes the violator liable to the person affected for all damages sustained by reason of the violation. Further, the violator must forfeit to that person the sum of $500. In addition, Civil Code Section 2941.5 provides that every person who willfully violates Section 2941 is guilty of a misdemeanor punishable by a fine of not less than $50 or more than $400, or by imprisonment in a county jail not to exceed 6 months, or by both such fine and imprisonment. The trustee's failure to timely deliver the deed of reconveyance (or the certificate of discharge/satisfaction, if applicable) has resulted in the trustee being subjected to emotional damages under a tort theory in addition to the sanctions and penalties (Pintor v. Ong (1989) 211 Cal.App 3rd 837).

Fees for Services Rendered

A trustee, beneficiary or lender/mortgagee may charge a reasonable fee to the trustor or mortgagor or the current owner of the land for services involved in the preparation, execution and recordation of the full reconveyance (or as applicable, the discharge/satisfaction) including, but not limited to, document preparation and forwarding services, plus any additional official fees that may be required (e.g., notary and recording).

Unless the lender/mortgagee is exempt from applicable state law, the fees charged for the foregoing are not to exceed $45 plus official fees. These fees are conclusively presumed to be reasonable. It is important to note that such fees cannot be charged prior to the opening of a bona fide escrow, or more than 60 days prior to full satisfaction of the debt or obligations secured by the deed of trust or mortgage.

Reinstatement Rights - Pre-sale
As previously discussed under a judicial foreclosure, a trustor/mortgagor or his or her successor in interest, any beneficiary/lender/mortgagee under a subordinate deed of trust or mortgage, or any other person having a subordinate lien or encumbrance of record, may reinstate the debt/loan at any time before entry of judgment by restoring the loan (usually to its installmentpayment basis) by paying the delinquencies and advances on the debt/loan plus authorized fees, costs, and expenses. Thereupon, all foreclosure proceedings terminate and the loan continues in full force and effect as if no such acceleration proceeding had taken place.

As previously mentioned, under a *power of sale* exercised in a non-judicial foreclosure, the statutory right of reinstatement for the individuals named above ends five business days prior to the date of the trustee's sale or the date of any postponed sale.

Redemption Rights - Post-sale
By way of review, only the judgment debtor or his or her successor in interest may redeem the security property subsequent to a judicial foreclosure sale. All junior lien holders are eliminated under the law effective July 1, 1983 (Code of Civil Procedure Section 729.020). Further, the redemption period is three months, if the sale proceeds satisfy the debt/loan plus interest, costs of the action, and authorized fees, costs, and expenses. If sale proceeds are insufficient to pay the entire amount owed (as defined), the redemption period is one year (Code of Civil Procedure Section 729.030). If the creditor waived the deficiency judgment or it was prohibited, there is no right of redemption (Code of Civil Procedure Section 726(e)).

During the redemption period permitted following a judicial foreclosure and a court ordered sale of the security property, the judgment debtor or tenant occupying the property is entitled to remain in possession but must pay rent to the successful bidder/buyer following the judicial foreclosure sale.

Often a deed of trust or mortgage permits the beneficiary/lender/mortgagee to take legal possession of the security property upon default prior to the foreclosure sale (whether a judicial or a trustee's sale) under the "assignment of rents" provision and manage the property, pay expenses, and collect the rents, applying the net proceeds to the maintenance of the property and to preserve the lender's security. However, to proceed to exercise an "assignment of rents" provision may require a court order appointing a receiver who will collect the rents and maintain the security property as authorized by the order.

Should the assignment of rents provision in a deed of trust or mortgage be in connection with a loan made on security property that is non-owneroccupied and the provision is deemed to be an absolute rather than a conditional assignment of rents (and a court of competent jurisdiction does not disagree with this legal conclusion), the lender/beneficiary/mortgagee may be able to take control of the security property without a receiver as a beneficiary/mortgagee in possession. Such an action should not be taken without the prior advice of knowledgeable legal counsel.

Statute of Limitations
Civil Code Section 2911 provides that a lien is extinguished if an action on the underlying debt or obligation is not brought within the required time limits. Judicial foreclosure actions must be filed within four years after maturity of the obligation or any installment payment. Deeds of trust and mortgages secure a written debt/loan or the performance of obligations that if not paid as agreed or performed create a cause of action in connection with the promissory note (evidencing the debt and representing the agreement to repay) for four years following the default, the date the loan matures, or the date that the debt was last acknowledged by the debtor/borrower, whichever occurs last.

However, a deed of trust or a mortgage with *power of sale* conveys to the trustee technical legal title to the security property for the purposes of exercising the powers granted to the trustee. Even though the statute of limitations bars an action on the promissory note, the *power of sale* continues and may be exercised, whether the security instrument is a deed of trust or mortgage. Except as amended in Civil Code Section 822.020, the "1982 Marketable Title Act" requires the security instrument to be periodically renewed to continue to be enforceable.

The 2006 amendments to Civil Code Section 882.020 provide the lien of a deed of trust or mortgage shall expire 10 years after the final maturity date or the last date fixed for payment of the debt/loan, if the date can be ascertained from the recorded document. If the final maturity date cannot be determined from the recorded

document, then the deed of trust or mortgage shall expire 60 years after the date the security instrument was originally recorded.

However, if a "notice of intent to preserve interest" is recorded prior to the expiration of the lien (whether a deed of trust or mortgage) under either of the above scenarios, then the enforceability of the security instrument shall be extended for an additional 10 years after the notice is recorded.

Judicial Sale

A judicial foreclosure is usually sought when a beneficiary or mortgagee wants to obtain a deficiency judgment. The mortgagee or beneficiary, as well as the servicing agent (including MLBs), must be mindful of whether a deficiency judgment against the debtor/borrower will be sought before electing the foreclosure remedy. Consultation with knowledgeable legal counsel is recommended before selecting the foreclosure remedy, i.e., a judicial foreclosure or non-judicial foreclosure.

The Process

The judicial foreclosure sale process involves:

1. Filing a complaint and notice of action (lis pendens) which will bind all persons acquiring liens or interests in the property during the pendency of the action;

2. A summons served on the parties whose interests are to be eliminated/extinguished, such as the trustor or his successor in interest and junior lien holders, including in deeds of trust or mortgages;

3. The trial, after which the judgment is entered (decree of foreclosure and order of sale); and,

4. The recording and serving by the Sheriff of Notice of Levy followed by the Notice of Sale.

The Notice of Sale cannot be earlier than 120 days after recording and serving of the Notice of Levy if a deficiency judgment is barred or properly waived.

When a deficiency judgment is available, the property is sold subject to the one-year redemption period, the 120-day notice period is not required and only a 20-day Notice of Sale is needed. The 20-day Notice of Sale must be made by posting the Notice of Sale in a public place and on the property at least 20 days before the sale and by publishing the notice once a week for three weeks in a newspaper of general circulation in the city or judicial district in which the property or any portion of the property is located. The notice must also be mailed to all defendants at their last known address and to any other person who has requested to be notified.

The Court Supervised Sale

The court ordered sale is to be held between 9 a.m. and 5 p.m. on a business day in the county where the property or some portion of the property is located. The foreclosing lender/creditor, debtor/borrower, junior lien holders (including deeds of trust or mortgages) and others may bid at the sale. The foreclosing lender/creditor may credit-bid up to the amount owed to it, him or her, and cash bid in excess of the amount of the debt/loan.

All other bidders must bid cash except that a bidder may, if the bid price exceeds $5,000, deposit with the party conducting the sale the greater of $5,000 or 10 percent of the bid amount, and pay the balance within ten days of the sale, plus interests, fees, costs, and expenses as authorized by the court. Should the successful bidder fail to pay the amounts owed pursuant to the successful bid, he or she may be subject to costs and damages as determined by the court. In such an event, a second sale is required.

After the Sale

The Sheriff issues the highest bidder a prescribed Certificate of Sale stating the title is subject to any redemption privilege of the debtor/borrower. The certificate operates to transfer title to the highest/successful bidder. The bidder/purchaser receives no rights to possession for the period of redemption, but does have the right to receive the rents inuring from or impose rents for the occupancy of the property. The title received by the highest/successful bidder is subject to any senior liens but free of any junior liens, including deeds of trust or mortgages. The Certificate of Sale is recorded. Recording of the certificate does not result in clear, marketable title. Such title will not be achieved until the Sheriff issues a Deed of Conveyance, as described below.

Sale proceeds are applied to costs of the lawsuit and attorney fees; to selling expenses; to the amount due the beneficiary/mortgagee of the security instrument foreclosed; to junior lien holders (including deeds of trust or mortgages) in order of priority; and finally the excess to the debtor/borrower (if any).

If the debtor/borrower does not redeem the property within the 3-month or l-year redemption period (as applicable), the Sheriff will issue a Deed of Conveyance containing special recitals concerning the judicial foreclosure and court ordered sale and will record or cause to be recorded the deed conveying title to the highest/successful bidder to whom the Certificate of Sale was previously issued. The grantee receives all right, title and interest of the trustor/mortgagor as of the date of initial recording of the deed of trust or mortgage foreclosed upon (i.e., the title conveyed relates back to the date of initial recording). The grantee may now evict the trustor/mortgagor or tenant in possession.

A lender/creditor seeking a deficiency judgment must file application in the court case within three months of the sale for a determination of the deficiency. If the court enters a deficiency judgment against the trustor/mortgagor and it is recorded by the beneficiary/lender/mortgagee, the judgment becomes a lien upon all property owned by the debtor/borrower or acquired by him or her within ten years of the entering of the judgment ruling.

If a debt/loan is secured by both real and personal property, the creditor may foreclose upon the real property under the *power of sale* and bring a separate action on the personal property security pursuant to the Commercial Code, or may (if authorized in the security instruments) elect to foreclose both the real and personal property security pursuant to the rules applicable to real property as set forth in Civil Code Section 2924 et seq.

Trustee's Sale - "Power of Sale"- Non-Judicial Foreclosure

When the security instrument includes a *power of sale,* the alternative remedy for a creditor/lender to proceed against the security property (in the event of a breach or default by the debtor/borrower) is through a non-judicial foreclosure. A non-judicial foreclosure results in a privately conducted but publicly held "trustee's sale" pursuant to the *power of sale* included within the security instrument. The exercise of the *power of sale* must be at the direction of the beneficiary/lender/mortgagee to whom the power is typically conferred (Civil Code Sections 2932 and 2932.5).

The Procedure

Accordingly, the beneficiary/lender/mortgagee following a breach of the terms and provisions of the promissory note and/or the security instrument (usually a failure to make specified installment payments of principal and interest or to make a balloon payment) and will notify the trustee to issue and record a Notice of Default. When notifying the trustee, the beneficiary/lender/mortgagee may (but often does not) deliver the original note and deed of trust or mortgage to the trustee. Further, adequate evidence of the amounts owing that are delinquent and/or in breach in the case of a monetary default, and/or in breach of the required performance of the obligations described in the security instruments in the case of a non-monetary default are to be provided to the trustee by the beneficiary/lender/mortgagee.

The amounts to reinstate or cure a monetary default will likely vary during the non-judicial foreclosure proceeding. Accordingly, the amounts owing that are reported delinquent and in breach to the trustee will not be comprehensively set forth in the Notice of Default as these amount may increase. Also, the debtor/borrower may be required as a condition of reinstatement to provide reliable evidence of the payment of senior liens (including deeds of trust and mortgages), property taxes, assessments, property casualty insurance premiums, and of the payment of any other liens in the chain of title that are to be paid to protect the security of the beneficiary/lender/mortgagee).

The document prepared by the beneficiary/lender/mortgagee to inform the trustee of the breach is generally referred to as a Declaration of Default. Usually, the trustee named in the security instrument is a corporate entity. The named trustee or properly substituted trustee prepares and records the Notice of Default and proceeds thereafter as a limited agent with the non-judicial foreclosure (Civil Code Sections 2924c and 2934a).

In the absence of an applicable agreement to the contrary, any one beneficiary in a "fractionalized" deed of trust may invoke the *power of sale* and initiate the non-judicial foreclosure by preparing and delivering to the trustee a Declaration of Default. Civil Code Section 2941.9 was added to establish a process through which the

beneficiaries of a deed of trust may agree to be governed by beneficiaries holding more than 50% of the recorded beneficial interests in the fractionalized promissory note evidencing the debt secured by the deed of trust (or in a series of notes secured by the same property by a deed of trust or deeds of trust of equal priority), exclusive from any notes or interests therein held by a licensed real estate broker (including MLBs) or any affiliate of the broker that is the issuer or servicer of the promissory notes and deeds of trust. Applicable law establishes a process through which the parties must agree in writing to majority rule and each "fractionalized" note holder or holders of notes issued in series must be noticed of the action taken. The majority action agreement between the note holders must be in the form of an affidavit and is to be acknowledged and recorded (Business and Professions Code Section 10238 et seq.; and Civil Code Section 2941.9).

The individual action of the holder of a fractional interest in a promissory note or of the holders of notes issued in series secured by the same deed of trust or by deeds of trust of equal priority, may also be limited by the administration, operation and management agreement (including loan servicing) representing the investment contract relationship established as part of the offering/prospectus resulting in the issuance of securities either by exemption, registration, or coordination (Securities and Exchange Comm. v. W. J. Howey Co., 328 U.S. 293 (1946) and Securities and Exchange Comm. v. Glenn W. Turner Enterprises, Inc., et al., No. 72-2544, 474 F.2d 476(1973)).

At the time of the preparation of the Declaration of Default, the beneficiary/lender/mortgagee will inform the trustee of the date of the original breach or default. Typically, the trustee obtains from the title company a trustee's sale guarantee report (TSG) assuring the trustee of the identity of the holders of and the priority of liens against the security property (including deeds of trust and mortgages) and to whom notice is required, among other matters. The trustee then prepares, records, mails, and posts on the security property the Notice of Default and Election to Sell pursuant to the *power of sale* (Civil Code Section 2924 et seq.).

Since non-judicial foreclosures are conducted in accordance with procedural law, it is important compliance with applicable law occurs. Any irregularity or defect in carrying out this procedure may invalidate the trustee's sale. The *power of sale* and the procedural law to which non-judicial foreclosures are subject are based upon Civil Code Section 2924 et seq., a codification of the process through which non-judicial foreclosures may be conducted without state action, i.e., a procedural and not a substantive law (I.E. Associates v. Safeco Title Ins. Co. (1985) 39 Cal.3d 281, 287-288).

Unless a mortgagor or trustor files suit contesting the trustee's sale to obtain a court ordered temporary restraining order (TRO) and/or a preliminary injunction (e.g., to determine whether a valid lien exists, whether there is a breach resulting in the alleged default, or whether there is a dispute in the amount owing), a judicial proceeding may be entirely bypassed in non-judicial foreclosures resulting in a trustee's sale of the security property (Anderson v. Heart Federal Savings ("Heart") 208 Cal. App. 3d 202, 256).

Asking a court to intervene can be costly and time consuming and will generally require the use of legal counsel. The debtor/borrower may be required to tender the amount owing in a manner acceptable to the court and must make an adequate showing of the grounds the court believes will likely result in a preliminary injunction for a TRO to be issued. For a preliminary injunction to follow, the debtor/borrower must demonstrate to the court that triable issues exist over the grounds raised in the dispute for the matter to be set for trial and for the non-judicial foreclosure to be enjoined until resolution of the dispute occurs by court order.

Under existing statutes, the time required between filing of the Notice of Default and of the Notice of Sale and the actual sale date allows the debtor the opportunity to pursue the judicial process discussed in the previous paragraph to ultimately establish underlying facts and applicable law. As previously noted, after the trustee's sale, the trustor/mortgagor, or any other party affected by the sale, may bring an action to set aside the sale (usually on procedural grounds), even though the sale is characterized as absolute.

Special Rules

Special rules apply in trustee's sales involving bankruptcy, substitution of trustee, federally insured or indemnified loans, individuals in military service, senior citizens, and Unruh Act deeds of trust or mortgages (on single-family owneroccupied residences arising from a contract for goods or services). The advice of knowledgeable legal counsel should be obtained in advance of proceeding with a non-judicial foreclosure involving any of the foregoing fact situations.

Notice of Default and Election to Sell
The Notice of Default must be executed by the beneficiary or the trustee and must state an election on the part of the beneficiary/lender/mortgagee to declare the entire debt due because of the breaches and defaults. Absent this declaration, the full amount owing on the debt cannot be collected at the trustee's foreclosure sale. The Notice should make it clear that unless the default is non-curable, the trustor/mortgagor or the successor in interest of the foregoing may reinstate and cure the default prior to five business days immediately before the date of the trustee's sale or of the date of any postponed sale.

The Notice of Default is recorded in the office of the county recorder where the real property or some portion of the property is located at least three months before Notice of Sale is given. Within ten days after recordation of the Notice of Default, a copy of the Notice containing the recording information must be sent by certified or registered mail to all persons who have requested notice and to the trustor/mortgagor at his or her last known address.

If there has been no request for notice by the trustor/mortgagor or the request by the trustor/mortgagor includes no address, then the Notice of Default must be published weekly for four weeks in a newspaper of general circulation in the judicial jurisdiction starting within ten days of the recording date, or the notice may be personally delivered to the trustor/mortgagor (Civil Code Section 2924b(d)).

The Notice of Default and the Notice of Sale are valid if the foreclosure procedural law has been strictly followed, whether the trustor/mortgagor has actual knowledge of the notices. The Notice of Default must also be sent within one month of recording by U. S. Mail, registered or certified, to persons listed in Civil Code Section 2924b, even though they have not recorded a request to receive notice. These persons are: successors in interest to the trustor/mortgagor; a beneficiary/lender/mortgagee of any junior recorded deed of trust or mortgage or the assignee of such beneficiary/lender/mortgagee; the vendee of a contract of sale; or to a lessee of a lease encumbering the security property being foreclosed that is junior to the security instrument being foreclosed or to the successor in interest to such vendee or lessee; to the State Controller, if a recorded lien for postponed property taxes exists against the property; and such other parties as are required by law, including the IRS in the event of an income tax lien.

Notice of Sale
If the loan is not reinstated and the trustee issues a Notice of Sale, the content and form of the notice is prescribed by Civil Code Section 2924f(b). The Notice of Sale sets a sale date not sooner than twenty days after the recording date of the notice. Actual practice usually requires a longer time (e.g., 31 days), especially if federal tax lien notice requirements are to be met or other justifiable delays are encountered. In any event, the sale date is set to allow time for the required recording, publication, posting, and mailing of the Notice of Sale.

The Notice of Sale must be recorded at least fourteen days, and mailed by registered or certified mail to the trustor/mortgagor and other persons requesting/receiving the Notice of Default, at least twenty days before the sale (Civil Code Section 2924b). The notice must be published once a week over a period of at least twenty days in a newspaper of general circulation in the city, county, or judicial district where the security real property or a portion of the property is located. Three publications of the notice not more than seven days apart are required. The notice must be posted for no less than twenty days in at least one public place in the city, judicial district, or county of the sale, and in a conspicuous place on the property (a door, if possible, if the property is a single-family residence).

If the loan has not been reinstated by the trustor/mortgagor, a partial payment accepted by the beneficiary may not terminate the foreclosure unless received in consideration of a forbearance agreement among the parties. The beneficiary/lender/mortgagee should be careful when accepting partial payments to set forth in writing:

1. Whether it is the intention of the parties that the partial payment constitute a reinstatement and, therefore, a cure of the default; or

2. Whether the partial payment is to be construed to be part of a work-out or forbearance agreement providing a plan for payment of all delinquencies and related and authorized fees, costs, and expenses; or

3. Whether the partial payment has been received without any effect on the foreclosure process, thereby permitting the beneficiary/lender/mortgagee to proceed with foreclosure as though no payment had been received.

The Trustee's Sale

The sale is to be conducted at a public auction by the trustee, or the crier/auctioneer named by the trustee, on a business day between 9 a.m. and 5 p.m. in a public place in the county where the property or some portion of the property is located. The sale is to occur on the date and at the time noticed for the scheduled sale, or on the date and time of the postponed sale. The date and time of a postponed sale is to be cried on the date and time of the scheduled sale or a previously postponed sale.

Unless expressly authorized in the notice by the trustee, all bids must be for payment in cash, cashier's check or its equivalent from a qualified depository financial institution specified in Section 5102 of the Financial Code that is authorized to do business in this state, or a "cash equivalent" which is authorized by law or has been designated in the Notice of Sale as acceptable to the trustee (Civil Code Section 2924h).

Until the bidding commences, the trustor/mortgagor or a holder of a junior deed of trust or mortgage may still redeem the property by paying off the defaulted loan in full, plus all authorized fees, costs, and expenses (as permitted by law). Reinstatement of a monetary default may be made at any time within the period commencing with the date of recordation of the Notice of Default, until five business days prior to the date of sale set forth in the initial recorded notice of sale. As previously stated, the reinstatement period revives as a result of each postponed sale where the postponed sale date is more than five business days subsequent to the initial sale date or the date of a previous postponed sale (Civil Code Section 2924c(e)).

Any person may bid at the trustee's sale, including the trustor/mortgagor, lender/creditor, or a junior lien holder (such as deeds of trust or mortgages). Only the foreclosing beneficiary/lender/mortgagee (who is the holder of the debt/loan evidenced by the promissory note and the security instrument being foreclosed) may credit-bid to offset up to the amount owed plus interest and authorized fees, costs, and expenses. Junior lien holders (including deeds of trust and mortgages) may not credit-bid the amount of their junior liens. However, amounts bid at the foreclosure sale by the junior lien holder would serve to reduce any potential liability that the trustor/mortgagor has to the junior lien holder. Further, if the junior lien holder (deed of trust or mortgage) is one and the same as the holder of the senior security instrument being foreclosed (or effectively controls the security instrument being foreclosed), then this holder is not entitled to purchase the security property and later sue the trustor/mortgagor for deficiency under a "sold out junior" status.

A trustee may reject all bids if the trustee reasonably believes they are inadequate (Civil Code Section 2924h). At the trustee's discretion, the sale may be postponed and a postponed sale date at the same location announced. Generally, the trustee's actions to reject bids or to postpone the sale are the result of prior instructions from the holder of the security instrument being foreclosed. Bid fixing, restraining from bidding, or the offering or accepting of consideration for not bidding at a trustee's sale ("chilling the bidding process") is unlawful and subjects the participants to fine, imprisonment, or both (Civil Code Section 2924h(g)). A trustee may state that the security property is being sold at the trustee's sale "as is". However, the trustee must disclose any material facts that affect the security property and its condition or value about which the holder has notice or knowledge (Karoutas vs. Home Fed Bank, 232 Cal. App. 3d. 767 (1991)).

In the event that the trustee's sale proceedings are postponed for a period or periods totaling more than 365 days, the scheduling of any further sale is to be proceeded by giving a new Notice of Sale that must be published, recorded, mailed, and posted in the manner required by applicable law (Civil Code Section 2924f). Fees and costs incurred to process the new notice of sale are not to exceed the amount specified by applicable law (Civil Code Sections 2924c, d, and 2924g(c)(2)). When postponing a sale, the trustee must publicly declare the reason for the postponement and announce the date, time, and place the postponed sale is to occur.

After the Sale

The successful bidder receives a trustee's deed to the property containing special recitals giving notice of compliance with the foreclosure statutes to protect this bidder and subsequent purchasers of the security property. The title conveyed is without covenant or warranty that no title defects exist, and the title relates back in time to the date the trustor/mortgagor signed the deed of trust or mortgage. The trustee's deed passes to the

successful bidder/purchaser the title held at the time the security instrument was recorded and any after-acquired title of the trustor/mortgagor, not the trustor's/mortgagor's title as of the sale date.

However, title will remain subject to certain liens:

1. Federal tax liens filed more than thirty days before the date of the trustee's sale unless the proper twenty-five day notice has been given the Internal Revenue Service;
2. Real property taxes and assessments; and,
3. Valid mechanic's liens.

Even with proper notice to the IRS, the federal government may have the right for 120 days following the trustee's sale to redeem the security property by paying the amount advanced by the successful bidder/purchaser.

Provided that the beneficiary/lender/mortgagee successfully makes a "full credit bid" (bids the full amount of unpaid principal and interest and any authorized charges, penalties, costs, expenses, attorneys' fees, trustee's fees, and any advances that may be lawfully due and owing to the beneficiary/lender/mortgagee); the sale eliminates the debt/loan and obligations of the trustor/mortgagor. Whether a beneficiary/lender/mortgagee "full credit bids" or "underbids", completion of a trustee's sale will extinguish the deed of trust or mortgage securing the debt/loan and the obligations in favor of a beneficiary/lender/mortgagee.

In addition, junior liens and encumbrances (e.g., deeds of trust or mortgages, judgment liens, easements, and leases which do not have priority over the security instrument that has been foreclosed) will be extinguished from the record of title to the security property. The interests of tenants who occupy a residential security property subject to a local rent control ordinance may not be extinguished by the foreclosure sale. Even if no local rent control ordinance is operative, tenants may not be removed from the foreclosed property prior to the time required pursuant to applicable to California law, generally no less than 60 days following the date of a properly delivered Notice to Vacate.

A beneficiary/lender/mortgagee may elect to "underbid" when a collateral action is anticipated against the debtor/trustor/mortgagor or a claim is anticipated against a third party for part payment of the amount due and owing under the promissory note and security instrument being foreclosed. A beneficiary/lender/mortgagee may elect to proceed with a legal action for fraud, waste or malicious destruction of the security property against the debtor/trustor/mortgagor or against third parties.

Further, if a casualty loss has occurred to the security property for which insurance coverage is available (even if not a result of the actions described in the previous sentence), a beneficiary/lender/mortgagee should "underbid" and then file a claim against the insurer under the terms of coverage extended by the insurance policy to recover the cost of damages to the security property as part of the amount due. The failure to "underbid" in such circumstances may result in the denial if the claim by the insurance carrier (Alliance Mortgage Co. v. Rothwell 10 Cal. 4th 1226 (Cal. 1995)). The issue of whether to "underbid" should be discussed in advance with knowledgeable legal counsel.

Liens or encumbrances, including real property taxes and assessments, which are senior to the foreclosed deed of trust or mortgage remain on the title to the security property. In a trustee's foreclosure sale, the title is free of any right of redemption by the debtor/trustor and the debtor/trustor has no further rights or interests in the security property absent a successful legal action to set aside or void the trustee's sale.

Separate from a civil action to set aside the trustee's sale, a Petition in Bankruptcy can be filed by the debtor/trustor/mortgagor. As part of the bankruptcy proceedings, the court may void the trustee's foreclosure sale at the request of the debtor/trustor/mortgagor or of the trustee appointed by the bankruptcy court, or as otherwise authorized under the U.S. Bankruptcy Code. Upon voiding the foreclosure sale, the security property may be returned to the bankrupt estate or ultimately to the estate of the debtor/trustor/mortgagor in a manner consistent with the order of the bankruptcy court.

It is important to note that sales transactions of residential real property during a non-judicial foreclosure proceeding may be rescinded by the debtor/trustor within two years from the date of such transaction upon written notice if unconscionable advantage has been taken of the debtor/trustor (Civil Code Section 1695.14).

The issues presented by the Home Equity Sales Contracts Act, commencing with Civil Code Section 1695 will be discussed later in this Chapter.

The successful bidder/purchaser is generally entitled to immediate possession of the security property and may evict the former debtor/trustor/mortgagor by instituting an Unlawful Detainer action subsequent to delivery of a three-day Notice to Quit. As previously mentioned, should the occupant be a tenant pursuant to a local rent control ordinance or who occupies under the terms of a lease junior to the foreclosed lien without a non-disturbance and attornment agreement, the successful bidder/purchaser at the foreclosure sale may evict the tenant in accordance with applicable law subsequent to the delivery of a 60 day Notice to Vacate. If the tenant fails to vacate, an Unlawful Detainer action could then be pursued by the successful bidder/purchaser subsequent to the delivery of a three-day Notice to Quit.

If a tenant occupies pursuant to a lease agreement that is either senior in priority to the foreclosed lien (or is junior but subject to a non-disturbance and attornment agreement) or whose occupancy is subject to the provisions of a local rent control ordinance, the successful bidder/purchaser should seek legal advice before taking any action to evict the tenant or otherwise terminate the occupancy of the tenant. On the other hand, the successful bidder/purchaser should also seek professional advice regarding whether an eviction is in the interests of the successful bidder/purchaser or if continuing the occupancy of the tenant is economically preferable, particularly in the context of a commercial or industrial property where the occupancy is pursuant to a long term lease.

When deciding to continue a tenancy or to evict the tenant in occupancy, the successful bidder/purchaser should consider whether a local ordinance has been adopted requiring the property be properly maintained, including the interior and exterior, e.g., grounds, landscaping and such amenities as a pool by the current owner of the fee title. These local ordinances often impose fines up to $1,000 per day up to a maximum of $100,000 which may attach to the property in the form of an assessment and, therefore, may be foreclosed in accordance with applicable law and subject to payment in the event of a conveyance or further encumbrance. This is a significant issue for beneficiaries/lenders/mortgagees who foreclose their security instrument when there is no third-party successful bidder resulting in the security property becoming real estate owned (an REO).

Disposition of Sale Proceeds

The trustee distributes the foreclosure sale proceeds in the following order:

1. To authorized trustee’s fees, costs, and sale expenses;

2. To beneficiary/lender/mortgagee to satisfy the full amount of unpaid principal and interest and any charges, penalties, costs, expenses, attorney’s fees, and advances that may be lawfully due and owing;

3. To junior lien holders in order of priority, whether their debt/loan is matured; and,

4. Any surplus that remains would then be distributed to the debtor/trustor/mortgagor.

If either a junior lien holder or the debtor/trustor/mortgagor disputes the distribution of funds, the trustee should file a Complaint for Interpleader and Declaratory Relief to have the court decide the issue.

Statement of Condition of Debt

Pursuant to Civil Code Section 2943, any time before or within two months after the recording of a Notice of Default under a deed of trust or mortgage with *power of sale* or before thirty days prior to entry of a decree of judicial foreclosure; the debtor/trustor/mortgagor or entitled person (as defined in the law) may make written demand of the beneficiary or mortgagee for a written beneficiary statement showing:

1. The amount of the unpaid balance of the obligation secured by the deed of trust or mortgage and the interest rate together with the total amounts, if any, of all overdue installments of either principal or interest, or both;

2. The amounts of periodic payments, if any;

3. The date on which the obligation is due in whole or in part;

4. The date to which real estate taxes and special assessments have been paid to the extent the information is known to the beneficiary/lender/mortgagee;

5. The amount of hazard insurance in effect and the term and premium of such insurance coverage to the extent the information is known to the beneficiary/lender/mortgagee;

6. The amount in an account, if any, maintained for the accumulation of funds with which to pay taxes and insurance premiums (escrow impound account);

7. The nature and amount, if known, of any additional charges, costs, or expenses paid or incurred by the beneficiary/lender/mortgagee which have become a lien on the security real property; and,

8. Whether the obligation secured by the deed of trust or mortgage can or may be transferred to a new borrower.

Section 2943 of the Civil Code also provides that the beneficiary/lender/mortgagee may make a charge not to exceed $30 for furnishing each required beneficiary statement, except when the loan is insured by FHA or indemnified by VA or is subject to some other federal exemption. The deed of trust or mortgage should provide whether the charge may be imposed and how much may be charged for the statement.

Within 21 days of receipt of the written demand, the beneficiary/lender/mortgagee or his or her authorized agent shall prepare and deliver the statement together with a complete copy of the promissory note or other evidence of indebtedness. If requested, the beneficiary/lender/mortgagee or its authorized agent shall furnish a copy of the deed of trust or mortgage at no additional charge. Such statements may be requested in connection with the sale, refinance, or further encumbrance of the security property.

A penalty of $300 and liability for damages is prescribed for the beneficiary's/lender's/mortgagee's willful failure to deliver the statement within 21 days. The beneficiary/lender/mortgagee may reasonably require the entitled person to produce evidence that he/she/they are eligible to make the request in accordance with applicable law. The beneficiary/lender/mortgagee may demand payment of the authorized fee at the time of request. The entitled person should include within the written request for the beneficiary statement that the request is being made pursuant to Civil Code Section 2943.

Civil Code Section 2943 includes the definition and use of pay-off demand statements as distinct from beneficiary statements. The beneficiary statement is intended to provide information when the loan may be transferred to a buyer of the security property or for loan status purposes. The pay-off demand statement details amounts owing for purposes of loan pay-off. While the beneficiary statement may not be requested subsequent to 60 days following the recordation of notice of default, the pay-off demand statement may be requested anytime except following the first publication of the notice of a trustee sale or of the applicable hearing before the court supervising the judicial sale.

The "Short-Pay Demand"

Recent California legislation has added requirements in connection with "Short-Pay Demand Statement". This phrase means a written statement issued subsequent to and conditioned on the existence of a "Short-Pay Agreement" that is in the possession of the entitled person and that was prepared in response to a written demand made therefor by an entitled person including an authorized agent. The "Short-Pay Demand Statement" is to set forth the amount less than the outstanding indebtedness (debt/loan) together with any terms and conditions under which the beneficiary/lender/mortgagee will execute and deliver a reconveyance of the deed of trust or discharge/satisfaction of the mortgage securing the promissory note. The operative period of this demand statement shall not be greater than 30 days from date of preparation by the beneficiary/lender/mortgagee.

The "Short-Pay Request" is defined to mean a written request made by an entitled person, including an authorized agent, requesting the beneficiary/lender/mortgagee to provide a "Short-Pay Demand Statement" that includes the following:

1. A copy of an existing contract to purchase the property for an amount certain;
2. A copy of the "Short-Pay Agreement" in possession of the entitled person; and,
3. Information related to the release of any other lien on the security property, if any.

Unless otherwise provided by applicable law, a beneficiary/lender/mortgagee or his or her authorized agent is required (upon receipt of a "Short-Pay Request") to prepare and deliver a "Short-Pay Demand Statement" to the person requesting the statement within 21 days of receipt of the "Short-Pay Request". The beneficiary/lender/mortgage or its authorized agent may elect not to proceed with the transaction that is subject to the "Short-Pay Request" and may refuse to provide a "Short-Pay Demand Statement" for the transaction. In lieu, a beneficiary/lender/mortgagee is to provide a written statement to the person requesting the "Short-Pay Demand Statement", within 21 days of the receipt of the "Short-Pay Request" that the beneficiary/lender/mortgagee elects not to proceed with the transaction.

Should the terms and conditions of the "Short-Pay Agreement" require approval by the beneficiary/lender/mortgagee of a closing statement or similar statement prepared by an escrow holder, approval or disapproval is to be provided in not more than 4 days after receipt by the beneficiary/lender/mortgagee of the closing statement, or the closing statement shall be deemed approved (provided the statement is not clearly contrary to the terms of the "Short-Pay Agreement" or to the "Short-Pay Demand Statement" provided to the escrow holder).

As is the case with a request for beneficiary statement, the beneficiary/lender/mortgagee must respond to a request for a pay-off demand statement or a "Short-Pay Demand Statement" within 21 days after receipt, and the failure of a beneficiary/lender/mortgage to timely respond may subject the beneficiary/lender/mortgagee to an automatic $300 sanction plus actual damages and attorney's fees. Needless to say, each request for a payoff demand statement or for a "Short-Pay Demand Statement" is to be in writing and should indicate that the request is being made pursuant to Civil Code Section 2943, as amended.

The fee for a pay-off demand statement is the same as the fee for a beneficiary statement. Failure to specifically identify whether the statement being requested is a beneficiary statement or a pay-off demand statement will allow the beneficiary to "default" to the pay-off demand statement exclusive of a "Short-Pay Demand Statement". The provisions added to Civil Code Section 2943 describing and requiring the "Short-Pay Demand Statement" procedure are subject to repeal as of January 1, 2014, unless a statute is enacted before January 1, 2014 that deletes or extends that date.

Annual and Monthly Accounting - Impound Accounts

Under Civil Code Section 2954, any trustor/mortgagor under a deed of trust or mortgage, or a vendee under a real property sales contract, may make a written request of the beneficiary/lender/mortgagee or of the vendor for a statement of condition of account. A statement is to be provided within 60 days after the end of each calendar year.

The statement includes an itemized accounting of money received for interest and principal repayment or held in or disbursed from an impound/trust account (an escrow account), if any, for payment of property taxes, insurance premiums, or other purposes relating to the security property. The debtor/trustor/mortgagor is entitled to receive one statement for each calendar year without charge. A monthly statement or passbook showing money received for interest and principal or held in and disbursed from an impound/trust account (an escrow account) constitutes compliance with this requirement.

No increase in the monthly rate of payment of a trustor/mortgagor or vendee for an impound/trust account (or escrow account) will be effective until the beneficiary/lender/mortgagee or vendor has furnished the trustor/mortgagor or vendee with an itemized accounting of the monies presently held in the impound account and with a statement of the new monthly rate of payment and the factors necessitating the increase. The use and maintenance of an impound/trust account (escrow account) by the beneficiary/lender/mortgagee is subject to applicable federal and state law, including the fees that may be imposed on the trustor/mortgagor.

Existing law prohibits the use of impound/trust account (escrow accounts) except in those fact situations described below:

1. When the security property is an owner occupied dwelling, unless required by state or federal regulatory authority if the loan has been made, insured or indemnified by a state or federal government lending or insurance agency; or upon the failure of the borrower to pay two consecutive tax installments on the security property prior to the delinquency date for such payments;

2. When the security property is owner occupied, unless the original principal amount of the loan is 90% or more of the sales price of the security property at the time of sale; or the loan is 90% or more of the appraised value of the security property; or whenever the combined principal amount of the loans against the security real property exceeds 80% of the appraised value of such property; or,

3. The loan is made in compliance with the requirements for higher priced mortgage loans established in Regulation Z of the Federal Truth-In-Lending Act (TILA) pursuant to 15USC Section 1601et seq., whether the loan is a higher priced mortgage loan; or when a loan is refinanced or modified in connection with a lender's homeownership preservation program or a lender's participation in such a program is sponsored by a federal, state or local government or a non-profit organization.

Contact Requirements Prior to Filing a Notice of Default

Civil Code Section 2923.5 has been added to require an initial contact with the borrower (as defined) at least 30 days prior to the recording of a Notice of Default. This requirement applies to loans secured by residential real property consisting of 1 to 4 dwelling units within which an owner occupies and the security instrument for the loan was recorded during the period of January 1, 2003 through January 1, 2008, inclusive. Exemptions from the required contact include:

1. When the borrower has previously surrendered the keys and possession of the security property to the beneficiary/lender/mortgagee or its authorized agent;

2. When the borrower has contracted with an entity whose primary business is advising homeowners on how to avoid or extend the foreclosure process; or,

3. When the borrower/homeowner has filed a petition in bankruptcy and an order has not been entered closing or dismissing the bankruptcy or granting a relief from stay.

Unless an exemption applies, contact or attempted contact must be made with the borrower to discuss the borrower's financial situation and foreclosure alternatives. Due diligence to contact the borrower (trustor/mortgagor) must be undertaken by the beneficiary/lender/mortgagee, its servicing agent, or another lawfully authorized agent.

Due diligence requires that an initial contact be made with the borrower (trustor/mortgagor), either in person or by telephone, advising of the availability of a United States Department of Housing and Urban Development (HUD) certified housing counseling agency and the toll free telephone numbers of such agencies who may provide counseling services to the borrower.

The borrower is also to be advised that he or she has a right to request a subsequent meeting with the beneficiary/lender/mortgagee, its servicing agent, or other authorized agent, with the meeting scheduled to occur within 14 days. The contact with the borrower is also to provide the opportunity to assess the borrower's financial situation and to explore options to avoid foreclosure.

A borrower may designate by written consent a HUD certified counseling agency, an attorney, or another advisor to discuss with the beneficiary/lender/mortgagee, its servicing agent or other authorized agent, the borrower's financial situation, options for the borrower to avoid foreclosure, or any loan modification or workout plan offered by the beneficiary/lender/mortgagee.

When the borrower, the loan transaction, and security property are subject to this law; a Notice of Default filed or recorded pursuant to Civil Code Section 2924 et seq. is to include a declaration that the beneficiary/lender/mortgagee its agent or other authorized agent has:

1. Contacted the borrower;

2. Has tried with due diligence to contact the borrower in accordance with applicable law; or,

3. That no contact was made with the borrower because the borrower has surrendered the keys and possession of the security property to the beneficiary/lender/mortgagee, its servicing agent, or other authorized agent; or the borrower has contracted with an organization, person, or entity, whose primary business is to advise homeowners how to extend the foreclosure and/or how to avoid the borrower's contractual obligations to beneficiaries/lender/mortgagees; or the borrower has filed a petition in bankruptcy pursuant to Chapters 7, 11, 12 or 13 and the bankruptcy court has not entered an order closing or dismissing the bankruptcy or granting a stay of relief from a foreclosure.

If the beneficiary/lender/mortgagee, its servicing agent or other authorized agent, has previously directed the trustee to record the Notice of Default (prior to the enactment of Civil Code Section 2923.5) and no Notice of Rescission has been recorded, then the Notice of Sale issued and recorded pursuant to Civil Code Section 2924 shall include a declaration that the borrower (trustor/mortgagor) was contacted to assess the borrower's financial situation and to explore alternatives to foreclosure, or that efforts were made exercising due diligence in accordance with applicable law and no contact occurred. Civil Code Section 2923.5 is to remain in effect until January 1, 2013, and as of that date is repealed, unless a later enacted statute extends the aforementioned date of repeal.

Delayed Notice of Sale

Civil Code Section 2923.52 has been added to require the delay period of three months between filing/recording of the Notice of Default and filing/recording of the Notice of Sale (Civil Code Section 2924(a)(2)) to be extended for an additional 90 days to allow the parties to pursue a loan modification as a means to delay foreclosure. The requirement for such further extension is subject to the following conditions:

1. The loan was recorded during the period from January 1, 2003 to January 1, 2008 inclusive, and the loan is secured by residential property;

2. The loan at issue is the first deed of trust or mortgage against the security property;

3. The borrower occupied the property as the borrower's principal residence at the time the loan became delinquent; and,

4. A Notice of Default has been recorded on the security property.

The requirement for the further extension of 90 days does not apply to loans made, purchased, or serviced by a California state or local public housing agency or authority; a state or local housing finance agency; a secured transaction that is subject to the Military and Veterans Code; or the loan is collateral for securities purchased by an agency or authority referred to hereinbefore. In addition, the 90 day further extension does not apply to loans serviced by a mortgage loan servicing agent, if the servicing agent has obtained a temporary or final order of exemption pursuant to Civil Code Section 2923.53 that is current and valid at the time the Notice of Sale is given.

For example, if the servicing agent is licensed and regulated by the DRE, the exemption order must be obtained from the Commissioner of the DRE. A comprehensive loan modification program must be implemented by the servicing agent that meets the requirements imposed by the commissioner of the department or agency through whom the servicing agent is licensed.

The loan modification program is to consider the objective of keeping borrowers in their California homes rather than foreclosing when the anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. The loan modification program targets a

ratio of the borrower's housing related debt to the borrower's gross income of 38% or less on an aggregate basis for the lender's loan modification program. As a predicate to the loan modification program being acceptable to the commissioner licensing and regulating the servicing agent, the program is to include a combination of the following features:

1. An interest rate reduction, as needed, for a fixed term of at least five years;
2. An extension of the amortization period of the loan term to no more than 40 years from the original date of the loan;
3. Deferral of some portion of the principal amount of the unpaid principal balance until maturity of the loan;
4. A reduction of principal amount owing;
5. Compliance with an applicable federally mandated loan modification program; and,
6. Such other factors the commissioner determines are appropriate, and the commissioner may consider efforts implemented in other jurisdictions that have resulted in a reduction in foreclosures.

When determining a loan modification solution for a borrower, the servicing agent is to seek to achieve long-term sustainability for the borrower. The commissioner has been given 30 days of receipt of an initial or revised application to determine whether the proposed loan modification program meets the requirements imposed by applicable law.

Upon approval of the loan modification program for which the servicing agent has applied, the commissioner is to issue a final order exempting the loan servicer pursuant to the terms of the order from the requirements of Civil Code Section 2923.52. If the commissioner concludes that the loan modification program is not acceptable, the application is to be denied. However, the servicing agent may submit a revised or modified application. The commissioners were required to adopt emergency and final regulations to clarify the application of this law (Civil Code Section 2923.52 and 2923.53) no later than 10 days after the date the law took effect, i.e., May 21, 2009. Civil Code Sections 2923.52 and 2923.53 are to remain in effect until January 1, 2011 and as of that date is repealed, unless a later enacted statute extends the aforementioned date of repeal.

PREVENTING FORECLOSURE ABUSES

Brief Overview

Since 1979, corrective legislation has been passed and subsequently amended aimed at home-equity purchasers and mortgage foreclosure consultants. These laws are found in Civil Code Sections 1695 et seq. and 2945 et seq. The purpose of the laws is to provide protection for and to prevent foreclosure abuse of homeowners whose residences are encumbered by deeds of trust or mortgages subject to an outstanding Notice of Default. The term residential real property as used in these laws means a security property consisting of 1 to 4 family dwelling units, one of which the owner occupies as his or her principal place of residence.

Home Equity Sales Contracts Law

Should a homeowner sell a residential property that he or she occupies (as defined) to an equity purchaser and the property is the security for a loan subject to an outstanding Notice of Default, the provisions of Civil Code Section 1695 et seq. (Home Equity Sales Contracts Law) would apply. An equity purchaser is defined to be a person who acquires title to the residence of the seller subject to an outstanding Notice of Default, unless the person acquires the title as follows:

1. For the purpose of using such property as a personal residence;
2. By deed in lieu of foreclosure of any voluntary lien or encumbrance of record (including deeds of trust or mortgages);

3. By a deed from a trustee acting under the *power of sale* contained in a deed of trust or mortgage in a non-judicial foreclosure sale conducted pursuant to Civil Code Section 2924 et seq.;

4. At a sale of the security property as otherwise authorized by statute;

5. By order or judgment of any court; or,

6. From a spouse, a blood relative, or a blood relative of a spouse.

If an equity purchaser intends to acquire a property subject to this law, the contents of the contract to effect such a transaction are mandated by Civil Code Section 1695.3. Included among the required contract terms are:

1. The name, business address and telephone number of the equity purchaser;

2. The address of the residence in foreclosure;

3. The total consideration to be given by the equity purchaser in connection with or incident to the sale;

4. A complete description of the terms of payment or other consideration including, but not limited to, any services of any nature which the equity purchaser represents he or she will perform for the equity seller before or after the sale;

5. The time at which possession is to be transferred to the equity purchaser;

6. The terms of any rental agreement;

7. A Notice Of Cancellation (in at least 12 pt bold face type if the contract is printed, or in capital letters if the contract is typed) as provided for in Civil Code Section 1695.5 setting forth the seller's right to cancel; and,

8. And a Notice Required By California law (in at least 14 pt bold face type if the contract is printed, or in capital letters if the contract is typed) informing the equity seller that until the seller's right to cancel has ended, the equity purchaser or anyone working for the equity purchaser cannot ask the seller or have the seller sign any deed or any other document related to the property or transaction. The name of the equity purchaser must be included in this notice and the notice must immediately precede the notice required in Civil Code Section 1695.5(a) and (b), i.e., the Notice of Cancellation.

The right to cancel any contract with an equity purchaser continues until midnight of the fifth business day (as defined) following the day on which the equity seller signs a contract that complies with the Home Equity Sales Contracts Law, or until 8:00AM on the day scheduled for the sale of the residential property pursuant to a *power of sale* conferred in a deed of trust or mortgage, whichever occurs first. This law allows rescission of such contracts under specified conditions (Civil Code Sections 1695.4, 1695.6, 1695.13, 1695.14, 1685.15, 1685.16 and 1695.17, or pursuant to any other applicable law).

Further, an equity purchaser who violates Section 1695.6 or Section 1695.13 may be liable for actual damages, exemplary damages in an amount not less than three times the equity seller's actual damages, attorney's fees and costs, and may be subject to an action for equitable relief. In addition, the court may award a civil penalty of up to $2,500 under certain fact situations.

A criminal conviction for violation of Section 1695.6 (or for any practice which operates as fraud or deceit upon the equity seller, including taking unconscionable advantage of the equity seller) may result in a fine of not more than $25,000 or by imprisonment in the county jail, or in a state prison for a period of not more than one year (or both the fine and the imprisonment) for each violation of this law.

The Home Equity Sales Contracts Law establishes a presumption that a grant to an equity purchaser with an option for the equity seller to repurchase is a *loan* rather than a sale transaction (i.e., a hidden security device).

Any representative of a home equity purchaser as defined in Section 1695.15 deemed to be the agent or employee of the equity purchaser is required to provide written proof to the equity seller that the representative has a valid and current California real estate license and that the representative is bonded by an admitted surety insurer in an amount equal to twice the amount of the fair market value of the property which is the subject of the contract. However, a holding in a recent California case on this issue has made unenforceable the requirement to obtain the bond as a predicate to representing the equity purchaser. As of this writing, the requirement to obtain a bond to represent an equity purchaser is in doubt.

Because of the specific requirements of the Home Equity Sales Contracts Law, the standard real estate purchase contracts and receipts for deposits (residential purchase agreements) customarily used in real estate brokerage are *not* acceptable for use in home equity sales when the residential real property is subject to an outstanding Notice of Default. Accordingly, a real estate licensee should seek the prior advice of legal counsel for preparation of the proper contract forms and for advice regarding the manner in which such sales must be conducted.

Mortgage Foreclosure Consultants Law

Civil Code Sections 2945 et seq. (Mortgage Foreclosure Consultants Law) addresses the problem of consultants who represent that they can assist homeowners who are in foreclosure (their residence is subject to an outstanding Notice of Default), often charge high fees, frequently secure the payment of their fees by a deed of trust or mortgage on the residential property in foreclosure, and have been known to perform no service or essentially a worthless service for the homeowner.

Foreclosure consultant means any person who makes any solicitation, representation, or an offer to any owner to perform for compensation, or who for compensation, performs any service the person in any manner represents he or she will do including any of the following:

1. Stop or postpone the foreclosure sale;
2. Obtain any forbearance from any beneficiary/lender/mortgagee;
3. Assist the owner in the right of reinstatement as provided for in Civil Code Section 2924c;
4. Obtain any extension of the period within which the owner may reinstate his or her debt/loan or obligations;
5. Obtain any waiver of an acceleration clause contained in the promissory note or in a deed of trust or mortgage on a residence in foreclosure (or in both the evidence of debt/loan and the security instrument);
6. Assist the owner to obtain a loan or advance of funds;
7. Avoid or ameliorate the impairment of the owner’s credit rating resulting from the recording of a Notice of Default or through the conduct of a foreclosure sale;
8. Save the owners residence from foreclosure; or,
9. Assist the owner in obtaining from the beneficiary/lender/mortgagee or trustee acting under a *power of sale* or from a counsel acting for the beneficiary/lender/trustee the remaining proceeds from the foreclosure sale of the owner’s residence (surpluses due to the owner as the borrower upon whom the foreclosure was conducted).

Excluded from the definition of a foreclosure consultant are the following:

1. A person licensed to practice law in this state when the person renders services in the course and the scope of the license;
2. A person licensed under Division 3 (commencing with section 12000) of the Financial Code when the person is acting as a prorater as defined in the law;
3. A person licensed under the Real Estate Law when the person is acting under the authority of that license as described in Sections 10131 or 10131.1 of the Business and Professions Code;

4. A person licensed under Chapter 1 of the Business and Professions Code (commencing with Section 5000 of Division 3) when the person is acting in any capacity under that license and under the provisions of that law (as an accountant);
5. A person or his or her authorized agent acting under the express authority or with the written approval of HUD or other department or agency of the United States or of this state to provide such services;
6. A person who holds or is owed an obligation secured by a lien on the residence in foreclosure (including deeds of trust or mortgages) when the person performs services in connection with the debt/loan and obligation or lien;
7. Any person acting under the California Finance Lender Law when the person is acting under the authority of that license;
8. Any person acting under the Residential Mortgage Lending Act when the person is acting under the authority of that license; or,
9. Any person or entity doing business under any law of this state, or the United States relating to banks, trust companies, savings and loans, savings banks, industrial loan companies, pension trusts, credit unions, insurance companies or any person or entity authorized under the law of this state to conduct a title or escrow business, or a mortgagee which is a HUD approved mortgagee and any subsidiary or affiliate of any of the above, or any agent or employee of any of the above while engaged in the business of these persons or entities.

Service Means

"Service" means and includes, but is not limited to, any of the following:

1. Debt, budget, or financial counseling of any type.
2. Receiving money for the purpose of distributing it to creditors in payment or partial payment of any obligation secured by a lien on a residence in foreclosure.
3. Contacting creditors on behalf of an owner of a residence in foreclosure.
4. Arranging or attempting to arrange for an extension of the period within which the owner of a residence in foreclosure may cure his or her default and reinstate his or her obligation pursuant to Section 2924c.
5. Arranging or attempting to arrange for any delay or postponement of the time of sale of the residence in foreclosure.
6. Advising the filing of any document or assisting in any manner in the preparation of any document for filing with any bankruptcy court.
7. Giving any advice, explanation, or instruction to an owner of a residence in foreclosure which in any manner relates to the cure of a default in or the reinstatement of an obligation secured by a lien on the residence in foreclosure, the full satisfaction of that obligation, or the postponement or avoidance of a sale of a residence in foreclosure pursuant to a power of sale contained in any deed of trust.
8. Arranging or attempting to arrange for the payment by the beneficiary, mortgagee, trustee under a power of sale, or counsel for the beneficiary, mortgagee, or trustee, of the remaining proceeds to which the owner is entitled from a foreclosure sale of the owner's residence in foreclosure. Arranging or attempting to arrange for the payment shall include any arrangement where the owner transfers or assigns the right to the remaining proceeds of a foreclosure sale to the foreclosure consultant or any person designated by the foreclosure consultant, whether that transfer is effected by agreement, assignment, deed, power of attorney, or assignment of claim.
9. Arranging or attempting to arrange an audit of any obligation secured by a lien on a residence in foreclosure, sometimes referred to as a "forensic loan audit".

Notwithstanding the foregoing list of exemptions from the status of a foreclosure consultant, if the activity is to assist the owner in obtaining surplus funds (if any) from the foreclosure sale of the owner's residence, the

person *is* a foreclosure consultant (unless the person is the owner's attorney). No exemption from the foreclosure consultant's law applies to a person except a licensed attorney when the foregoing service is being offered or provided.

It is important to note the term "person" means for this purpose any individual, partnership, corporation, limited liability company, association, or other group no matter how organized. The question of services that come within the activities controlled by this law should be reviewed with knowledgeable legal counsel in advance of performing any services or activities that may be subject to this law. They are broad and encompass most any service, advice or activity offered or provided to a homeowner regarding the credit of the homeowner/borrower, the ownership of the property, and concerning the security instruments of record when the residential property is subject to an outstanding Notice of Default.

This law requires that contracts for services of foreclosure consultants contain specified provisions. The law allows cancellation or rescission of such contracts under certain prescribed conditions (as well as the violation of any applicable law that would result in cancellation or rescission of contracts). This law makes it a crime to violate the provisions relating to such foreclosure consultant contracts.

Among the requirements for the contract for foreclosure consultants is a Notice Required by California Law (printed in at least 14 pt bold face type) and the notice must be completed with the name of the foreclosure consultant. The notice must immediately precede a second notice, a Notice of Cancellation. The purpose of the notices is to ensure the homeowner is informed that no money may be paid to or received by the foreclosure consultant until the foreclosure consultant has completely finished what the foreclosure consultant contracted to do; that the homeowner may not be asked to sign or to sign any lien, deed of trust or mortgage, or execute a deed that relates to the property or to the services being provided by the foreclosure consultant; and that the homeowner may cancel the contract with the foreclosure consultant within five business days (as defined) from the date of the transaction (i.e., entering into the contract). These notices are required pursuant to applicable law (Civil Code Sections 2945.2 and 2945.3).

The foreclosure consultant's fees are statutorily limited as well as the manner via which payment of the fees may be obtained. The foreclosure consultant may not take a power of attorney from the homeowner for any purpose and may not induce or attempt to induce a homeowner to enter into any contract that does not comply in all respects with Civil Code Sections 2945.2 and 2945.3. Needless to say, foreclosure consultants may not act in any manner that is deceptive, fraudulent, misleading or unconscionable.

Unless specifically exempt by this law, foreclosure consultants must register with the California Department of Justice and must maintain in force a surety bond in the amount of $100,000 executed by a surety admitted to do business in this state. As in the Home Equity Sales Contracts Law, the foreclosure consultant who commits any violation described in Civil Code Section 2945.4 may be punished by a fine of not more than $10,000 or imprisoned in the county jail or state prison for not more than one year, or both. Finally, any provision in a contract with a foreclosure consultant that purports to limit the liability of the foreclosure consultant under Civil Code Section 2949.9 is void and, at the option of the homeowner, would render the contract void.

Loan Modifications, Forbearances or Extensions, and Advance Fees

Background

The "Mortgage Meltdown" discussed earlier in this Chapter has resulted in significant problems for the California housing market. Many borrowers are struggling or unable to make their mortgage loan payments. Other borrowers are concerned about adjustable rate mortgages that have or are expected to reset to higher interest rates producing increased monthly payments. Often these increased monthly payments are beyond the capacity of many borrowers to pay. This is particularly true for those borrowers who obtained loan products by qualifying at an initial "teaser" rate to achieve monthly payments that were affordable even for a short time. Other borrowers qualified for their mortgage loans based on a represented stated income that was substantially greater than the actual income earned.

Unable to make these increased mortgage loan payments, many of these borrowers turned to real estate brokers (MLBs) to assist them with loan modifications or forbearances to prevent or delay foreclosure by the lenders or the current holders of these mortgage loans. Real estate brokers (MLBs) can lawfully perform such services pursuant to Section 10131(d) of the Business and Professions Code. Further, real estate brokers (MLBs) are

specifically exempt (with a notable exclusion regarding surplus funds) from the strict requirements of the Mortgage Foreclosure Consultants Law that is discussed in this Chapter (Civil Code Section 2945.1).

Some borrowers sought the services of attorneys to obtain modifications of their mortgage loan terms, including a reduction in the monthly payments. Under applicable law, California licensed attorneys may render loan modification and/or forbearance services within the course and scope of their law practice. Attorneys who are members of the California State Bar can lawfully perform such services. If not actively and principally involved in the practice of negotiating loans secured by real property and when rendering services in the course and scope of a law practice, attorneys are exempt from the Real Estate Law (Business and Professions Code Sections 10133(a)(3) and 10133.1(a)(5)).

The DRE has reported "…financially distressed borrowers have fallen and continue to fall prey to pervasive unlicensed loan modification and foreclosure rescue companies/entities, including natural persons offering such services. In many cases, these companies are unlicensed entities that are nothing more than perpetrators of fraud. They promise timely and helpful loan modification services, ask for and collect monies up front, perform no valuable services, and simply pocket the monies paid in advance leaving borrowers exposed to foreclosure of the mortgage loans secured by their homes."

Evidence indicates persons or entities that are unlicensed have been involved in more "…monstrous and unconscionable foreclosure rescue frauds, including ones where the unsophisticated homeowners surrender the home title to the unlicensed scam artist or to an accomplice".

California Legislation to Prevent Mortgage Loan Modification Abuses

Legislation was introduced, passed and signed by the Governor, which became effective October 11th, 2009 (Civil Code Sections 2944.6 and 2944.7). This law prohibits any person or entity that negotiates, attempts to negotiate, arranges or attempts to arrange, or otherwise offers to perform for a fee or other compensation paid by a borrower, a mortgage loan modification or other form of loan forbearance without first providing the borrower with a notice prescribed by statute. The notice (statutory statement) is to be printed or word processed in not less than 14pt bold type and provided to the borrower prior to entering into any fee agreement regarding loan modification or loan forbearance services. This section shall remain in effect only until January 1, 2013, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2013, deletes or extends that date.

The obligation to provide the notice (statutory statement) in advance includes a contemplated loan modification (as authorized by federal or state regulators) which proposes an extension of the amortization period for the loan term to no more than 40 years from the original date of the loan. The specific content of the notice (statutory statement) is set forth in Civil Code Section 2944.6(a).

In the notice, the borrower is referred to non-profit housing counseling agencies approved by HUD and a list of these agencies is available by visiting a local HUD office or www.hud.gov. The borrower is to be informed of the free services available through HUD approved non-profit counseling agencies (Business and Professions Code Section 10147.6 and Civil Code Section 2944.6(a)).

This notice provision does not apply to a person or entity or an agent acting on behalf of the foregoing when the loan modification or loan forbearance services are in connection with a mortgage loan owned (held) or serviced by such persons or entities. If the loan modification or forbearance service is offered to the borrower in a language specified in Civil Code Section 1632, the notices, documents and instruments (including the agreement to provide such services) are to be translated into the language used. These languages include Spanish, Vietnamese, Tagalog, Chinese, and Korean (Civil Code Sections 1632 and 2944.6(a)).

This recent legislation prohibits any person or entity who offers to negotiate or attempts to negotiate, or offers to arrange or attempts to arrange, or offers to otherwise perform any loan modification or forbearance service from claiming, demanding, charging, collecting, or receiving any compensation, until the person or entity performs every service contracted for or represented to be performed. The purpose of this prohibition is to prevent any form of advance fees in connection with loan modification or other loan forbearance services (Business and Professions Code Sections 10026, 10085, 10085.5, 10085.6, 10131.2, 10146, and 10147.6; and 10CCR, Chapter 6, 2970 and 2972; and Civil Code Section 2944.7).

Prior to proceeding with the use of any advance fee agreement for the performance of any services for which a real estate broker's license is required, these agreements and materials used to obtain advance fees (including contract forms, letters or cards used to solicit the public, radio and television ads, among other advertisements) must be submitted to and requires the prior approval of the DRE. The DRE may elect to issue a no objection statement. Either way, real estate brokers (MLBs) may not proceed until the DRE authorizes the advance fee agreements and materials the licensee intends to use.

When advance fees are collected they are to be handled as trust funds and deposited into the trust account of the real estate broker (MLB) and must be accounted for and disbursed in the manner authorized by the DRE (Business and Professions Code Sections 10085 and 10146, and 10CCR, Chapter 6, 2970 and 2972). The failure to comply with the advance fee requirements as described in this Chapter and in accordance with applicable law is a presumptive violation of 506 and 506(a) of the Penal Code (conversion and embezzlement).

In addition, any person or entity contracting or representing to perform such services is prohibited from receiving any wage assignment or any lien of any type on real or personal property to secure the payment of compensation. Also, such persons are prohibited from accepting a power of attorney from the borrower for any reason whatsoever. The prohibition of the payment of advance fees (as defined) does not preclude the lender or the holder of the loan or its servicing agent from collecting principal, interest, or other charges under the terms of the mortgage loan before the loan is modified (including charges to establish a new payment or amortization schedule, or for structuring the modification providing for a reduction in the unpaid principal balance for the express purpose of reducing the monthly payment under the terms of the loan).

The lender or holder of the mortgage loan and its servicing agent are not precluded for collecting interest, or other charges under the terms of the loan after the loan is modified, or from accepting payments by a federal agency in connection the "Making Home Affordable Plan" or other federal plan to help borrowers refinance or modify their residential mortgage loans, as well as otherwise avoiding foreclosure. Each of these codified sections are intended to apply to residential real property containing four or fewer units (Civil Code Sections 2944.6(e) and 2944.7(a), (c), and (d)).

A violation of this law by a natural person is a public offense punishable by a fine not exceeding $10,000 or by imprisonment in the County jail for a term not to exceed one year or by both a fine and imprisonment. If the violation of the law occurs by an entity, the violation is punishable by a fine not exceeding $50,000. The penalties described in this law are cumulative to any other remedies or penalties provided by law (Business and Professions Code Section 10147.6(e); and Civil Code Sections 2944.6(c) and 2944.7(b)). The section prohibiting the collection of advance fees is repealed as of January 1, 2013, unless extended by a later statute enacted before January 1, 2013 (Civil Code Section 2944.7).

Conclusion

It is illegal for any person to take "unconscionable advantage" of any property owner in foreclosure or in connection with mortgage loan modification or loan forbearance services. While real estate broker licensees may, under certain circumstances, be exempt from the provisions of the Mortgage Foreclosure Consultants Law, a licensee should proceed with an abundance of caution when dealing with owners of residential property where a Notice of Default has been recorded and remains outstanding or a Home Equity Sales Contract is being considered. This note of caution extends to engaging in any activities involving mortgage loan modification or other loan forbearance services, including the prohibition from collecting advance fees.

Among other requirements, real estate licensees must act within the course and scope of their licenses, must not accept any advance fees, and must not acquire any interest in the residence in foreclosure. Prior to representing either a seller of residential real property or an equity purchaser when the property is subject to an outstanding Notice of Default, or prior to offering loan modification or other loan forbearance services, real estate brokers (MLBs) should seek the advice of knowledgeable legal counsel.

OVERVIEW OF THE LOAN PROCESS

Originating a new loan begins when a prospective borrower contacts an MLB or lender representative now also referred to as a mortgage loan originator (MLO). The MLO should be prepared to listen to the applicant's

needs, gather appropriate information and respond to the inquiry with accurate program descriptions that would be best suited to the applicant, the consumer/borrower. Preparing for inquiries in advance will enable the MLO to handle the inquiries in a logical and uniform manner.

Whether the loan will be delivered to a depository institution, to a non-bank (including licensed creditors/lenders), or to private investors/lenders; the MLO should know the details of each loan program offered as well as the guidelines, policies and procedures of the funding sources with respect to originating residential mortgage loans. The MLO's ability to obtain comprehensive information up front will result in the best service to both the applicant and to prospective lenders or permanent investors.

There are four steps to originating a real estate loan:

1. The Application;
2. Loan Processing;
3. Underwriting Analysis; and,
4. Loan Approval, Funding and Closing.

The Application

The application form is a summary of all key components required by a lender or permanent investor to determine if an applicant qualifies for the loan request, has the ability to repay the loan, and whether collateral sufficient to support the debt/loan will be provided by the borrower. The loan application is to be completed with the assistance of a representative of the lender or the MLB (as previously mentioned, each is also known as MLOs). The application is to be completed accurately and entirely to facilitate processing, underwriting, funding and closing the requested loan.

Historically, application forms varied from lender to lender. Now, a "standard" form for residential mortgage loan applications is commonly used in the mortgage lending and brokerage industries. The form is a collaborative effort between FNMA and FHLMC. Each agency has assigned a different number to the same form; the FNMA Form is 1003 and the FHLMC Form is 65. The application form most often referred is the FNMA 1003. Today, even FHA and VA use this form.

An initial interview with the prospective borrower is necessary, whether occurring telephonically, electronically, or in person (face-to-face). The interview provides MLOs with the opportunity to make certain the applicants understand the terms of the loan requested, among other important issues within the loan process. The requirements of the lender to whom the loan application is or will be submitted will often control how the initial interview is to occur. Interviews with the prospective consumer/borrower are necessary to complete accurately the loan application package.

The proposed loan request is normally set forth in writing on the 1003. It identifies the amount and proposed terms of the requested loan, the purpose of the loan, and how and when the loan is to be repaid. Each loan request is to be evaluated in a fair, impartial, and non-discriminatory manner.

The Federal Equal Credit Opportunity Act (ECOA) prohibits discrimination based on age, sex, race, marital status, color, religion, national origin, receipt of public assistance, or that the applicants (consumers/borrowers) have, in good faith, exercised any right under the Consumer Credit Protection Act. In addition under the Fair Housing Act, discrimination is prohibited based on the existence of a handicap or on familial status, e.g., the age and presence of children, except when the housing qualifies under HUD standards as senior housing. Each person's character and capacity must be considered fairly and equitably based on income adequacy; satisfactory net worth, financial standing and management; job stability; on an acceptable credit rating, and on other pertinent factors that are not unlawfully discriminatory. Credit guidelines are to be applied to each potential consumer/borrower in an equal manner, including the income of each spouse.

Advance Fees

MLOs who are MLBs as well as lenders may wish to collect money in advance from a loan applicant to cover the cost of services to be performed in arranging or originating the mortgage loan. Money collected "up front" is an advance fee. Advance fees are defined in and subject to the regulation of the Real Estate Commissioner pursuant to Business and Professions Code Sections 10026, 10085, 10085.5, 10131.2 and 10146. Fees imposed

at the time of the loan application are also subject to the requirements imposed under the Real Estate Settlement Procedures Act (RESPA) that is discussed later in this Chapter (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq.).

Unless the advanced fee is for a credit or appraisal report and is in the exact amount required by the service providers, an MLB/MLO may only collect an advance fee pursuant to a written agreement previously reviewed and authorized by the Department of Real Estate (DRE). Real Estate Commissioner's Regulation 2970 sets forth the basic contents of an advance fee agreement. The MLB must also submit for the DRE's prior approval, advertising materials used in conjunction with an advance fee arrangement. Additionally, the verified accountings and trust fund handling as required by Business and Professions Code Section 10146 and set forth in Commissioner's Regulation 2972 must be reviewed for and to establish the appropriate policies and procedures to maintain the MLB's/MLO's books and records in compliance with the foregoing.

Any real estate broker or MLB who contracts for or collects advance fees from a principal must deposit the funds into a properly constructed trust account. Advance fees are not the broker's/MLB's funds. Amounts may be withdrawn for the benefit of the broker/MLB only when actually expended for the benefit of the principal or five days after verified accounts have been mailed to the principal for whom the fees are being held. If advance fees are not handled in accordance with the Real Estate Law, it will be presumed that the broker/MLB has violated Penal Code Sections 506 and 506a (i.e., embezzlement and conversion). Penalties, fines and jail or prison terms may result.

As previously mentioned, the DRE permits by policy MLBs/MLOs to collect fees in advance for appraisal and credit reports as long as the broker collects as near as possible the exact amount(s) necessary and deposits these funds into a properly constructed trust account. Refunds of any excess to the principal are required as soon as the excess is identified. Though credit and appraisal report fees are not treated as advance fees for the purposes of prior approval of the DRE (as defined above), these funds ***are*** trust funds. On October 11, 2009, Governor Schwarzenegger signed Senate Bill 94 (Calderon), and the legislation took effect immediately upon his signature. California law prohibits any person, including real estate licensees and attorneys, from demanding or collecting an advance fee from a consumer for loan modification or mortgage loan forbearance services affecting 1-4 unit residential dwellings.

Loan Processing

Once the application is complete with the assistance of an MLB/MLO, the applicant will be given a list of items that will comprise a loan application package. In addition, certain disclosures to the applicant (consumer/borrower) are required. Disclosures and notices of rights will be addressed later in this Chapter.

The MLB/MLO will usually submit the application to loan processing to assemble a loan application package. A loan application package consists of a properly completed application form and the supporting documentation required to process the loan and to make a credit decision. During the loan process, the lender typically uses a series of checklists to ensure each of the required steps properly occurred and the necessary documentation and support information has been gathered to approve and to close the loan requested (the loan for which the applicants applied). The loan processing checklists often include:

1. A Compliance Checklist;
2. A Stack Order;
3. A Borrower Checklist; and,
4. A Property Checklist.

Borrower Information

The following information is gathered by the processor and helps the lender to assess their risk by understanding the borrower's capacity/ability and willingness/desire to repay the loan:

1. Purpose of the loan. Learning why the applicant (consumer/borrower) wants to borrow money and the use of the loan funds will help to determine the risk associated with the extension of credit. The loan purpose will categorize the loan requested to determine the program criteria and what disclosures are required. The three common categories of loan purpose include (a) purchase, either for occupancy or

investment; (b) refinance, either to obtain a better loan rate and terms, or to receive a "cash-out"; or (c) an equity loan to obtain financing for home improvement or other described financial needs or objectives.

2. Source of Repayment. Typically, the primary source of repayment will be from the combined income received through the employment or professional activities of the applicants. Determining the type of business or profession pursued by or the employment of the applicants, how long the applicants have been in business or have engaged in a defined professional activity or how long employed in acurrent or related job in the same industry, will help to establish the stability of the income. Most lenders look for a minimum of 2 years in the same line of work or professional pursuit. In some instances, the source of income is through self-employment, from either a business or professional activity.

3. The applicant (consumer/borrower) may also present investment income as the source of repayment. In such instances, support documentation will prove to be critical in this analysis. The underwriting lender will look at the applicants' historical income and longevity of employment; the future expected trends of the employment, business, or profession of the applicant; and whether there is a likelihood of continuance in the same employment, business, or professional activity.

4. Assets. The asset breakdown represents the strength and composition of the financial standing of the applicants. Liquidity is important to determine the applicants' ability to provide down payment funds and required cash reserves, as well as to overcome unforeseen interruptions in income or irregular expense items. It is also an indication of the applicants' ability to save. Equity in other real estate, businesses, investments, or insurance policies also serves to demonstrate the applicants' overall substance.

5. Liabilities. Liabilities represent the applicants' leverage/debt against assets and the financial obligations that result in monthly payments, referred to as expenses. These expenses are usually broken into two categories, defined as the monthly housing expenses to establish a "front-end" ratio of debt to income, and the total monthly obligations to establish a "back-end" ratio of debt to income. The monthly housing expenses include the required monthly loan debt service, the debt service on any other financing against the security property, property taxes, assessments, causality and hazard insurance premiums, mortgage insurance premiums, and the dues or assessments of homeowners associations. The total monthly obligations include housing expenses and additional monthly debt service such as long-term contractual installment debt (vehicle or furniture payments), revolving debt such as credit card payments and open accounts, spousal and child support, and other liabilities that require monthly payments. The foregoing currently does not include when underwriting conventional loans or alternative mortgages or non-traditional loan products, utilities or the maintenance of the property (unless the loan product is FHA insured or VA indemnified).

6. Credit History. Each lender sets general policy guidelines outlining acceptable credit quality. These policies typically include loan terms that are predicated on different credit score thresholds. Credit policies are influenced by the lender's intent to keep the loan in their portfolio or to sell the loan in the secondary marketplace. Whether the lender relies solely on a credit score or on the overall repayment habits of the applicants, the credit history is a good indication of the applicants' financial management and how the prospective mortgage loan will be repaid, given a continuance of represented income. A lender may favorably consider repeat consumers/borrowers who have a proven "track record" of repayment or other banking or loan relationships with the lender.

Property Information

The value, condition of title, and overall quality of the property is evaluated to ensure the collateral will be adequate to secure repayment of the loan. Because of the long terms associated with real estate loans, the lender will estimate not only the current value and condition of the intended security property, but the economic trends in the neighborhood and community where the property is located. To further this evaluation, the loan processor will order the following reports:

1. Preliminary "Title" Report. A primary concern is that the consumer/borrower has good title to the real property which would secure the loan. Once a lender decides that serious consideration can be given to

a loan application, a preliminary report will be obtained on the proposed security property from a title company or from the intended title insurer to describe the terms of the offer to insure title to the property.

The purpose of a preliminary report is to:

a. Identify the property, including assessor's parcel number, street address, legal description and any issue that may be presented by the legal description;

b. Identify the current vesting (owner of record); and,

c. Reveal proposed title policy exceptions, including property taxes, assessments, encumbrances, liens, easements, claims and conditions of record, etc.

When all objections to title are resolved to the satisfaction of the lender, a title policy insuring the interest of the lender must ordinarily be obtained at the time the loan is funded. In this policy, the title insurer agrees to defend and indemnify the lender against damages/losses suffered by the lender arising from actions founded upon claims of encumbrances or title defects which were known, or should have been discovered, by the title insurer when the policy was issued.

2. Appraisal. A staff or independent fee appraiser will be engaged to inspect the property and estimate present market value and future value trends. The relationship between the amount of the proposed loan and the estimate of fair market value of the intended security property is the "Loan-to-Value" ratio. Most lenders base their loan amounts on the purchase price or appraised value, whichever is less.

The purpose of the appraisal report is to ascertain:

a. An estimate of the current market value of the intended security property;

b. Description and condition of land and improvements;

c. Applicable zoning and if the current uses of the land and improvements are consistent with the zoning;

d. Neighborhood and community market conditions;

e. Any discernable issues with the legal and physical description of the intended security property; and,

f. The nature of the occupancy.

3. Property due diligence. Depending upon the fact situation, the following property issues may also be addressed:

a. If other than the borrower, the status of and whether the occupant is asserting a title claim;

b. If a loan is to finance the purchase of the proposed security property, the sales price and proposed terms;

c. If a refinance, the date of original purchase, the price and terms of such purchase;

d. Are there additional assessments (regular or special);

e. If income producing property, the historical and projected operating income and expenses, and the amount of expected net operating income available to support the mortgage loan debt service; and,

f. Has any work occurred on or related to the security property within the last 90 days that might result in a mechanics' lien or other title claim.

Once up front disclosures are provided, the applicant has supplied all requested support documentation, and the credit, prelim and appraisal reports have been received, among any other items requested by the lender; the loan file should contain enough information to be presented to an underwriter. The application package should be organized in a logical manner using application and processing checklists to ensure conformity and compliance with the lender's policies and procedures.

Construction and Rehabilitation Loan Requests

In addition to the elements of loan processing for loan transactions where the intended security property is improved residential or commercial, as defined, vertical construction loan transactions require the gathering of additional documentation to support the loan request.

The following list is included to illustrate the documents and information to be gathered for vertical construction loans. Many of the items on the list will also apply to land acquisition and development loans whether residential, income producing or other forms of commercial property:

1. Current Preliminary Report meeting the requirements of the intended lender or permanent investor regarding the date of issuance and subsequent "date down" showing the condition of and the claims against title (including conditions, covenants, restrictions, encumbrances, liens, etc.);
2. Land Survey, if applicable or required for ALTA extended coverage, showing the exact location of the security property and the improvements thereon, or a proper final tract map or parcel map (if a subdivision) in accordance with the Subdivision Map Act;
3. Soils Report, if obtained, showing the composition and condition of the soil and sub-soil, topography, flood, and landslide or soil subsidence hazards, or related existing conditions, etc. (including whether the report is generic to a subdivision or site specific);
4. Geologic Hazard Report, if applicable, showing any known geologic or seismic hazards including historic landslides which may affect the intended security property;
5. Environmental Impact Report or Negative Declaration as required by the governmental agencies having jurisdiction over the matter;
6. If the financing contemplated is to be secured by a junior encumbrance in a context of a subdivision or contiguous phases or units in the same subdivision, whether the financing is subject to the requirements imposed for promotional notes pursuant to the Securities Law;
7. Contractor's resume and qualifications, and the contract for new construction showing a cost breakdown and description of materials, building plans and specifications as approved by the local government of jurisdiction, etc.;
8. Contracts from design professionals and bids from the major subcontractors intended to be engaged for the project;
9. Approvals from local and regional governments, districts or commissions having jurisdiction over the project, e.g. Coastal Commission;
10. Appraisal report in a form appropriate for the transaction, including an estimate of the market value of the intended security property "as is" and "as completed" applying a discounted cash flow or an anticipated development analysis with absorption rates and estimating costs for holding periods when appropriate, in accordance with USPAP;

11. Evidence of compliance with the Subdivided Lands Law if the project is a CID subject to the issuance of a Public Report and of the financial arrangements and bonding to ensure lien free completion in accordance with the requirements imposed by local governments and the DRE; and,
12. Insurance policies extending coverage for course of construction, general liability and workers compensation, among others, including proper endorsements.

The above list is intended to be illustrative and not comprehensive. The documents and information to be gathered will vary substantially depending on the nature of the land development or vertical construction to be financed. Loan documents/instruments evidencing and securing land development or construction loans are unique and include construction loan and security agreements; UCC-1 filings; assignments of contracts with contractors, subcontractors and design professionals; assignments of plans, specifications, and building permits, among many others. These transactional loan documents/instruments, agreements, disclosures, etc., should be reviewed by knowledgeable legal counsel before proceeding with land development or vertical construction loans.

Loan Processing Wrap Up

When the loan is packaged by an MLB, the broker's file should be maintained in a logical manner consistent with the practices of the broker (MLB) recognizing the policies and procedures of the lender to whom the loan is to be delivered. The lender or the authorized agent of the lender can then underwrite a properly developed loan package.

Underwriting Analyses

The underwriter's role is to assess the risk of the proposed loan and make recommendations whether to approve the loan. In addition, the underwriter will ensure the loan package is in compliance with not only applicable laws but with the lender's policies. The underwriter will typically use an underwriting checklist to make sure all components, elements, and conditions are considered and/or included, and that a credit memo or other written summary of verified information, recommendations, and conclusions of the underwriter will be completed.

The underwriter will carefully consider the ability/capacity and willingness/desire of the consumer/borrower to repay the loan as well as the adequacy of the collateral. This analysis is based on:

1. Information contained in the loan application and supporting documents;
2. Information developed by the lender in checking the credit and character of the prospective consumer/borrower;
3. Verification of employment, bank deposits, etc. of the consumer/borrower;
4. A review of the information obtained in the preliminary "title" and appraisal reports and from the property due diligence;
5. A interview with the consumer/borrower either telephonically or in person; and,
6. A review of the specific loan file to ensure compliance with the lender's policies and procedures, including the loan product being offered to the consumer/borrower.

Lenders evaluate residential loan requests using various measures to answer two basic questions concerning the consumer/borrower. What is the borrower's capacity for repaying the loan? What is the borrower's willingness/desire to repay the loan? The first issue deals with the capacity to repay and involves calculating debt ratios. The traditional secondary mortgage market (primarily represented by Fannie Mae and Freddie Mac) dictated standard underwriting ratios of 28% and 36%.

The first number of 28% is the historic "front-end" ratio that was often ignored when underwriting alternative mortgages or non-traditional loan products. As previously indicated, the borrower's housing expenses include, principal and interest payments on senior and junior encumbrances, property taxes, and homeowners insurance premiums, collectively referred to as PITI. If the property is located within a common interest development (CID), many lenders add on to the housing expenses the dues/assessments imposed by the homeowners association (HOA). The relationship between total housing expenses and the borrower's gross monthly income is translated into a ratio with the housing expenses not to exceed 28% of the gross monthly income, i.e.,

the "front-end" ratio. In restructuring existing mortgage loan/debt, an acceptable "front-end" ratio is as much as 38% of the borrower's gross monthly income.

The second traditional number of 36% is the historic "back-end" ratio that was also often ignored when underwriting alternative mortgages or non-traditional loan products. As previously indicated, the borrower's total monthly obligations include, the aforementioned housing expenses, as well as any other long-term installment debt (defined as obligations that have more than 10 months of payments remaining before they are paid off); certain forms of revolving debt such as credit cards and open account payments; spousal or child support; and other qualifying liabilities subject to monthly debt service. The historic relationship between the total housing expenses plus other qualifying monthly obligations was translated into a ratio not to exceed 36% of the borrower's gross monthly income.

Fannie Mae as part of revamping their underwriting guidelines has since abandoned the above described housing ratios in favor of a total debt ratio, now called the benchmark ratio of from 36% to 38%, depending upon the fact situation. It is important to understand the 36% to 38% benchmark ratio is a guideline only which is considered in conjunction with other factors as part of a comprehensive risk assessment. An incremental increase in the ratio above 36% to 38% may not be considered significant in the overall decision. Underwriting guidelines currently consider a low or high ratio as a contributory risk factor that may decrease overall risk when the ratio is less than 30%, or increase the overall risk when the ratio is over 42%. Part of the risk analysis is the consideration of the net available income to service the consumer/borrower's general obligations and living expenses including income taxes, food, utilities, transportation, etc.

The credit report is the means the lender uses to measure the borrower's willingness/desire to repay. Traditionally, lenders evaluated a borrower's credit by doing a line-by-line analysis of each "tradeline" or source of credit appearing on the consumer/borrower's credit report. This often resulted in a level of scrutiny which required consumers/borrowers to provide additional loan documentation by way of a letter to explain, "why they were late once on a department store credit card four years ago". This was true even though it may have had little relevance in predicting risk for the current credit decision.

Today, most lenders rely on credit scores to summarize a consumer/borrower's credit profile with respect to its overall predictability of future delinquency risk. Even with the use of credit scores which have become commonplace, specific issues may result in the requirement for a letter of explanation. For example, a past record that includes a Notice of Default, a bankruptcy, or an action by a creditor/lender to obtain a judgment for non-payment of a debt will likely result in a letter of explanation (See additional discussion of credit scores under Fannie Mae's Automated Underwriting).

Fannie Mae's Automated Underwriting

Fannie Mae has automated the underwriting process for lenders through its Desktop Underwriter (DU) program. DU is a knowledge based software tool that contains rules for the quantitative assessment of risk associated with a given loan request. It not only provides a comprehensive risk assessment of the borrower's capacity and willingness/desire to repay a loan, but also determines whether the loan meets the eligibility criteria for purchase by Fannie Mae.

MLBs/MLOs through Desktop Originator (DO) are able to access the DU to deliver point of sale underwriting decisions for the consumers/borrowers who are their clients. This results in greater efficiencies for lenders and MLBs. In addition, the immediate feedback enables the MLB/MLO and the consumer/borrower to utilize "what if scenarios" in putting together a structured loan program that is the most suitable for the client while at the same time pursuing the objective of loan approval.

Automated underwriting initiatives rely heavily on credit scores generated from each of the three national repositories of credit data: Experian, Transunion, and Equifax. Credit scores are derived from statistical models applying complex mathematical formulas to evaluate the raw credit data in a consumer/borrower's file to predict the desired repayment of the loan being requested. These three digit scores generally range from 300 – 850 with the higher the score representing the lesser risk. The borrower should ask the MLB or MLO to whom they are applying about credit practices the borrower should avoid that could result in an inadvertent decline in the reported credit score.

The historic statistical analysis has suggested that one out of every 39 consumers with a score from 660–679 (considered a fair or acceptable score for many loan programs) will become 90 days or more late on a loan. A score of 700 or higher is considered a very good score and will generally qualify a consumer/borrower for most loan programs. The general benchmarks used by lenders for credit scores are 620, 650 and 680. A credit score of less than 650 issued to a borrower will likely result in a higher interest rate. Conversely, a credit score in excess of 680 will likely result in a preferential lower interest rate.

Freddie Mac offers an automated loan-underwriting program called Loan Prospector (LP). It operates in a similar manner to the Fannie Mae automated underwriting system and relies, as well, on credit scores generated from each of the three national repositories of credit data. Freddie Mac also uses similar credit score benchmarks which are applied in the same manner.

Underwriting Income Property

There are different methods of underwriting income property. The methodology is often dependent on the type of loan request and the primary source of repayment. For example, if the loan is secured by a rented or leased fee commercial investment property (such as an apartment building, retail store, or an office building), the lender likely will rely heavily on the security property's cash flow that is available to service the mortgage debt. Since the income from the security property will be the primary source of repayment, the lender will ask to review rental and lease agreements and for lessee estoppel certificates to be obtained.

In the case of an apartment property, the rent roll and the status of the rent on each unit are included in the information required to underwrite the loan. Secondary sources of repayment may come from the borrower's excess cash flow or liquidity (depending on if the loan is recourse or non-recourse). The tertiary source of repayment may come from the sale of the security property. In this method of underwriting, a debt coverage ratio will be established. Generally, the underwriter determines the debt coverage ratio by using the following formula:

	Projected Gross Rents	(Economic or projected gross rent scenarios will be considered)
Plus	Other Income	(e.g., laundry, parking, common area maintenance reimbursements)
Equals	Total Gross Income	(Economic or projected)
Less	Vacancy Factor	(Includes projected vacancies, collection, and credit losses)
Equals	Effective Gross	
Less	Operating Expenses	(Economic or projected)
Equals	Net Operating Income	(Economic or projected)

The projected gross rents estimate the income the security property should generate if rented at economic or the then current market rents. If long-term leases encumber the security property with contract rents that are less than economic or the then current market rents, the market value of the intended security property is burdened by these actual rents. The available income stream upon which to rely for a debt coverage ratio is reduced by the contract rents from the long-term leases. The actual gross income from the contract (actual) rents will correspondingly reduce the available economic or projected net operating income (NOI), i.e., the actual NOI will be less than the economic or projected NOI. The actual NOI will prevail when calculating the debt coverage ratio.

The NOI is the cash flow of the property and the amount available to service the mortgage debt. The debt coverage ratio (DCR) is determined by dividing the annual NOI by the annual mortgage debt service. The debt coverage ratio will vary depending on the loan, property type, and the creditor/lender or the permanent investor. For example, an institutional lender making a loan on an apartment building may require a 1:15:1.0 DCR. This means that for every dollar of debt service, there must be $1.15 of NOI. In a commercial loan transaction where the intended security property is other than an apartment building and the underwriter believes the loan represents a greater risk to the creditor/lender or to the permanent investor, the lender may ask for a 1.25:1.0 DCR.

If the loan is a recourse transaction or there is a third party guarantor, the financials of the borrower and the guarantor will be evaluated to determine their overall financial strength. The objective is to estimate the financial ability to service any shortfalls, should the security property's income stream be interrupted.

In the case of income property that is occupied by an owner/user (such as an industrial building where the borrower's business is located) another underwriting method may be used. In this instance, the primary source of repayment is from the borrower's business. Accordingly, a global cash flow analysis will be considered encompassing not only the income of the business, but also income from other sources the borrower may have. The available cash flow is compared to the expenses of the business as well as to any personal debt/loans of the borrower. The lender will also consider the continued viability of the business as a "going concern". This analysis of the business is an essential element in the qualification for a loan to be insured by the Small Business Administration (SBA).

Further, if the loan is a non-recourse transaction secured by a single-tenant building (such as a fast food restaurant), the strength of the tenant, the ability to produce sufficient cash flow to support the mortgage debt service, and the continued long-term viability of the business as a "going concern" will be evaluated by the underwriter.

In addition, when evaluating an investment grade commercial loan transaction, the tools of analysis used may include an inquiry into four main categories:

1. *Liquidity.* One component of the borrower's assets is their liquidity. The borrower's liquidity includes cash and cash equivalents that are available for down payment, liquid reserves, and in some cases from additional collateral. An underwriter must consider how able a borrower is to pay bills as they come due. Current assets are compared to current liabilities. A liquidity ratio of 2 to 1 or better (current assets are twice the liabilities) is recognized as acceptable by most lenders. Cash on hand and accounts and notes receivable due within one year are considered "current assets"; debts and obligations due or payable within one year are considered "current liabilities."

2. *Leverage*. This is the ability of the borrower to control a large investment with a small amount of his or her own equity capital and a large amount of other people's money (the use of leverage). The more money borrowed in relation to the value of the security property, the greater the leverage. Leverage tests reveal how much of the total financing for the project is supplied by the owner and how much is supplied by creditors such as the mortgage lender.

   Included in the leverage analysis is a consideration of the "debt-to-equity ratio". Leverage tests in connection with analysis of a borrower's financial statements are completed by comparing the borrower's equity interest in the assets owned and the total value of the capital investment to the long-term debt. The purpose is to find how much of the total investment is ownership and how much is debt. In a purchase transaction, to determine the original equity ratio, the down payment is divided by the purchase price; and to determine the original debt ratio, the loan amount is divided by the purchase price.

   It is common for equity investors to seek debt ratios in excess of 75-80%. However, the ability to exceed this ratio is often capped by applicable regulatory law. Lenders, looking at risk factors, carefully scrutinize loan proposals to assure a safe equity ratio based on property characteristics and the borrower's repayment record. The rule of thumb for debt to equity ratio will be something between 3:1 and 4:1. The borrower often wants a more extreme ratio, because it reduces the amount of equity capital that is at risk in the transaction. Real estate investment examples in a liquid money market have been presented where ratios of 1 to almost zero are achieved by borrowers. This is usually a very dangerous situation for the lender and is not available in a highly regulated atmosphere. An exception allowing for zero debt to equity ratio is when the repayment of the loan is guaranteed or insured by some reputable third party in the transaction, e.g., the United States Department of Agriculture (USDA), or a financially strong company such as a major chain store or oil company.

   Some lenders are willing to risk entering a high debt to equity loan situation in anticipation of market prices going up, which automatically achieves growth in the owner's equity resulting a more moderate ratio through property appreciation. History has repeatedly shown that the expectation of market appreciation is uncertain, especially in unstable economic conditions where a flat or down market often occurs.

Coverage of fixed expenses is a test of how many times net income before income taxes and fixed expenses (gross income minus operating expenses) will cover the fixed expenses. It reveals how far the income can drop before the security property (or the borrower) will be unable to meet the fixed expenses such as real estate taxes, insurance, license and permit fees. Net operating income after operating expenses is divided by fixed expenses to get this ratio. If the ratio is 1:1, the net operating income after operating expenses is just barely able to cover the fixed expenses. This is known as the break-even ratio.

3. *Activity*. Activity tests are designed to reveal just how hard and effectively assets are working. There are several tests for this but the most widely used is the income to total asset ratio. This ratio is found by dividing total income by the value of the total assets.

4. *Profitability*. Profitability tests are designed to see how much net profit results from the operation. The following are several of a variety of ratios and tests that are used to inquire into profitability.

   Included is the "return on net worth." This is the ratio of net profit (after taxes) to the net worth of the project. This will yield a percentage return on investment which can be compared with the return available from other investments of comparable risk. This is known as the alternative investment theory.

   Another profitability test is "yield analysis". This form of analysis is well suited to estimating profitability of real estate projects because it is relatively easy to compute and takes into consideration three factors unique in their combination to real estate investment: cash return, equity return, and tax shelter. It involves dividing the total return (net spendable cash income, principal reduction of mortgage loans, and tax shelter) by the borrower's equity. This is referred to as the internal rate of return (IRR).

Loan Approval, Funding and Closing

Lender's Action

Most lenders operate with a *Loan Committee* of experienced senior officers who consider loan applications recommended to them by loan officers or borrower representatives (MLBs/MLOs). These MLOs have screened the applications through borrower interviews including due diligence about the borrower and the intended security property. The due diligence includes obtaining appraisal reports and other applicable reports such as credit data. The underwriting analysis will typically represent the summary of the due diligence accomplished regarding the borrower and the intended security property.

Through the underwriting analysis, the loan request will be approved, declined or the file may be closed for incompleteness. The file is closed if the applicants have failed to provide required documentation and support information. If the loan request and application is approved, the file progresses to the Loan Funding/Closing Department for document/instrument preparation, funding of the loan, and ultimate closing of the loan transaction.

Funding and Closing of the Loan

Depending upon how the lender is organized, the Loan Funding/Closing Department or the Document Preparation Department will (subsequent to loan approval) prepare and complete the documents and instruments required to evidence and secure the intended loan as well as the federal and state disclosures and notices of rights to which the borrower is entitled. A loan closing and funding checklist will be added to the file to ensure all appropriate documents/instruments are included. In addition, lender's escrow instructions will be prepared and transmitted with the documents, instruments, disclosures, and notices of rights to the escrow holder for the signature of the borrowers.

The mechanics of closing the loan will vary. For the sale of a residence, an escrow holder is usually handling a sale transaction between the seller and buyer and a loan transaction between the lender and the buyer/borrower. In a loan transaction where no sale is involved (i.e., a refinance or further encumbrance of the security property), the escrow holder's assignment will be limited to escrowing the intended loan as well as obtaining

the signatures of the borrowers on the loan documents, instruments, disclosures, notices of rights and escrow instructions necessary to close the loan transaction.

The escrow holder will typically furnish the lender with a certified copy of the signed escrow instructions, together with any amendments thereto, and other documents, instruments the lender may require. As indicated, an escrow officer employed by the escrow holder should obtain the signatures of the borrower on the required documents, instruments, instructions, disclosures and notices of rights as directed by the lender. This activity should not be delegated to independent signing agents without the express authority of the lender. MLBs/MLOs are not authorized under the Real Estate Law to participate in the delegation of this function to independent signing agents to carry out the obligations imposed under the Real Estate Law and pursuant to the exemption available under the Financial Code when the broker is acting as the escrow holder (Business and Professions Code Section 10133.1(c)(1) and (c)(2) and 10 CCR, Chapter 6, Section 2841; and Financial Code Section 17006(a) and (b)).

The escrow holder returns the loan documents and certified copies of the instruments to be recorded to the lender for final review and approval in advance of loan funding. The escrow holder then awaits confirmation that the lender is ready to fund the loan and for the receipt of the loan funds to close the loan escrow.

Recordation

When the lender's instructions have been complied with, no conflicts remain or exist in the instructions of the principals, and the lender approves the documents, instruments, agreement, disclosures, etc., as executed; the lender sends/wires the loan funds to escrow. Upon receipt and verification of the loan funds, the escrow holder transmits or causes to be transmitted to the county recorder for recordation the appropriate instruments conveying or encumbering the title to the security property as instructed by the principals of the escrow. The escrow holder confirms the recording and then proceeds to order the requested title insurance coverage.

Subsequent to recordation and close of the loan escrow, the escrow holder distributes the loan documents, instruments, agreements, disclosures, etc., pursuant to the instructions of the principals of the escrow that were not otherwise previously delivered. Loan funds are disbursed in accordance with the foregoing instructions.

PREDATORY LENDING AND BROKERING PRACTICES

Background

"Predatory Lending" is a general term used to describe abusive lending practices by some depository institutions, licensed creditors/lenders, and by some MLBs viewed as "preying" on unsophisticated consumers/borrowers. The U. S. Congress and the California legislature have each acted to address these practices through the introduction of legislation that has added substantial new law regarding the making and arranging of residential mortgage loans with the primary focus on owner occupied dwellings. In addition, new federal regulations have been adopted as guidance for lenders and MLBs/MLOs when engaged in the making and arranging of alternative mortgage instruments or non-traditional mortgage products. "Redlining" of certain neighborhoods and communities was among the practices considered to be unacceptable.

In this section, the term "lender(s)" are the persons or entities that regularly make loans and whose names appear on the promissory notes as the initial payee or that meet a defined status, when the mortgage loans are subject to the Real Estate Settlement Procedures Act (RESPA) implemented through Regulation X, as well as other applicable federal law. Regulation X is found in 24 CFR Section 3500 et seq. The term "creditor(s)" are the persons or entities that, among other defined responsibilities and reporting obligations, extend credit to consumers/borrowers in transactions subject to the Truth-In-Lending Act (TILA). Accordingly, the federal definition is two-pronged, i.e., the "creditor(s)" for the purpose of making disclosures and delivering notices of rights pursuant to TILA and "lender(s)" that regularly make loans and whose names appear on the promissory notes as the initial payees and on the security devices/instruments as the beneficiaries/lenders/mortgagees.

California and Federal Legislation

The first effort to address predatory lending practices was accomplished by the California Legislature in 2001. This legislation is now commonly known as the Predatory Lending Law and is found in Financial Code Section 4970 et seq. This law became operative on July 1, 2002. During the same period, the U.S. Congress and the

FRB pursued amendments to TILA found in 15 USC Section 1601 et seq. and in Regulation Z, 12 CFR Section 226 et seq. On December 20, 2001, the FRB issued final amendments to Section 226.32 of Regulation Z and to the related “Commentary”. Creditors/lenders were required to comply with these amendments on October 1, 2002, commonly known as “Section 32” or the “High-Cost Loan Law”.

The aforementioned state law limited or controlled specific loan terms and added prohibited conducts by creditors/lenders and MLBs in connection with consumer loans defined to be secured by the borrower’s principal dwelling. The federal law amendments added disclosures to consumers/borrowers in loan transactions where the security property is an owner occupied dwelling (as defined).

Federal Regulations

As previously mentioned, the Office of the Comptroller of the Currency (OCC); the Board of Governors of the Federal Reserve System (Fed or FRB); the Federal Deposit Insurance Corporation (FDIC); the Office of Thrift Supervision (OTS); and the National Credit Union Administration (NCUA); (collectively the Agencies) published the, “Interagency Guidance on Non-Traditional Mortgage Product Risks,” November 7, 2006, which became effective November 14, 2006. The same Agencies issued the, “Statement on Subprime Mortgage Lending”, which became effective June 29, 2007.

The Guidance and the Statement were adopted by state regulators of banking (depository institutions), licensed lenders, and of MLBs, including the Commissioner of the DRE (Business and Professions Code Section 10240.3). Accordingly, these documents/regulations had a sweeping affect on mortgage lending and brokering (as well as severely limiting the secondary market for alternative mortgage instruments and non-traditional mortgage products) throughout the entire country, including the terms available for residential loans. Limitations and prohibitions on certain conducts by creditors/lenders and MLBs were imposed through these documents/regulations.

Redlining

The aforementioned “redlining” practices by creditors/lenders and MLBs have been outlawed. The practices defined as a violation of applicable law included creditors/lenders and MLBs drawing lines on maps around areas within neighborhoods and communities in which lending and brokering activities did not occur (i.e., creditors/lenders and MLBs refused to make or arrange residential mortgage loans, as defined). This past and unlawful practice of “redlining” was replaced by a much bigger problem of “reverse redlining”.

Reverse redlining involves targeting these previously underserved areas that were occupied by residents and tenants who were often members of lower socio-economic classes or who were members of racial and ethnic minorities (as well as recent immigrants). A catalyst for targeting these previously underserved areas was the federal Community Reinvestment Act that was amended and expanded in 1999 by the Gramm-Leach-Bliley Act.

The occupants of these geographic areas were generally less knowledgeable about loan programs and the lending process and were typically uncertain or afraid to assert their legal rights, even in instances where it appeared they were taken advantage of by creditors/lenders and MLBs (who failed to appropriately perform their disclosure duties and related obligations, including the fiduciary duties owed to consumers/borrowers by MLBs). Because of the reverse redlining, the individuals residing in these geographic areas became targets for abusive lending and brokering practices.

Consumer/Borrower Abuses by Creditors/Lenders and MLBs

These practices involved unlawful tactics such as fraud, deceit, misrepresentation or deception, and unfair business practices that may otherwise not be unlawful; but were unethical and, if pursued by MLBs, resulted in breaches of fiduciary duties owed to consumers/borrowers. Inducing consumers/borrowers to repeatedly refinance the mortgage loan secured by their principal residences and charging high rates and fees each time (sometimes referred to as “churning”) is an example of the unfairness cited by the Federal Reserve System in their background commentary for the Home Ownership and Equity Protection Act (HOEPA), the “High-Cost Loan Law”. This “churning” practice is patently unfair and unethical, particularly when no demonstrable benefit from the refinance inures to the consumer/borrower (such as improving the rate and terms as the borrower’s credit worthiness and financial standing improves), i.e., the refinance was not in the interest of consumers/borrowers.

As previously discussed in this section, federal and state legislation was enacted and regulations were adopted in an effort to curb predatory practices. These regulations expanded regulatory oversight of what are described as "High-Cost Loans" or "Higher-Cost or Priced Loans". Until a California Supreme Court decision struck down the City of Oakland's Predatory Lending statute in favor of regulation at the state and federal level, some cities and other local political subdivisions had adopted or considered adopting their own predatory lending statutes. In the previously mentioned case, the court held California through its state legislation had occupied the field and that any local ordinance was preempted thereby.

"High-Cost Loans" – An Overview of Sections 32 and 35

Federal legislation was enacted to regulate predatory lending practices pursuant to the aforementioned HOEPA in Section 226.32 in Regulation Z where the regulations were promulgated to implement the amendments to TILA (as mentioned, commonly known as Section 32). In addition, the Federal Higher Cost Mortgage Loan Act, commonly referred to as Section 35, was adopted by Congress. Section 226.35 in Regulation Z of TILA is where the regulations were promulgated implementing this law (15 USC Section 1601 and 12 CFR Sections 226.32 and 226.35).

In "High-Cost Loans" (Section 32), the interest rate threshold is determined by comparing the Annual Percentage Rate (APR) with United States Treasury Securities of a comparable maturity. The APR is the effective mortgage loan interest rate, which includes fees and charges considered prepaid finance charges, as defined (12 CFR Section 226.4 (a)(b)). For first or senior deeds of trust or mortgages, if the difference in the APR exceeds the rate of comparable Treasury Securities by 8% or more, then the APR has met one of the two defined thresholds for a "High-Cost Loan". For second or junior loans, the APR threshold is 10% over Treasury Securities of comparable maturities.

The second of the two tests is whether the defined points and fees (including compensation paid to MLBs) exceeds a threshold equivalent to 8% or more of the "net" loan amount (after deduction of the qualifying prepaid finance charges, except for the prepaid interest represented by the initial partial month's interest proration imposed at the time of loan closing). If either the APR based test or the fee based test is met or exceeded, then the mortgage loan is considered a "High-Cost Loan" for purposes of applying HOEPA.

"Higher-Cost/Priced Loans" (Section 35) are defined for federal purposes as a consumer credit transaction secured by the consumer/borrower's principal dwelling with an APR that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set on the subject mortgage loan. When the subject mortgage loan is a first or senior encumbrance, the applicable APR that triggers Section 35 is set at 1.5% or more than the applicable prime offer rate. If the loan is a second or junior encumbrance, the applicable APR that triggers Section 35 is set at 3.5% or more than the applicable prime offer rate. The applicable prime offer rate is the average prime offer rate for conventional loans.

The average prime offer rate means an APR that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors/lenders for mortgage loan transactions (including compensation paid to MLBs) that have low-risk pricing characteristics. The Federal Reserve Board (FRB) publishes average prime offer rates for a broad range of types of transactions including conventional mortgages in a table updated weekly known as the H15 Statistical Release (http://www.federalreserve.gov/releases/h15/update/). Key issues included in Section 35 require creditors/lenders to *not* extend credit solely based on the value of the consumer/borrower's collateral without at the same time considering the consumer/borrower's ability to repay the mortgage loan debt service.

In addition, prepayment penalty fees are regulated and escrow (impound) accounts must be established by creditors/lenders to provide for the monthly collection of sufficient sums for the future payment of property taxes and property and casualty and other mortgage related insurance coverage when the property taxes and the premiums for such coverage become due and payable. These escrow (impound) accounts are established by creditors/lenders or by their servicing agents on behalf of consumers/borrowers in such loan transactions.

These federal and state laws to prevent creditors/lenders and MLBs from engaging in predatory practices will be discussed further in this Chapter. MLBs/MLOs are well advised to familiarize themselves with each of these laws, including implementing regulations, as the remedies include rescission of the mortgage loan, actual and punitive damages, attorney's fees and costs, license revocation or suspension, possible exclusion from the

mortgage and other real estate related industries for specified periods, and in some circumstances criminal penalties. MLBs/MLOs should seek the advice of knowledgeable legal counsel prior to engaging in residential mortgage loan transactions when the intended security property is the owner occupied dwelling of the consumer/borrower.

California "High-Cost Loans" – "The Covered Loan Law"

Legislation was passed into law in 2001 that created California's "Covered Loan Law" effective with transactions originated on or after July 1, 2002. As previously discussed, this law provides that mortgage loans (as defined) with annual percentage rates or points and fees that exceed certain levels must adhere to specific restrictions and limitations.

The law is intended to protect consumers/borrowers of these "High-Cost Loans" from abusive lending and brokering practices and is limited to consumer credit transactions that are secured by residential real property located in California and used, or intended to be used, as the consumer's/borrower's principal residence and improved by a 1 to 4 unit residential dwelling. For the purposes of this law, "consumer loans" exclude bridge loans (defined as temporary loans having a maturity of one year or less that fund the acquisition or construction of a dwelling intended to be the primary residence of the consumer/borrower) or a reverse mortgage (as defined) (Regulation Z, 12 CFR Section 226.32 and Financial Code Section 4970(d)).

The state's "High-Cost Loan" legislation was codified in the California Financial Code, commencing with Section 4970. This Predatory Lending Law is more restrictive than federal law regarding the application of the APR tests. The first test to be applied under state law is whether the amount of the original principal balance qualifies the mortgage loan as a "Covered Loan", defined to mean a loan secured by real property located in this state used or intended to be used or occupied as the principal dwelling of the consumer/borrower and which is improved by a 1 to 4 dwelling unit. To establish "Covered Loan" status, the original principal balance of the loan is not to exceed the most current conforming loan limit for a single-family first mortgage loan, as established by FNMA for the community in which the security property is located. Applicable federal law does not apply a "Covered Loan" original principal balance limit/test.

The second test is the APR threshold standard. State law applies a standard of more than 8% greater than the yield of Treasury Securities of comparable maturities (established on the 15th day of the month immediately proceeding the month in which the application is received by the creditor/lender) as the threshold for purposes of determining "Covered Loan" status. This 8% APR threshold standard applies to *both* first or senior and second or junior mortgage loans. Again, the FRB H15 Statistical Release identifies the yield of the Treasury Securities of comparable maturities.

A third test is applied to determine whether a mortgage loan is subject to the California Predatory Lending Law. This test is measured by the total points and fees paid by the consumer/borrower at or before closing for a loan secured by a deed of trust or mortgage. If the total points and fees exceed 6% (including compensation paid to MLBs) of the "total loan amount", which fees and points are defined as the items required to be disclosed as prepaid finance charges under Regulation Z (12 CFR Sections 226.4(a) and (b)); "Covered Loan" status applies to the mortgage loan transaction, i.e., the mortgage loan is subject to the California Predatory Lending Law (the common title applied to "Covered Loan" transactions).

When persons MLBs/MLOs arrange the "Covered Loan", such persons are fiduciaries of the consumer/borrower and any violation of these fiduciary duties is a violation of applicable law. Further, brokers (MLBs/MLOs) arranging "Covered Loans" owe fiduciary duties to the consumers/borrowers in such loan transactions, regardless of any other representation the brokers may have as agents and fiduciaries in "Covered Loan" transactions (Financial Code Section 4979.5).

This means the brokers (MLBs/MLOs) who are delivering "Covered Loans" to private investors/lenders for whom they must act as agent and fiduciaries are "dual agents", and this status is to be disclosed and consented to by each principal to the loan transaction. Brokers (MLBs/MLOs) *are agent and fiduciaries* of consumers/borrowers in residential mortgage loan transactions (whether "Covered Loans" or otherwise) and *are agents and fiduciaries* of private investors/lenders, regardless of the nature of the loan transactions or the intended security properties. Brokers (MLBs) who are engaging in commercial loan transactions, as defined (loans secured by other than 1 to 4 dwelling units) are the agents and fiduciaries of commercial borrowers,

unless such borrowers are either separately represented or have received and consented to disclosures that they are unrepresented and no conduct has occurred that would otherwise establish and agency and fiduciary relationship with the borrower. It is important to understand that brokers (MLBs) whether registered as MLOs are *not facilitators* in mortgage loan transactions (Business and Professions Code Sections 10131(d) and (e), 10131.3, 10176(d), 10177(q), and 10237 et seq.; Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; Corporations Code Section 25100(e) and 25206; Corporations Commissioner's Regulations 10CCR, Chapter 3, Sections 260.115 and 260.204.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c), among others).

The Predatory Lending Law restricts or prohibits loan terms that provide for prepayment penalties, balloon payments, negative amortizations, advance payments, default interest rates, and single premium life and disability insurance. The law also establishes rules for the payment of home improvement loan proceeds to contractors. Generally, such loan proceeds are to be paid jointly to the consumer/borrower and to the home improvement contractor (Financial Code Section 4973(a), (b), (c), (d), (e), and (g)).

To make or arrange a "Covered Loan", the person originating such loan must have a reasonable belief, based on certain criteria, the consumer/borrower can repay the loan from income or financial resources *other than the equity in the property securing the loan*. The law also limits the amount of points and fees that can be financed by the consumer/borrower as part of the loan proceeds. Persons originating "Covered Loans' (whether creditors/lenders or MLBs) must give consumers/borrowers a notice required by statute entitled, "Consumer Caution and Home Ownership Counseling Notice". This notice is to be delivered not less than three business days prior to signing of the loan documents by consumers/borrowers. The font size, content, and format of this notice is prescribed by statute (Financial Code Section 4973(k)).

This law provides for administrative and civil penalties for violators, other than an assignee who is a "holder in due course" (which may not include private investors/lenders). In addition, violating certain restrictions or prohibitions regarding loan terms can render those terms unenforceable. For example, this law establishes rules for prepayment penalty fees and for a minimum loan term length, if a balloon payment transaction is contemplated. Consumers/borrowers must be qualified in accordance with the guidance included in this law applying debt to income ratios; and a "Covered Loan" is not to contain a "call" or acceleration provision that would permit creditors/lenders (in their sole discretion) to accelerate the indebtedness evidenced by the promissory notes and deeds of trust or mortgages, except as expressly authorized in accordance with this law and in the loan documents (Financial Code Section 4973(a), (b), and (i)).

The three authorized circumstances permitting creditors/lenders to accelerate all sums due irrespective of the maturity date include:

1. As a result of the consumer's/borrower's default;
2. Pursuant to a "due-on-sale" provision; or,
3. Due to a fraud or material misrepresentation by the consumer/borrower in connection with the mortgage loan or the value of the security real property (Financial Code Section 4973(i)).

Further, persons who originate "Covered Loans" shall not refinance or arrange the refinancing if the new loan is made for the purpose of debt consolidation or "cash-out", unless the refinanced "Covered Loan" results in identifiable benefits to the consumer/borrower measured by the stated loan purpose and the fees, interest rate, points (including MLB compensation), and total finance charges.

This law further provides that it is unlawful for persons (creditors/lenders and MLBs) who originate (make or arrange) "Covered Loans" to steer, counsel, or direct any perspective consumer/borrower to accept a loan product with a risk grade less favorable than the risk grade for which the consumer/borrower would qualify based upon the creditor's/lender's and the MLB's then current underwriting guidelines, prudently applied, including information available to such persons and as provided by the consumer/borrower. If the person is a broker (MLB), the MLB/MLO is not to steer, counsel, or direct any prospective consumer/borrower to accept a mortgage loan product at a higher cost than that for which the consumer/borrower qualifies, based upon the loan products offered by the persons (creditors/lenders) with whom the broker (MLB) regularly does business (Financial Code Section 4973(l)).

It is also important to understand persons who originate covered loans are not to avoid, attempt to avoid, or otherwise circumvent the Predatory Lending Law by structuring the loan transaction for the purpose of evading the law. This includes using an open-end credit plan (e.g., Home Equity Line Of Credit); dividing the loan into separate parts; or proceeding in any other manner, whether specifically prohibited or of a different character, that constitutes fraud (Financial Code Sections 4970(d) and 4973(m)(n)).

In addition, "stated income" loans may not be made or arranged unless the consumer's/borrower's income is based upon a reasonable belief (supported by information in the possession of the person originating the loan after the solicitation of all information customarily solicited in connection with loans of this type). A "Covered Loan" is not to be knowingly or willfully originated as a *stated income loan* with the intent or the effect of evading the Predatory Lending Law. Further, persons making or arranging "Covered Loans" must be able to demonstrate a reasonable belief the consumer/borrower will be able to make the scheduled payments to repay the loan based upon their current and expected income, current obligations, current employment status and other financial sources, *excluding the equity in the consumer's/borrower's dwelling* (Financial Code Section 4973(f)).

Depending upon the issue, loan terms negotiated in violation of this law may result in voiding (rendering unenforceable) such loan terms. Furthermore, persons who make "Covered Loans" (creditors/lenders) when the person is on notice of, knew, or otherwise showed reckless disregard of violation(s) of the Predatory Lending Law by MLBs, such persons and the brokers shall be jointly and severally liable for all damages awarded under this law with respect to the unlawful conduct of the brokers (Business and Professions Code Section 10177(d) and Financial Code Section 4974(b)).

The provisions of the "Covered Loan" law are in addition to the consumer/borrower protections established in Article 7 of the Real Estate Law and in the Home Ownership and Equity Protection Act of 1994 (Section 32) of TILA (HOEPA). Section 32 was discussed previously in this section as was Section 35 of TILA which also provides additional consumer/borrower protections. Article 7 will be discussed later in this Chapter. The following subsection will discuss recently enacted law, California "Higher-Cost/Priced Mortgage Loans" (Financial Code Section 4995 et seq.). This law is also intended to provide further consumer/borrower protections.

California "Higher-Cost/Priced Mortgage Loans"

The California law identified as "Higher-Cost/Priced Mortgage Loans" was codified in Financial Code Section 4995 et seq. The definition of loan transactions subject to this law to be applied for state purposes is the same as established under federal law (Regulation Z, 12 CFR Section 226.35). This state law imposes limits on prepayment penalty fees. Creditors/lenders and MLBs who violate the duty of fair dealing, i.e., licensed persons (as defined) who in bad faith attempt to avoid the application of the law by engaging in one or more of a defined series of prohibited activities or conducts, are subject to damages, civil sanctions, to license discipline, and potentially to criminal sanctions.

"Higher-Cost/Priced Mortgage Loans" are defined under state law in the same manner as under federal law (Financial Code Section 4995(a)). Each law applies to consumer credit transactions secured by the consumer/borrower's principal dwelling with an APR that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set on the subject mortgage loan. When the subject mortgage loan is a first or senior encumbrance, the applicable APR that triggers this state law is set at 1.5% or more than the applicable prime offer rate. If the loan is a second or junior encumbrance, the applicable APR that triggers this state law is set at 3.5% or more than the applicable prime offer rate (Regulation Z, 12 CFR Section 226.35). As previously mentioned, the applicable prime offer rate is the average prime offer rate of conventional mortgage loans that may be determined by reference to the H15 statistical release.

This law applies to licensed persons and to mortgage brokers (MLBs), as defined. Licensed persons include real estate brokers licensed under the Real Estate Law; finance lenders or brokers licensed under the Finance Lenders Law; residential mortgage lenders/brokers licensed under the Residential Mortgage Lending Act; commercial or industrial banks organized under the Banking Law; savings associations organized under the Savings Associations Law; and credit unions organized under the Credit Union Law (Financial Code Section 4995(b)). Licensed persons also include mortgage brokers who are providing mortgage brokerage services (Financial Code Section 4995(c)). "Mortgage brokerage services" means arranging or attempting to arrange, as

the exclusive agent of the consumer/borrower, or as a dual agent for the borrower and the creditor/lender, for compensation or expectation of compensation (whether paid directly or indirectly) a "Higher-Cost/Priced Mortgage Loan" made by an "unaffiliated third party" (Financial Code Section 4995(d)).

The language "unaffiliated third party" may prove to be difficult to interpret (Financial Code Section 4995(d)). The reasonable interpretation would suggest if the mortgage broker (MLB) is delivering the loan to an affiliated party that "mortgage brokerage services" are not being provided. MLBs are apparently presumed to be exclusive agents of the affiliated party (creditor/lender) funding and making the loan and, therefore, are not required to be the agent and fiduciary of the consumer/borrower (Financial Code Section 4995(d)).

This relationship may be altered by the conduct of the mortgage broker (MLB). For example, should the MLB solicit or cause the consumer/borrower to be solicited with express or implied representations (including through conduct) the mortgage broker (MLB) will act as an agent to obtain and arrange the loan (whether a residential mortgage that is a "High-Cost Loan" or a "Higher-Cost/Priced Mortgage Loan", or another form of mortgage loan, regardless of the nature of the intended security property) and the mortgage broker (MLB) in fact makes the loan to the borrower from funds belonging to or controlled by the MLB (an affiliated party); the mortgage broker is acting within the meaning of subdivision (d), Section 10131 of the Business and Professions Code.

Accordingly, the MLB would be unable to discharge the agency fiduciary relationship with the consumer/borrower or with a borrower in other than a consumer loan transaction (Business and Professions Code Sections 10240(b) and 10241(j); Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c), among others).

Notwithstanding any other provision of applicable law, prepayment penalty fees imposed by a licensed person in connection with a "Higher-Cost/Priced Mortgage Loan" shall not exceed 2 percent of the principal balance prepaid during the first 12 months, or 1 percent of the principal balance prepaid during the second 12 months following loan consummation (Financial Code Section 4995.1).

As aforementioned, this California law imposes a duty of fair dealing upon licensed persons when making or arranging "Higher-Cost/Priced Mortgage Loans". This means licensed persons may not in bad faith attempt to avoid the application of the law by dividing the loan transaction into separate parts with the purpose and intent of evading the law or through any other form of subterfuge (Financial Code Section 4995.2(a)). Licensed persons are prohibited from making or causing to be made, any false, deceptive or misleading statement or representation in connection with "Higher-Cost/Priced Mortgage Loans" (Financial Code Section 4995.2(b)).

Mortgage Brokers (MLBs) who limit their business plan/model to arranging only California "Higher-Cost/Priced Mortgage Loans" are required to disclose that fact, orally and in writing, to consumers/borrowers at the time of initially engaging in mortgage brokerage services. Further, MLBs who provide mortgage brokerage services are prohibited from steering, counseling, or directing a consumer/borrower to accept a loan at a higher cost than for which the consumer/borrower could qualify based upon the loans offered by the person from whom the broker regularly does business. In addition, mortgage brokers providing mortgage brokerage services for a consumer/borrower, cannot receive compensation (including a yield spread premium, fee, commission, or any other compensation) for arranging "Higher-Cost/Priced Mortgage Loan" with a prepayment penalty exceeding the compensation the MLB would otherwise received for arranging such a loan without a prepayment penalty. When MLBs provide mortgage brokerage services for consumers/borrowers, the broker's compensation is to be the same whether paid by the creditor/lender, the consumer/borrower, or by a third party (Financial Code Section 4995.2(c), (d), and (e)).

Licensed persons are prohibited from making or arranging California "Higher-Cost/Priced Mortgage Loans" that include provisions for negative amortization, and licensed persons are also prohibited from recommending or encouraging consumers/borrowers to default on existing mortgage loans or other debts prior to or in connection with the closing or planned closing of a "Higher-Cost/Priced Mortgage Loan" that refinances all or any portion of existing loans or debts (Financial Code Sections 4995.2(f) and (g)).

Licensed persons may avoid some of the sanctions if they voluntarily undertake (prior to any institution of any action under this section) to notify the consumer/borrower within 90 days of loan closing of any compliance failure, offer to correct the failure, and offer to make restitution, including changing the terms of the loan in a

manner authorized by this law (i.e., offering the consumer/borrower at his/her option a California "Higher-Cost/Priced Mortgage Loan" consistent with the requirements of this law, or offering to change the terms of the loan in a beneficial manner so that the loan would no longer be considered a "High-Cost/Priced Mortgage Loan") (Financial Code Section 4995.2(h)). Some of the foregoing remedies may not be available for a licensed person who is a MLB/MLO as they require acts of creditors/lenders.

The California "High-Cost/Priced Mortgage Loan" Law becomes effective July 1, 2010. It is important to note that the remedies for violations of this law are not exclusive, but will include any other rights or remedies available under applicable law, including a violation of Civil Code Section 2923.1. Practitioners should not pursue a business plan/model that includes making or arranging loans intended to be secured by property that is the principal residence of or the owner occupied dwelling of the consumer/borrower which is a California "High-Cost Loan" or "Higher-Cost/Priced Mortgage Loan" (as defined) or when such loans are subject to federal law (i.e., Sections 32 and 35 of Regulation Z of TILA); without first obtaining the advice of knowledgeable legal counsel.

In Summary
The basic premise of both federal and state statutory and regulatory responses is to limit or control specified loan terms and to prohibit creditors/lenders and brokers (MLBs) from engaging in defined activities or conducts. The terms "High-Cost Loans" or "Higher-Cost/Priced Loans" were employed in both federal and state law to new law intended to apply to loans that exceed a prescribed interest rate and/or fee threshold for which additional disclosures and noticed of rights are required. These new laws describe certain transactional terms, activities, and conducts of creditors/lenders and MLBs that are prohibited and deemed unlawful. Further, consumers/borrowers are provided with the opportunity (as defined) to cancel the contemplated residential mortgage loan transaction (i.e., a loan secured by an owner occupied or principal dwelling). Creditors/lenders and MLBs violating these statutory and regulatory provisions are subject to sanctions, including fines, economic and punitive damages, attorney's fees and court costs, and to license discipline.

Additional federal and state laws to prevent creditors/lenders and MLBs from engaging in predatory practices will be discussed in this Chapter. MLBs/MLOs are well advised to familiarize themselves with each of these laws, including implementing regulations, as the remedies include (among those outlined in the previous paragraph) rescission of the residential mortgage loan, license revocation or suspension, possible exclusion from the mortgage and other real estate related industries, and in some circumstances the possibility of criminal penalties. MLBs/MLOs should seek the advice of knowledgeable legal counsel prior to engaging in residential mortgage loan transactions when the intended security property is the owner occupied dwelling of the consumer/borrower.

FEDERAL AND STATE COMPLIANCE AND REPORTING REQUIRMENTS

Equal Credit Opportunity Act (ECOA)

Authority and scope
The authority and scope of ECOA is set forth in the regulation issued by the Board of Governors of the Federal Reserve System pursuant to title VII (Equal Credit Opportunity Act) of the Consumer Credit Protection Act, as amended (15 USC Section 1601 et seq.). ECOA applies to all persons who are creditors, as defined in 12 CFR Section 202.2(l) of the applicable regulations. Certain exemptions are operative; however, they generally do not extend to creditors/lenders of residential mortgage loans. Information collection requirements imposed upon creditors/lenders contained in the foregoing regulation have been approved by the Office of Management and Budget under the provisions of 44 USC Section 3501 et seq. and have been assigned OMB No. 7100-0201.

Purpose
The purpose of ECOA is to promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, or age (provided the applicant has the capacity to contract); whether all or part of the applicant's income is derived from a public assistance program; or that the applicant has in good faith exercised any right under the Consumer Credit Protection Act. ECOA prohibits creditors/lenders practices that discriminate on the basis of any of these factors. The use of the term consumer may not necessarily exclude certain commercial loan applications from being subject to ECOA.

This law requires creditors/lenders to notify applicants of actions taken on their applications (including credit denials); to report credit histories in the names of both spouses on an account; to retain records of credit applications; and to collect information about the applicant's race and other personal characteristics in applications for dwelling-related loans (generally, residential mortgage loans occupied as the primary residence of the consumer/borrower); and to provide applicants with copies of appraisal reports prepared and used in connection with credit transactions.

Federal and State Licensed and Chartered Creditors/Lenders are Subject to ECOA in Mortgage Transactions

Among the requirements imposed by ECOA when an action is taken by such creditors/lenders after an application has been received from a consumer/borrower is to provide a prescribed notice informing the applicant of the reasons for the denial or altering of the credit terms requested. The notice is to be issued within 30 days of the decision. The reasons may include the credit worthiness and financial standing of the consumer/borrower, the value of the security property, the incompleteness or lack of necessary information required to complete the loan application, or that the file remains open and no credit decision has been made, among others. The specific notice requirements are included in Regulation B of ECOA.

Regulation B also addresses the issue of spousal and multiple signatures on the loan documentation. For example, requiring a signature simply because the individual is married to the applicant, amounts to substantive discrimination when the transaction is subject to ECOA. The Official Staff Commentary contains the advice that submission of a joint financial statement is meant to presume that the application is for joint credit. The FRB strongly recommends that a creditor/lender clearly document the use of additional signatures. It is also recommended that mortgage loan originators (MLOs) whether employed by the creditor/lender or performing as an independent agent and fiduciary of the consumer/borrower, keep log sheets of the substance of conversations with the applicant(s) about the loan application. Creditors/lenders are advised not to presume the consumer/borrower will transfer title to the security property as a means to escape the reach of collectors.

Another clarification has been included within the revised ECOA regulations requiring creditors/lenders when considering separately the income of each applicant or combining the income of both applicants to apply the same methods for all applications, regardless of the relationship of the applicants to each other. Record retention is required for a period of 25 months from the date of initial solicitation for extensions of credit. Records to be kept include the solicitation criteria and any lists maintained in connection therewith. Further, records of any complaints received from consumers/borrower must also be maintained by creditors/lenders.

Subsequent to the establishment of a secondary market for alternative mortgages or non-traditional loan products, consumer advocates have raised questions about when an applicant is in fact an applicant and have asked the FRB to take action to protect consumers prior to the submission of a loan application. The question is whether ECOA and the regulations thereof protect consumers who have not yet applied for credit. In response, the FRB has added requirements for record keeping to allow examiners to evaluate the design and demographic impact of solicitations, including the information used to select targets for such solicitations, of any consumer complaints received, and of any evidence of unequal treatment.

The definition of creditor has been clarified to include, when multiple parties are involved in a single credit application, anyone involved in making the credit decision or in setting the terms of the credit. Such persons are creditors for the purposes of ECOA. This means that an MLB/MLO who negotiated the terms with a consumer/borrower is an ECOA creditor by virtue of having set terms of credit.

Third Parties Subject to the Requirements for Creditors under ECOA

Under Regulation B, the term “creditor” includes any person “who in the ordinary course of business” regularly delivers loan applications to creditors/lenders, or selects or offers to select creditors/lenders to whom requests for credit may be made.” This definition does not apply to the term “creditor” pursuant to TILA which specifically excludes third parties who are arrangers of extensions of credit. Official Staff Commentary 2(1)-2 provides guidance to mortgage brokers (MLBs/MLOs), i.e., “For certain purposes, the term ‘creditor’ includes persons such as real estate brokers who do not participate in credit decisions but who regularly refer applicants to creditors or select or offer to select creditors to whom credit requests can be made. These persons must comply with Section 202.4, the general rule prohibiting discrimination, and with Section 202.5(a) on discouraging applications.” MLBs/MLOs are subject to the general prohibitions against discrimination in

mortgage loan transactions and are not to engage in any unlawful conduct that would discourage any persons applying for a mortgage loan (Business and Professions Code Section 10177(l)(1) and (2), among others).

Adverse Action Issues. The Official Staff Commentary to Regulation B also provides guidance regarding the giving of notices of adverse action when the loan application of a consumer/borrower is delivered by third parties such as MLBs/MLOs to creditors/lenders. When loan applications are submitted by MLBs/MLOs on behalf of consumers/borrowers to more than one creditor/lender and the loan transaction proceeds with one of the creditors/lenders, the remaining creditors/lenders who received the loan applications are under no duty to provide a notice of adverse action to the consumer/borrower.

A notice of adverse action under ECOA (if applicable) would be issued by the creditor/lender whose proposed loan transaction was initially accepted by the consumer/borrower. Should the consumer/borrower elect not to proceed with any of the creditors/lenders receiving concurrent loan applications, each creditor/lender who took an adverse action are well advised although may not be required to either provide the consumer/borrower directly or through the MLB/MLO (who accepted and delivered the loan application) with the required notice of adverse action.

A notice of adverse action given by an MLB/MLO must disclose the identity of each creditor/lender on whose behalf the notice is being given. The FRB requires notices of adverse action given by third parties to distinguish the reasons for the decline of credit or altering of the credit terms by each creditor/lender to which the specific reasons apply. The Official Staff Commentary provides guidance on how notices of adverse action are to be given by MLBs/MLOs as third parties.

Guidance to creditors/lenders is provided regarding the content of such notices when the loan application is delivered by a third party. Applications submitted through a third party are subject to the following:

1. Third-party notice – delivery by creditor. The notification of adverse action may be given by one of the creditors to whom an application was submitted through the third-party.…

2. Third-party notice – enforcement agency. If a single adverse action notice is being provided to an applicant on behalf of several creditors and they are under the jurisdiction of different federal enforcement agencies, the notice need not name each agency; disclosure of any one of them will suffice.

3. Third-party notice – liability. When a notice is to be provided through a third party, a creditor is not liable for an act or omission of the third party that constitutes a violation of the regulation if the creditor accurately and in a timely manner provided the third party with the information necessary for the notification and maintains reasonable procedures adopted to prevent such violations."

The foregoing guidance is published in Comment 9(g) to Section 202.9 of Regulation B. When delegation to an MLB/MLO as a third party occurs for the purpose of giving the notice of adverse action on behalf of the creditor/lender, the broker must be specifically authorized by the creditor/lender. In such circumstances, the creditor/lender (particularly when applying California law) may well be liable for compliance violations resulting from any deficiencies in the adverse notice or for any other violations of Regulation B engaged in by the authorized MLB/MLO. The issue presented is whether the MLB/MLO when authorized becomes the agent of the creditor/lender for the purpose of issuing the notice of adverse action.

ECOA and State Law Requirements for Real Estate Brokers (MLBs/MLOs)

Real estate brokers (MLBs/MLOs) may have primary responsibility for providing the notice of adverse action. The MLB/MLO may be authorized to engage in certain legitimate prescreening functions, relying on qualification standards supplied or required by the creditor/lender. Should the MLB/MLO make the determination the loan application is not to be delivered to the creditor/lender as the consumer/borrower does not meet the qualification standards imposed; the broker has taken an adverse action on the application and would be responsible for providing the notice of adverse action.

Pursuant to California law, MLBs/MLOs must provide a notice to the consumer/borrower of any adverse action and whether the adverse action is based in whole or part on any information contained in the consumer credit report received and used by such licensees (regardless of the role of these brokers in the loan transaction). The notice of adverse action required under California law is based upon the use of a consumer credit report and not

on the predicate of receiving a loan application. However, it is generally accepted that compliance with the notice requirements under Regulation B of ECOA will comply with California law provided MLBs/MLOs issue the notice of adverse action based upon the use of a consumer credit report rather than on the receipt of the loan application (Civil Code Section 1785.20).

Home Mortgage Disclosure Act (HMDA)

Background and Application

The Home Mortgage Disclosure Act (HMDA) was adopted by Congress in 1975 (12 USC Section 2801 et seq.). HMDA was authorized and implemented by the FRB and became effective in 1976. It is commonly known as Regulation C, which was significantly amended in 2004. HMDA and the implementing Regulation C applies to federally insured banks, savings and loans, savings banks, credit unions as well as "for profit" mortgage lending institutions (licensed lenders and non-banks other than depository institutions). These mortgage lending institutions are subject to reporting under HMDA when home purchase loans originated equal or exceed 10% of the lending institution's loan origination volume, or if the purchase money loans originated equaled at least $25 million, or if the lending institution had either $10 million in assets or originated at least 100 home purchase loans, including refinances of home purchase loans.

Collection and Disclosure of Information

HMDA requires that creditors/lenders (as defined above) collect and publically disclose information about housing related loans, including characteristics about the applicants and consumers/borrowers. The original purpose of HMDA was to provide the citizens/residents and public officials of the United States with sufficient information to determine whether such creditors/lenders are serving the housing credit needs of the communities and neighborhoods in which they are located, to assist public officials and private investors in distributing funds in areas that may need investment, and to assist in identifying possible discriminatory lending patterns and enforcing fair lending laws. These obligations are also included in the Community Reinvestment Act (CRA).

Covered Loans

Covered loans include home purchase loans, home improvement loans and refinances secured by a dwelling. "Dwelling means any residential structure, whether or not attached to real property. It includes vacation or second homes and rental properties; multifamily as well as 1 to 4 family structures; individual condominium and cooperative units; and manufactured and mobile homes. It excludes recreational vehicles such as boats and campers, and transitory residences such as hotels, hospitals, and college dormitories" (FFIEC publication, "A Guide to HMDA Reporting, Getting It Right!").

Reporting Requirements

HMDA reporting is limited to property on which a dwelling is located and does not apply to loans on unimproved land, construction only loans and other temporary financing, purchased loans or interests in mortgage backed securities, servicing rights, loans acquired as part of a merger or acquisition; and the acquisition of a partial interest in a home purchase, home improvement, or a refinancing loan; prequalification requests, or "assumptions" that do not involve a written agreement between the creditor/lender and the new borrower (generally described as a "subject to" transfer). As aforementioned, the federal agency, FFIEC, has published "A Guide to HMDA Reporting, Getting It Right!" which is available on the FFIEC's website (http://www.ffiec.gov/hmda/guide.htm). This publication describes in detail the scope, purpose and how to properly report as required by HMDA.

The Holden Act

Background and Purpose

Following the enactment of HMDA under federal law, California adopted "The Holden Act" to impose similar requirements upon creditors/lenders that either are state licensed or chartered depository institutions or licensed under California law (Health and Safety Code Section 35810 et seq.). To the extent that this state law includes subject matter addressed under HMDA or under the Federal Fair Housing Act (42 USC Section 3601 et seq.), the federal law is intended to apply and would prevail, unless the state law is more restrictive.

The purpose of the Holden Act is to ensure, among other objectives, no financial depository institution discriminates in the availability of financial assistance for the purpose of purchasing, rehabilitating, improving, or refinancing housing accommodations (whether in whole or in part) due to the conditions, characteristics, or

trends in the neighborhood or geographic area surrounding the housing accommodations. An exemption is provided when the financial depository institution can demonstrate the consideration of the foregoing conditions in a particular case is required to avoid an unsafe and unsound business practice (Health and Safety Code Section 35810(a)).

Discrimination Standards

The foregoing discriminatory standards are also applied by this law when considering Government Code Sections 12926, 12926.1, 12955, and 12955.2, including with reference to familial status (the relationships that may exist among the occupants, as well as the issue of age). However, California law recognizes the limited exemption from the familial status standard applicable to older persons (senior citizens), as defined in Government Code Section 12955.9. Further, Civil Code Sections are controlling relating to certain housing for senior citizens when applying the familial status issue (Civil Code Sections 51.2, 51.3, 51.4, 51.10, 51.11, 799.5, and 1360). The housing exemptions for senior citizens from otherwise applying the non-discriminatory familial status issue includes housing accommodations specifically designed for use by older persons (whether as rental housing or as housing within common interest developments (CIDs)). The statutes regarding familial status are intended to ensure no discrimination occurs regardless of the relationships or age that may exist among the occupants of the housing accommodations (Health and Safety Code Section 35811).

The Holden Act also precludes discrimination by depository institutions and licensed lenders (creditors/lenders) regarding the racial, ethnic, religious, or national origin composition of a neighborhood or a geographic area surrounding the housing accommodations (or whether such composition is undergoing change or is expected to undergo change). Further, in appraising of housing accommodations for the purpose of providing financial assistance, depository institutions and licensed lenders are not to use practices that are inconsistent with the prohibitions regarding discrimination concerning the composition or the expected future composition of a neighborhood or geographic area. However, the aforementioned creditors/lenders are not precluded when directing the appraisal of intended security properties from considering conditions of the housing accommodations that constitute a threat to the health or safety of the occupant or that which may apply in the appraisal process when estimating the fair market value of such properties (Health and Safety Code Sections 35812 and 35813).

Compliance and Reporting Obligations

The Secretary or the Secretary's designee of Business Transportation and Housing Agency (BT & H) is charged with the responsibility of monitoring and investigating the lending patterns and practices of the depository institutions and licensed lenders to ensure compliance with the provisions of this law. Annual reports to the California Legislature by the Secretary are required on the activities of supervising regulatory agencies and departments in ensuring compliance and reporting from all persons/entities that are in the business of originating residential mortgage loans in California, including (among others) insurers, mortgage bankers, investment bankers, credit unions, and MLBs/MLOs that are engaged in the making of such mortgage loans.

These regulations are to include reports as required and deemed necessary by the Secretary to the appropriate supervising regulatory agencies or departments. The reports are intended to be substantially consistent with the reporting standards established under HMDA. The Secretary's regulations are intended to also address the reporting requirements imposed upon those creditors/lenders whose assets or residential mortgage loan volumes are insufficient to meet the federal reporting requirements (Health and Safety Code Sections 35815 and 35816).

The Fair and Accurate Transaction Act (FACT) – "The Red Flag Rules"

Background and Application

The FACT Act was passed in 2003 and is an extension of the Gramm-Leach-Bliley Act (GLB Act). The citation for the FACT Act is Public Law 108–159, December 4, 2003. Sections of the FACT Act have become effective over a period of time and regulations are promulgated by different federal agencies for distinguishable purposes. The last two Sections of the FACT Act are known as the "Red Flag Rules" and the "Address Discrepancy Policy". These Sections became effective August 1, 2009.

Regulations

The Federal Trade Commission (FTC) and the National Credit Union Association (NCUA) issued regulations to implement the "Red Flag Rules" and the "Address Discrepancy Policy", which regulations affect depository institutions and "creditors" (as defined) with "covered accounts" (15 USC Sections 1681a(q)(3)(4), 1681c(h),

1681m(e), and 1691a(e), and 16 CFR Part 681). Included within the definitions of the foregoing are financial depository institutions, i.e., state or federally licensed or chartered banks, savings associations, savings banks, mutual savings banks, and credit unions; and any other persons/entities that hold a "transaction account" belonging to a customer or client/principal depending upon the fact situation.

"Creditor" Defined
For the purposes of the aforementioned statutes and regulations, the term "creditor" is any person/entity that regularly extends, renews, or continues credit; any person/entity that regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original "creditor" who is involved in the decision to extend, renew, or continue credit. "Creditors" under this law (who are other than depository institutions) include mortgage bankers, finance companies, automobile dealers, mortgage brokers (MLBs/MLOs), real estate brokers involved in defined activities in relationship to property sales, utility companies, telecommunication companies, and non-profit entities that defer payment for goods and services (among others).

While depository institutions are primarily regulated by the FRB and other related federal banking regulatory agencies (including the NCUA), most "creditors" come under the jurisdiction of the FTC. This would include, as aforementioned, MLBs/MLOs. As defined for application of the "Red Flag Rules" under the FACT Act, the term "creditor" is not intended to apply to the definition of "creditor" (often referred to as creditor/lender) for the purposes of extending credit or making loans to consumers/borrowers pursuant to TILA. The term creditor for this purpose is the lender in the loan transaction required to complete and deliver the disclosures and notices of rights and to otherwise comply with TILA and Regulation Z (15 USC 1601, Subsection 103(f), and 12 CFR Section 226.2(a)(17)).

Covered Accounts
Under the FACT Act and related federal law and implementing regulations, a "covered account" is an account used primarily for personal, family, or household purposes, and which involves multiple payments or transactions. "Covered accounts" include credit card accounts, mortgage loans, automobile loans, margin accounts, cell phone accounts, utility accounts, checking accounts, and savings accounts, among others. The term "covered account" is also intended to apply to an account for which there is a foreseeable risk of identity theft, e.g., such as small businesses or sole proprietor accounts.

Transaction Accounts
The term "transaction account" is defined pursuant to the aforesaid regulations to mean a deposit or other account from which the owner makes payments or transfers (i.e., checking accounts, negotiable order of withdrawal accounts, savings deposits subject to automatic transfers, and shared draft accounts). This term would also apply to accounts held in behalf of clients/beneficiaries such as escrows or impounds for the future payment of property taxes and insurance premiums; and trust accounts for advance fees, earnest money deposits, loan servicing, or funds from property management activities, among others.

Loan servicing trust accounts in connection with transactions involving residential mortgage loans are presumably included within the definition of "covered accounts" as the funds held and disbursed are used primarily for personal, family, or household purposes, and the loan servicing involves multiple payments or transactions. Commercial loan servicing accounts maintained on behalf of private investors/lenders raise questions regarding this issue. For example, are the funds of the private investors/lenders used for or in any way applied to personal, family, or household purposes? This is a factual matter to be determined with the assistance of professionals including knowledgeable legal counsel and a CPA.

Policies and Procedures
Depository institutions and "creditors" under the "Red Flag Rules" are to establish policies and procedures (or a written program) that identifies and detects the relevant warning signs of identity theft, such as unusual account activity, fraud alerts on consumer reports, attempted use of suspicious account application documents, or unauthorized access to the data or records maintained regarding the account(s). The policies and procedures (or the written program) should describe appropriate responses to prevent and mitigate the conduct or activities identified by the warning signs (the "Red Flags").

The objectives when designing a program to comply with the "Red Flag Rules" are to 1.) Detect identity theft ("Red Flags"); 2.) Prevent future identity theft; 3.) Mitigate identity theft; and 4.) Update the program

periodically, as necessary. Since the transaction files of MLBs/MLOs are to be maintained a minimum of three years (and for certain purposes, longer periods), the policies and procedures (or the written program) to accomplish the foregoing objectives of detecting, preventing, mitigating, and updating the program is to apply to and for the protection of the information contained within these files.

"Red Flag Rules"

The "Red Flag Rules" are intended to be flexible to provide depository institutions and "creditors" with the opportunity to design and implement a program that is appropriate for the size and complexity of each, as well as to consider the nature of their financial operations. The "Red Flag Rules" fall into five categories:

1. Alerts, notifications, or warnings from a consumer reporting agency;
2. Suspicious documents;
3. Suspicious personal identifying information, including a suspicious address;
4. Unusual use of or suspicious activities relating to a "covered account"; and,
5. Notices from customers/clients, victims of identity theft, law enforcement authorities, or other businesses about possible identity theft in connection with "covered accounts".

Address Discrepancy Policy

Depository institutions and "creditors" are required to adopt an "Address Discrepancy Policy". The purpose of such a policy is to establish procedures to identify and respond to discrepancies noted in the information received from customers/clients regarding their past and present addresses. For example, the credit report reveals a different address of the customer/client than the loan application; the address for tax information returns is distinguishable from the address where payments or disbursements to the consumer/client are to be made; or when the consumer/borrower is requesting a loan on an owner-occupied security property and the applicant's current reported address in third party verifications are different than the security property; among others. Not only are policies and procedures required to identify these discrepancies ("Red Flags"), but guidance for staff members is necessary to assist in resolving these discrepancies before proceeding any further with the financial services requested.

How to Comply

The starting point for developing a program is the Guidelines issued for the Red Flags Rule are available at www.ftc.gov/os/fedreg/2007/november/071109redflags.pdf . The guidelines are found on pages 63773 and 63744 of the document. It is also recommended that practitioners contact knowledgeable legal counsel to prepare a Red Flag manual incorporating the policies and procedures to be applied in each fact situation, including the elements and issues discussed in this section. The program must provide for appropriate responses to the Red Flags identified to prevent and mitigate identity theft, including monitoring an account, closing an account, not opening an account (or declining to proceed with the loan application), contacting the customer/client when detecting a Red Flag, or any combination of the foregoing. In certain events, such as a recent data breach or a phishing fraud that targeted the depository institution or "creditor" may require specific preventative actions.

Administering the Program

No matter how good the policies and procedures (written program) looks on paper, the true test is how it works. The program must describe how it is to be administered, including the approval of the management of the business organization and how the program will be maintained and kept current. According to the Red Flag Rule, the program requires approval by the board of directors of the business organization, and if the firm operates without a board, then by a senior employee whose responsibility it is to administer the program. The board or designated employee must approve any changes made to the program.

Further, the program should include staff training as appropriate and provide a means for the manager to monitor the work of service providers, including third parties. Evidence of compliance with the Red Flags Rule by independent service providers who are third parties with whom the business organization does business should be included as an element of the program. The program is to describe how oversight is accomplished and it must be kept relevant and current.

Penalties for Non-Compliance
Although there are no criminal penalties for failure to comply with the Red Flags Rule, depository institutions or "creditors" that violate the rule are liable for a civil penalties of $1,000 per occurrence, a fine of $2,500 per occurrence, plus actual damages.

California depository institutions and "creditors" (as well as any "business" as defined) should not overlook applicable state law and the civil penalties imposed for the failure to securely maintain and to destroy in a timely and lawful manner the customer/client records that include personal information (as defined). Disposal of such records under California law requires shredding, erasing, or otherwise modifying the personal information in these records to make the information unreadable, or to be undecipherable by any means (Civil Code Section 1798.80 et seq.). In addition, actions for identity theft may be brought under California law against any person or entity by victims of identity theft. Civil and criminal sanctions are available under this law (Civil Code Section 1798.92 et seq.).

The Fair Credit Reporting Act (FCRA)
Background
The Fair Credit Reporting Act of 1971 and subsequent amendments guarantees consumers rights as they relate to credit information, including a prospective consumer/borrower's right to know about their own credit. State and federal laws require the mortgage broker (MLB/MLO) to provide specific disclosures to the consumer who is applying for credit secured by real property (15 USC Section 1681 et seq. and Civil Code Section 1785.14 et seq.).

Disclosure of credit scores
FCRA Section 609(g) was added by the FACT Act and requires the disclosure of an applicant's credit score. The Act applies to persons making or arranging loans whenever a credit score is used in conjunction with an application for the loan that will be secured by a 1 to 4 unit residential real property, whether the credit is closed end or open ended. Further, it applies regardless of the outcome of the credit decision. Therefore, disclosures are to be made whether the application is approved, denied, withdrawn or closed for incompleteness. This law does not apply to credit applications for loans secured by mobile homes.

A credit score is defined by the Act as a numerical value or a categorization derived from a statistical tool or modeling system used by a person who makes or arranges a loan to predict the likelihood of certain credit behaviors, including default; also referred to as a "risk predictor" or "risk score". This definition appears to include credit scores maintained by credit repositories including bureaus that do not take into account the characteristics of the subject transaction. This definition may extend to depository institutions and other creditors who undertook to develop their own credit score methodology.

The three most commonly used in California are Experian's Fair Isaac Corporation score, the FICO Score; TransUnion's Empirica Score; and Equifax's Beacon Score. It does not include any mortgage score or rating of an automated underwriting system that considers factors in addition to credit information such as the loan-to-value ratio, the applicant's assets or other elements of the underwriting process or decision. Fannie Mae's Desktop Underwriter and Freddie Mac's Loan Prospector are excluded, since they take into account the proposed down payment, loan-to-value ratio and other loan specific data.

The disclosure of an applicant's credit information must be delivered "as soon as reasonably practicable." The contents of the notice under federal law are defined in Section 609 (g)(1)(A). Initially, this law requires that "a copy of the information identified… that was obtained from a consumer credit reporting agency" and a required statutory notice be provided to the consumer/borrower. Subsequently, this law requires that six items of information need to be given as follows:

1. A statement that the information and credit scoring model may be different than the credit score used by the lender;
2. The current credit score;
3. The range of possible credit scores;
4. The key factors, up to four, that adversely affected the consumer's credit score in the model used (i.e., key factors mean all relevant elements or reasons adversely affecting the credit score for the particular

individual, listed in order of their importance and based on their effect on the credit score; and if the key factors include the number of inquiries made with respect to the consumer report, this factor must be disclosed without regard to the four factor limit);

5. The date the credit score was created; and,
6. The name of the person or entity that provided the credit score or credit file from which the score was created.

The statutory notice required in Section 609 (g)(1)(D) further requires the name, address and telephone number of each credit repository/bureau providing a credit score that was used plus the statutory text. Later in Section 609 (g)(1)(E)(ii) it provides that this law does not require any person to disclose any information other than a credit score and the key factors.

The disclosure of credit scores applies to each individual for whom a credit score was used; therefore, each applicant is to be provided with the statutory required notice and the information set forth above.

Depending upon the fact situation, creditors/lenders and MLBs/MLOs acting under California law must also provide the consumer/borrower with a notice regarding the use of "Credit Scores" and of information prescribed by state statute, including the key factors that adversely affect the consumer/borrower's credit score in the model used. Further, the information provided is to include how to contact the three credit repositories to correct any inaccuracy in the consumer/borrower's credit report. The three repositories are Experian, TransUnion, and Equifax (Civil Code Sections 1785.14, 1785.15, 1785.15.1, 1785.15.2, 1785.16, and 1785.17).

Credit Disputes

If an applicant believes there is a mistake in his/her credit report and wishes to dispute or correct the mistake, the applicant can contact the credit repository that developed the report. Under FCRA, the repository must complete an investigation of the disputed items within 30 days and provide a written notice of the results of the investigation within 5 days of completion, and to provide a copy of the credit report (if it has changed) based on data developed from the dispute. The FTC is responsible for enforcing FCRA.

The Home Valuation Code of Conduct (HVCC)

Background

The Home Valuation Code of Conduct (the Code) is the result of a joint agreement among Fannie Mae, Freddie Mac, the Federal Housing Finance Agency (FHFA), and the New York State Attorney General. The Code is intended to enhance the independence and accuracy of the appraisal process and to provide added protections for homebuyers, lenders, investors in mortgage loans, and to generally support the housing market. While the Code arises from an agreement, depository institutions are subject to the impact on the agreement of regulations concerning third party relationships promulgated in OCC regulations 12 CFR Sections 5.34, 5.36, and 5.39 describing the permissibility of the activities to be conducted. Further, affiliated relationships that may result from the joint agreement are subject to the rules applicable to such relationships (Sections 23A and 23B of the Federal Reserve Act, 12 USC 371c and c(1)).

Delivery of Single Family Mortgages to Fannie Mae and Freddie Mac

Effective May 1, 2009, Fannie Mae and Freddie Mac no longer purchase residential mortgages from Sellers that have not adopted the Code with respect to single-family mortgages (other than government insured or indemnified loans) delivered to Fannie Mae or Freddie Mac. Also, effective for single-family mortgages with loan application dates on or after May 1, 2009, Fannie Mae and Freddie Mac seller/servicers must represent and warrant that the appraisal report is obtained in a manner consistent with the Code.

The sale of mortgage loans that are excluded from the foregoing representation and warranty include FHA and VA insured or indemnified mortgage loans; Section 184 Native American Mortgages; and Section 502 Guaranteed Rural Housing Mortgages.

Fannie Mae and Freddie Mac have jointly established the Uniform Mortgage Data Program (UMDP) under the direction of the FHFA to provide common requirements for appraisal and loan delivery data, including a Uniform Appraisal Dataset that standardizes key appraisal data elements to enhance data quality and promote consistency; and a Uniform Collateral Data Portal (UCDP) for the electronic collection of appraisal data.

Non-compliance with the Code

Complaints about non-compliance with the Code may be submitted electronically or through the mail using the complaint submission form. The complaint submission form must be completely filled out to be accepted and reviewed. Anonymous or incomplete complaints will not be reviewed. Instructions are provided on the complaint types that are eligible for submission to Fannie Mae or Freddie Mac.

Taking Precautions

There are many factors that led to the inflated property values experienced a few short years ago, which substantially contributed to the market conditions that are being experienced at the time of this writing. One of those factors involved real estate appraisers who were not objective in their appraisal work, but rather were unduly influenced to arrive at specified values by those who hired them. Appraisers were influenced in a variety of ways, ranging from subtle to overt, but the net effect was uncontrolled market appreciation that could not be sustained.

To address the problem of the improper influence of real estate appraisers, Civil Code Section 1090.5, was enacted and became effective October 5, 2007. It provides in part that "No person with an interest in a real estate transaction involving an appraisal shall improperly influence or attempt to improperly influence, through coercion, extortion, or bribery, the development, reporting, result, or review of a real estate appraisal sought in connection with a mortgage loan." To further restrain undue influence upon appraisers, the law also provides that if a person who violates the law is licensed under any state licensing law, and the violation occurs within the course and scope of the person's duties as a licensee, the violation shall be deemed a violation of that state licensing law.

To help real estate licensees avoid any potential impropriety, the DRE (working in conjunction with the Office of Real Estate Appraisers, the Department of Corporations, and the Department of Financial Institutions) developed the following list of practices which may constitute evidence of a violation of California law and should be avoided when engaging the services of a licensed real estate appraiser.

1. Withholding or threatening to withhold timely payment or partial payment for a completed appraisal report, regardless of whether a sale or financing transaction closes;
2. Withholding or threatening to withhold future business from an appraiser, or demoting or terminating or threatening to demote or terminate an appraiser;
3. Expressly or impliedly promising future business, promotions, or increased compensation for an appraiser;
4. Conditioning the ordering of an appraisal report or the payment of an appraisal fee or salary or bonus on the opinion, conclusion, or valuation to be reached, or on a preliminary value estimate requested from an appraiser;
5. Requesting that an appraiser provide an estimated, predetermined, or desired valuation in an appraisal report prior to the completion of the appraisal report, or requesting that an appraiser provide estimated values or comparable sales at any time prior to the appraiser's completion of an appraisal report;
6. Providing to an appraiser an anticipated, estimated, encouraged, or desired value for a subject property or a proposed or target amount to be loaned to the borrower, except that a copy of the sales contract for purchase transactions may be provided;
7. Requesting the removal of language related to observed physical, functional or economic obsolescence, or adverse property conditions noted in an appraisal report;
8. Providing to an appraiser, appraisal company, appraisal management company, or any entity or person related to the appraiser, appraisal company, or appraisal management company, stock or other financial or non-financial benefits;
9. Allowing the removal of an appraiser from a list of qualified appraisers, or the addition of an appraiser to an exclusionary list of disapproved appraisers used by any entity, without prior written notice to such appraiser, which notice shall include written evidence of the appraiser's illegal conduct, a violation of the Uniform Standards of Professional Appraisal Practice (USPAP) or state licensing

standards, substandard performance, improper or unprofessional behavior or other substantive reason for removal;

10. Ordering, obtaining, using, or paying for a second or subsequent appraisal or automated valuation model (AVM) in connection with a mortgage financing transaction unless: (i) there is a reasonable basis to believe that the initial appraisal was flawed or tainted and such basis is clearly and appropriately noted in the loan file, or (ii) such appraisal or AVM is done pursuant to written, pre-established bona fide pre- or post-funding appraisal review or quality control process or underwriting guidelines, and so long as the lender adheres to a policy of selecting the most reliable appraisal, rather than the appraisal that states the highest value; or,

11. Any other act or practice that impairs or attempts to impair an appraiser's independence, objectivity, or impartiality or violates law or regulation, including, but not limited to, the Truth in Lending Act (TILA) and Regulation Z, or USPAP.

It should be noted that neither Civil Code Section 1090.5, nor any other California code section, prohibits a person with an interest in a real estate transaction from asking an appraiser to do any of the following: (1) consider additional, appropriate property information; (2) provide further detail, substantiation, or explanation for the appraiser's value conclusion; and/or (3) correct objective factual errors in an appraisal report.

While the above list is illustrative of acts that may be evidence of violations of the prohibitions against undue influence contained in Civil Code section 1090.5, it is not exhaustive. It is, however, intended to alert real estate licensees of practices that could potentially lead to disciplinary action. In this regard, real estate licensees are admonished to exercise caution when working with real estate appraisers and avoid actions that could be considered improper influence."

The USA Patriot Act

Background

An applicant is to be identified to determine if there exists an association with terrorism, narcotics trafficking and/or money laundering. This is accomplished by utilizing the lists published by the Office of Foreign Asset Control. The information regarding the persons or nation-states that identify with such an association is known as the U.S. Treasury Department's Specially Designated Nationals (SDN) and Blocked Persons list. This list also includes nation-states that have been placed on non-favored nation status. If the applicant is either specifically named or is from one of the nation-states appearing on the list, the financial institution (depository institution) or licensed creditor/lender, including MLB/MLO, cannot proceed with a loan application or with other financial services. The website for the list is www.ustreas.gov/offices/enforcement/ofac/sdn/.

The Office of Foreign Assets Control (OFAC) administers a series of laws that impose economic sanctions against hostile targets to further U.S. foreign policy and national security objectives. The list identifies "pariah" countries, as well as certain groups, such as narcotics traffickers and terrorists, who threaten the security, economy, and safety of the United States and its citizens. Management of sanctions is entrusted to the Secretary of the Treasury. While OFAC is responsible for promulgating, developing, and administering the sanctions for the Secretary under eight basic statutes, all of the bank regulatory agencies cooperate in ensuring financial institution compliance with the regulations implementing the USA Patriot Act.

Compliance

"U.S. persons" or "persons subject to the jurisdiction of the United States", depending on the sanctions program, must comply with OFAC regulations. This law is expected to include licensed creditors/lenders and MLBs/MLOs that have been characterized as financial institutions for other purposes under federal law, e.g. FACT. Commercial banks, whether large or small, are subject to these terms and are responsible for complying with OFAC regulations.

While depository institutions are routinely examined to ensure they maintain policies and procedures in place for complying with the requirements of OFAC, licensed creditors/lenders (other than depository institutions), as well as MLBs/MLOs are primarily left to their own practices to establish compliance with this issue. These creditors/lenders and brokers need to establish internal policies and procedures (including obtaining the lists available from the previously identified website) to ensure that loan applications and other financial services are not extended to SDN and Blocked Persons.

For example, establishing new accounts (such as fiduciary, discount, or other securities or brokerage transaction accounts), pursuing certain loan brokerage activities, developing new loan customers/clients, proceeding with wire transfers, and engaging in other bank or financial transactions should not occur until the identity of a potentially Blocked Person are compared to OFAC's listings. MLBs/MLOs should be subject to more limited compliance with this law than would depository institutions, depending upon the activities pursued by these brokers. Real estate brokers (MLBs) who receive capital/funds from private investors/lenders should research their liability under this law, as these brokers will likely be subject to broader application of the USA Patriot Act than brokers who package loans to be delivered to depository institutions or licensed creditors/lenders.

Reporting Procedures and Requirements

Whenever a bank blocks or rejects a prohibited transaction, that bank must report its action to OFAC within 10 days, describing the action taken, including a copy of the payment order or other relevant documentation. In addition to this periodic report, all holders of blocked property must file a comprehensive annual report of blocked property (form TDF 90-22.50) by September 30 each year. Reportedly, no procedures have yet to be developed to monitor licensed creditors/lenders or MLBs/MLOs in connection with this issue. Nonetheless, the importance of establishing a compliance program and developing internal audit procedures should be obvious.

Specially Designated Nationals and Blocked Persons

Individuals and entities which are owned or controlled by, or acting for or on behalf of, the governments of target countries or are associated with international narcotics trafficking or terrorism are listed on the Treasury Department's Specially Designated Nationals (SDN) and Blocked Persons list. The purpose of maintaining this list in current status is to inform persons subject to the jurisdiction of the United States they are prohibited from dealing with those identified and they must block all property within their possession or control in which these blocked individuals and entities have an interest.

An Overview of Current OFAC Profiles for Blocking Transactions

Commercial banks (and it is believed the following extends to all persons/entities subject to this law) must block transactions involving the following:

1. Individuals appearing on OFAC's SDN list;

2. Cuban and North Korean citizens, except U.S. residents, wherever located;

3. Individuals, regardless of citizenship, currently residing in Cuba or North Korea;

4. Entities on OFAC's SDN list;

5. Companies and Commercial Enterprises located in North Korea and Cuba; and,

6. Governmental entities and officials of Libya, Iraq, North Korea, Cuba, Sudan, Serbia, and the Federal Republic of Yugoslavia, including those entities and individuals appearing on OFAC's list of SDNs and Blocked Persons. All banks in Libya, Iraq, and Serbia are government-controlled banks.

Objectives and Screening

The most fundamental objective of OFAC compliance procedures is to provide enough information to key staff members in relevant operations to recognize and stop, or "interdict," suspected transactions for further review before processing. An effective internal communication network is critical to OFAC regulatory compliance. Compliance training programs should be initiated by all persons/entities subject to this law.

Such training initiatives can range from mentioning regulations in staff meetings and incorporating compliance requirements into operating manuals including policies and procedures, and joining with other affected persons or entities (including trade associations) to sponsor seminars. Relevant operational areas of every affected person or entity should receive, at a minimum, a listing of sanctioned countries and continuously updated SDN list (Public Law 106-56-October 26, 2001).

The Flood Disaster Protection Act (FDPA)

Background

The Flood Disaster Protection Act (FDPA) was adopted to provide adequate amounts of federally subsidized flood insurance to owners of improved real property located in a designated flood hazard area of communities that participate in the National Flood Insurance Program (NFIP). The purpose of this program is to provide an alternative to the federal disaster relief funds normally required in flooded areas. The NFIP is administered by the Federal Emergency Management Agency (FEMA) The federal banking agencies adopted uniform interagency flood regulations effective October 1, 1996. Further information can be found in the Interagency Questions and Answers Regarding Flood Insurance at www.occ.treas.gov/handbook/compliance.htm.

Both consumer and commercial loans to be secured by improved real property or with a mobile home (located or to be located in an identified special flood hazard area) are loans designated for consideration of flood insurance coverage. The Act also applies to increases in, extensions or renewals of such loans. Federally regulated lending institutions are prohibited from making, increasing, renewing or extending such loans, unless the property securing the loan is covered by sufficient flood insurance.

"The FDPA imposes five basic requirements on a creditor/lender:

1. Prior to making, increasing or renewing or extending a loan, the lender must determine whether the property is located in an area designated by FEMA as a special flood hazard zone rated "A" or "V";

2. If the property is located in a special flood hazard area (SFHA), the lender must determine whether the property is located in a community participating in the NFIP and then provide special notices to the borrower, loan servicer, and flood insurer;

3. If the community participates in the NFIP, the lender may not close the loan without proof that sufficient flood insurance is in place (if the community does not participate in the NFIP and flood insurance is unavailable from FEMA, lenders may wish to obtain flood insurance coverage from a private insurer to protect the collateral);

4. If the lender ever determines that flood insurance has lapsed or become insufficient in amount, the lender must force place the insurance required; and,

5. Certain notices about flood insurance coverage are required at various points during the life of the loan."

The statutes imposing the above requirements are found in 42 USC 4001-4129, which include the National Flood Insurance Act of 1968 (1968 Act); the Flood Disaster Protection Act of 1973 (FDPA); and Title V of the Riegle Community Development and Regulatory Improvement Act of 1994.

Compliance

Regulators of this law include FRB, NCUA, FDIC, the OCC, OTS, and the Farm Credit Administration (FCA), collectively the agencies, issued a joint rule to implement the National Insurance Reform Act (the OCC's implementing regulation is cited as 12 CFR 22). The agencies have adopted, "Interagency Questions and Answers Regarding Flood Insurance", published in the Comptroller of the Currency Administrator of National Banks Comptroller's Handbook, May 1999. The questions and answers serve as guidance to comply with the regulations.

The Federal Financial Institutions Examination Council (FFIEC) has published statements in the Federal Register regarding notice and request for comments on loans in areas having special flood hazards, including interagency questions and answers regarding flood insurance. The publication by the FFIEC is cited as Council (FFIEC) 62 FR 39523 (July 23, 1997).

Eligibility for the purchase of flood insurance extends to communities that agree to adopt ordinances to mitigate the impact of future flooding, such as conditioning the issuance of building permits for new residential construction upon the requirement that the structure be built so that the lowest floor is above the flood elevation level.

There are 14 Flood hazard areas defined. If the property is located within an "A" and "V" rated FIRM zones (A, A1-30, AE, A99, AH, AR, V1-30, VE, V and VO) insurance is required. Insurance is available but not required for the remaining zones. If the improved property or mobile home is located or will be located in a flood hazard area but not in an area of special flood hazard, B, X, C or D zones, flood insurance is not required but may be obtained.

The flood insurance regulations apply to federally regulated depository institutions and loan servicers acting on behalf of such institutions. The loan servicer's obligations to comply with the NFIP are governed by the loan servicing agreement.

"A 'loan servicer' means the party responsible for:

1. Receiving any scheduled periodic payments from a borrower on a loan including amounts for taxes, insurance premiums and other charges with respect to the property securing the loan; and,

2. Making payments of principal and interest and any other payments from the amounts received from the borrower under the loan.

The flood regulations apply to any loan made by a regulated lender secured in whole or in part by real property improved with vertical structures or with a mobile home. The term mobile home does not include a recreational vehicle. Loans secured by vacant land are not subject to flood insurance. Commercial, business agricultural and residential loans are subject to flood insurance.

The Agencies have created the term "designated loan" and defines that term to mean a loan secured by a building or mobile home that is located or to be located in a special flood hazard area in which flood insurance is available under the Act.

When a loan is made to construct improvements upon the property that is located in a special flood hazard area, flood insurance coverage must be maintained throughout the construction. Where a building and its contents both secure a loan, and the building is located in a special flood hazard area, flood insurance coverage is required for the building and any contents stored in that building. Exemptions to the flood insurance requirements generally include loans that have an original principal balance of $5,000 or less and a term of one year or less.

FNMA and FHLMC have imposed requirements that loans sold to these entities have adequate flood insurance coverage. To promote consistent treatment for lenders, the OTS and the FDIC have adopted the position of the OCC and FRB that a loan purchase does not require that a determination be made whether the security property is located in a special flood hazard area. Although commercial banks may purchase mortgage loans where flood insurance was not obtained, these depository institutions must review their loan portfolio to measure the operative risk and exposure in the absence of flood insurance coverage. This may require the depository institution to purchase the flood insurance coverage as a means of reducing portfolio risk.

FNMA outlines the basic flood insurance requirements for mortgagees sold on the secondary market in their most recent Fannie Mae Servicing Guide (Servicing Guide) that can be found online at www.efanniemae.com. FHLMC's flood insurance guidelines are contained in Volumes 1 and 2 of its single family Seller/Servicer guide that can also be accessed on their website at www.freddiemac.com. The NCUA directs federal credit unions to not purchase member loans without determining whether such loans secured by improved real property have adequate flood insurance coverage.

Lenders are required to document their flood hazard determinations on the Department of Homeland Security/Federal Emergency Management Agency Standard Flood Hazard Determination Form (SFHDF) O.M.B. No. 1660-0040. The current form has an expiration date of December 31, 2011. The form is made available on FEMA's website, www.fema.gov.

A notice to the borrower is required whenever a lender makes, increases, extends, or renews a loan secured by a building or a mobile home located in a SFHA. The notice is also to inform the borrower whether flood

insurance coverage is available under the NFIP. The notice must be in writing and includes required contents. The flood regulations contain a model notice form that the lender may use at its option.

When flood insurance coverage is required, a lender must ensure that adequate flood insurance coverage is in place by the time the loan closes. Applicable regulations include the methods for determining the amount of coverage.

“In general it must be at least equal to the lesser of:

7. The outstanding principal balance of the designated loan;

8. The maximum amount available under NFIP for the particular type of property; and,

9. The value of the improvements (overall value of the property less the value of the land).”

Lenders may require more insurance than required by the applicable regulations to ensure repayment of the loan; however, the coverage may not be more than the replacement cost of the improvements. The amount of building coverage limits and contents coverage limits currently in effect are published in the questions and answers that may be found on the FEMA website. California law prohibits requiring hazard insurance in an amount in excess of the replacement value of the improvements on the real property (Civil Code Section 2955.5).

FEDERAL AND STATE DISCLOSURES AND NOTICE OF RIGHTS

Article 7 - The Borrower

The Real Estate Law has long required the licensing of one who solicits or negotiates mortgage loans for another or others for compensation (or expectation of compensation) evidenced by promissory notes secured by deeds of trust or mortgages (either directly or collaterally) by/though liens on real property. The statutory scheme found in Article 7 of the Business and Professions Code, commencing with Section 10240, was enacted to curb a variety of abuses carried on by some participants in the mortgage brokerage industry. These abuses included exorbitant commissions; inflated costs and expenses; short term loans with large balloon payments; and misrepresentations or concealments of material facts. Article 7 is referred to by the industry, the Courts, the Regulators, the public and others as the Real Property Loan Law, the Mortgage Loan Brokers’ Law, or the Necessitous Borrowers’ Act (Business and Professions Code Section 10240 et seq. and 10CCR, Chapter 6, 2840 et seq.).

Non-licensed Assistants

A real estate broker (MLB) who engages in mortgage loan activities or in the purchase, sale, or assignment of promissory notes may, under specified conditions, employ non-licensed assistants. Business and Professions Code Section 10133.1(c)(1) and (c)(2) was added in 2000 to provide for an exemption from licensure of persons who are employees of real estate brokers (MLBs/MLOs) when such persons are performing activities under the supervision of the MLBs, as defined. The exemption allows a non-licensed employee to assist the MLBs/MLOs in certain residential mortgage loan transactions (as defined) provided such employees do not participate in any negotiations among the principals of such transactions (10 CCR, Chapter 8, Section 2841). Beginning January 1, 2011 loan processors and underwriters must be employees of the real estate broker (MLB/MLO) or be separately licensed as mortgage loan originators if providing services as independent contractors.

Real estate brokers (MLBs) must exercise reasonable supervision and control over the non-licensed employees’ activities at an office or branch office licensed to each employing broker. In December of 2000, the activities and conditions for employment of unlicensed assistants were included in the Commissioner’s Regulations (10 CCR, Chapter 6, Section 2841). This regulation implemented the exemption authorized by Business and Professions Code Section 10133.1(c)(1) and (c)(2) and mirrors the “Guidelines For Unlicensed Assistants” that were published by the DRE in the Winter of 1993. The aforementioned Guidelines were issued as a safe harbor

on which real estate licensees may rely when applying the clerical exemption included in applicable law (Business and Professions Code Section 10133.2).

Accordingly, MLBs employing unlicensed assistants in loan transactions, as defined, that are not subject to Section 2841 of the Regulations would apply the "Guidelines For Unlicensed Assistants" to establish the parameters of the activities authorized for such persons under the supervision of these real estate brokers.

Application of Article 7

Certain Sections of Article 7 apply to every real estate broker (MLB) who engages in loan transactions, as defined. Except for Business and Professions Code Section 10240, this Article applies to dwellings defined to mean a single dwelling unit in a condominium or cooperative, or a parcel of real property containing 1 to 4 residential units which are owned by a signatory to the deed of trust or mortgage secured thereby that was made or arranged by an MLB (Business and Professions Code Sections 10240.1 and 10240.2). The provisions of this Article apply to loans secured directly or collaterally by a first trust deed, the principal of which is less than thirty thousand dollars, or to a loan secured directly or collaterally by a subordinate lien, the principal of which is less than twenty thousand dollars.

The remaining provisions of Article 7 apply only to first or senior deeds of trust or mortgages, the original principal balance of which are $30,000 or more; or to junior deeds of trust of mortgages, the principal balance of which are $20,000 or more. When the first or senior deeds of trust or mortgages are securing an original principal balance up to $30,000 or the junior deeds of trust or mortgages are securing an original principal balance of up to $20,000, these transactions are commonly referred to as "Sheltered Loans".

Article 7 applies to loans made or negotiated by real estate brokers (MLBs) acting within the meaning of subdivision (d) of Section 10131 and subdivision (b) of Section 10240 of the Business and Professions Code. Subdivision (b) of Section 10240 includes loan transactions in which a broker (MLB) solicits a borrower with express or implied representations that the MLB will obtain and arrange a loan as an agent, but in fact makes the loan with the broker's own funds or funds the broker/MLB controls. In such fact situations, the broker may not discharge the agency and fiduciary relationship established with the borrower, even though the MLB is acting as well as a principal (and as the agent and fiduciary of private investors/lenders funding the loan) when making the loan with funds the broker (MLB) owns or controls (Business and Professions Code Sections 10131(d) and (e), 10131.1, 10131.3, 10177(q), 10230 et seq., 10237 et seq., and 10240(b), and 10 CCR, Chapter 6, Section 2840 et seq. and 2846; Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; and Corporations Code Sections 25019, 25100(e) and 25206, and 10 CCR, Chapter 3, Sections 260.115 and 260.204.1; among others).

Mortgage Loan Disclosure Statement

The MLDS is at the heart of Article 7. This statement's purpose is to provide a prospective borrower with information concerning the important features or the material facts of an intended loan transaction, including the fees, costs, and expenses to obtain the financing. A real estate broker (MLB) soliciting or negotiating a loan transaction, as defined, on behalf of another or others (for compensation or in the expectation of compensation) or when making the loan with funds owned or controlled by the MLB, which loan is evidenced by a promissory note and a deed of trust or mortgage (secured either directly or collaterally by/through a lien on real property); must present and deliver a completed MLDS to the prospective borrower within 3 business days of receipt of a completed written loan application or before the borrower becomes obligated to take or accept the loan (whichever is earlier).

MLBs either directly or through a salesperson or broker associate employed by the broker are required to obtain the signature of the borrower(s) on the MLDS prior to the time that the borrower becomes obligated to complete the loan transaction. The licensee must certify in the MLDS that the loan transaction complies with Article 7, as applicable (Business and Professions Code Section 10240 et seq. and 10 CCR, Chapter 6, Sections 2840, 2842.5, 2843 and if lending 2844).

The information that must be included in the MLDS is set forth in the Real Estate Law (Business and Professions Code Section 10241 et seq. and 10 CCR, Chapter 6, Section 2840 et seq.). Unless the MLDS is in the form prescribed for use in the Commissioner's regulations, the form of MLDS must be specifically approved by the Commissioner prior to its use (10 CCR, Chapter 6, Section 2840 et seq.). The Commissioner

has established approved forms in Regulations 2840 and 2842. Mortgage Loan Disclosure Forms can be obtained at any DRE office or on the DRE Web site at http://www.dre.ca.gov/frm_mlb.html. Other mortgage lending and brokerage forms published by the DRE are available through the same web page.

In 2008, the DRE promulgated Commissioner's Regulation 2842 and adopted the Mortgage Loan Disclosure Form, RE 885 for the disclosure of terms on non-traditional and subprime mortgage products. This form must be used when offering any loan that is defined as a "non-traditional mortgage product" in Regulation 2842, or as defined throughout this chapter as an *alternative mortgage(s) or non-traditional loan product(s)*. Further, the Real Estate Commissioner promulgated at the same time Regulation 2844 describing the standards to which MLBs/MLOs are subject when making a loan from funds owned or controlled by the broker that qualifies as a "non-traditional mortgage product" (Business and Professions Code Sections 10131.1, 10240(b), and 10241(j), and 10 CCR, Chapter 6, Section 2844).

In addition to the MLDS, real estate brokers (MLBs/MLOs) are required under the Real Estate Settlement Procedures Act (RESPA) to complete and deliver a Good Faith Estimate (GFE) to the consumer/borrower. The GFE is more fully discussed in the following section of this Chapter.

Broker Owned or Broker Controlled Funds

Both forms of the MLDS provide for disclosure that the broker (MLB) anticipate that the loan will be made with broker-controlled funds (including funds that the broker owns). The phrase "broker-controlled funds" means funds owned by the broker, by the broker's spouse, child, parent, grandparent, brother, sister, father-in-law, mother-in-law, brother-in-law or sister-in-law, or by any entity in which the broker alone or together with any of the above relatives has an ownership interest, among others (Business and Professions Code Sections 10131.1, 10240(b), and 10241(j), and 10 CCR, Chapter 6, Section 2844). The definition of the broker's own funds or funds that the broker (MLB) controls should not be determined without consideration of the applicable sections of the Corporate Securities Law of 1968 and the Corporations Commissioner's Regulations pertaining thereto.

Alternate Disclosures - Applicable Federal Law

When the real estate broker (MLB/MLO) is the creditor/lender, the broker may rely on federal disclosures and the notices of rights required in federally *regulated* residential mortgage loan transactions, i.e., the disclosures and the notices of rights required pursuant to the Real Estate Settlement Procedures Act (RESPA) and to the Truth-In-Lending Act (TILA). A predicate to reliance exclusively on the foregoing federal disclosures and notices of rights is the original principal amount of the loan must exceed the "Sheltered Loan" limits as set forth in California law (12 USC 2601 et seq. and 24 CFR Parts 3500 et seq., Regulation X; 15 USC 1601 et seq. and 12 CFR Section 226 et seq., Regulation Z; and Business and Professions Code Sections 10240(c) and 10245).

A further and an important predicate is the qualifying MLBs/MLOs must be the creditor/lender and may not be performing exclusively as the agent and fiduciary of the consumer/borrower (see the federal cases cited below in the section entitled, "Disclosures – Case Law"). Qualifying MLBs/MLOs would not be required to complete and deliver the MLDS in accordance with state law, if the "good faith estimate" that satisfies the requirements of RESPA includes the broker's real estate license number and a clear and conspicuous statement that the "Good Faith Estimate" does not constitute a loan commitment.

Further, if the residential mortgage loan contains a provision for a balloon payment, the notice and disclosure required under applicable California law must be included. Alternatively, the qualifying MLB/MLO may rely on the balloon payment notice and disclosure required for the subject residential mortgage loan by Fannie Mae or Freddie Mac, or the MLB/MLO may use a disclosure determined by the Real Estate Commissioner to satisfy the requirements of TILA (12 CFR Section 226 et seq. and 24 CFR Parts 3500 et seq.; and Business and Professions Code Section 10241(h)).

The prospective consumer/borrower must also be provided with the applicable disclosures required by TILA and must acknowledge receipt of the RESPA "good faith estimate" and TILA required disclosures and notices of rights prior to becoming obligated to the residential mortgage loan transaction. The broker (MLB/MLO) must maintain copies of the disclosures and the signed acknowledgement for three years pursuant to applicable law (Business and Professions Code Sections 10148 and 10240(c)).

Disclosures - Case Law

The federal District Court and the Court of Appeals for the 3rd Circuit have held that the disclosures and notices of rights required pursuant to TILA (including Regulation Z thereof) must be made by the creditor/lender and not by a third party agent. However, these holdings do not appear to extend to an agent that is functioning in the place and stead of the creditor/lender through an express management/administration/operations agreement (including the loan servicing relationship), i.e., in an investment contract relationship with private investors/lenders funding and making the residential mortgage loan as the creditors for TILA purposes. Further, these holdings should not apply to the exclusive authorized agent and loan correspondent for the depository institution or licensed creditor/lender funding and making the loan as the creditor for TILA purposes. The agent in this circumstance is also acting in the place and stead of the creditor/lender.

The Court in the three separate reported case citations issued in the 3rd Circuit regarding this issue did not alter the holding applicable to this discussion, i.e., the TILA required disclosures and notices of rights must be completed and given to the consumer/borrower by the creditor/lender and not by a third-party agent, as defined. The MLB/MLO making the residential mortgage loan relying on funds the broker controls or on the broker's own funds (as defined) would be the creditor/lender for TILA purposes.

Further, when the MLB/MLO is performing in an investment contract relationship, or is the exclusive authorized agent and loan correspondent for a depository institution or a licensed creditor/lender may also qualify as the creditor/lender pursuant to TILA. The status of creditor/lender (or performing in the role of creditor/lender as described above) is an essential predicate to reliance on the alternative federal disclosures and the notices of rights discussed in the previous section, "Alternate Disclosures - Applicable Federal Law". This means an MLB/MLO who is acting as the exclusive agent of the consumer/borrower is not entitled to complete and deliver TILA disclosures and notices of rights. (Vallies v. Sky Bank, 432 F. 3d 493 – 2006; Vallies v. Sky Bank, 583 F. Supp. 2d 687 – 2008; and Vallies v. Sky Bank, 591 F. 3d 152 – 2009).

In *Realty Projects, Inc. v. Smith* (1973 32 C.A. 3d 204), the court held that the statutory obligation of a licensee to act fairly and honestly demanded that the licensee inform prospective borrowers of the differences between commissions and other charges for loans in amounts subject to the Real Property Loan Law as against loans not covered by that law. While the Court referred to the respondent/licensee as the agent of the prospective borrower, the Court did not rely upon an agency theory in reaching its decision regarding this disclosure duty. Rather, this duty was declared to stem simply from the respondent's status as a licensee.

However in the case of *Wyatt v. Union Mortgage Co.* (1979 24 C.A. 3d 773), the Court held that a mortgage loan broker's (MLB's) duty to disclose information about late charges and the effective interest rate of a loan was based upon a fiduciary relationship between the broker (MLB) and the prospective borrower, i.e., part of the fiduciary duties owed to the consumer/borrower (Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1 and Financial Code Sections 4979.5, 4995(c) and (d), and 4995.3). It should be noted that Civil Code Section 2923.1 and Financial Code Sections 4979.5, 4995(c) and (d), and 4995.3 were each codified subsequent to the reported decision in Wyatt v. Union Mortgage Co.

Commissions and Other Charges

Article 7 limits the amount that may be charged as commission or fees and as "costs and expenses" for arranging or making a loan. Again, these limitations do not apply to a first or senior loan of $30,000 or more or a junior loan of $20,000 or more (residential mortgage loans other than "Sheltered Loans"). The maximum commissions for loans subject to Article 7 are:

1. First or senior loans:
    a. 5 percent of the principal of a loan of less than 3 years;
    b. 10 percent of the principal of a loan of 3 years or more;
2. Second or other junior loans:
    a. 5 percent of the principal of a loan of less than 2 years;

b. 10 percent of the principal of a loan of at least 2 years but less than 3 years; and,

c. 15 percent of the principal of a loan of 3 years or more.

Costs and expenses of making or arranging a loan subject to Article 7, including appraisal fees, escrow fees, notary and credit investigation fees (but excluding actual title charges and recording fees) charged to or imposed upon a consumer/borrower cannot exceed 5 percent of the original principal balance/amount of the loan or $390, whichever is greater, to a maximum of $700. The amount charged cannot exceed the actual costs and expenses paid, incurred or reasonably earned. Fees, costs, and expenses imposed by the MLB/MLO must be reasonably earned and actually incurred. No charge can exceed the amount customarily charged for the same or comparable service in the community where the service is rendered (Business and Professions Code Section 10242 and 10 CCR, Chapter 6, Section 2843).

Balloon Payments

For the purposes of Article 7, a balloon payment is defined as an installment payment that is greater than twice the amount of the smallest installment payment required by the terms of the promissory note (Business and Professions Code Sections 10244 and 10244.1).

Generally, no mortgage loan subject to Article 7 that qualifies as a “Sheltered Loan” may have a balloon payment, if the term of the loan is less than 3 years. However, if the real property securing the loan is an owner-occupied dwelling, a balloon payment is not permissible if the term of the loan is 6 years or less (Business and Professions Code Section 10244 and 10244.1). As in the case of the 3-year balloon payment provision, this restriction does not apply to a promissory note given back to the seller (“carry back”) by the purchaser of the dwelling on account of the purchase price (Civil Code Section 2956 et seq.). Notwithstanding the foregoing, should the residential mortgage loan qualify as a “High-Cost Loan”, applicable California law otherwise limits the use of balloon payments when the term of the loan is less than 5 years (Financial Code Section 4973(b)(1)).

The MLDS includes a required notice regarding balloon payments. This notice must be in 10 point bold typeface/font (using capital or upper case letters) and it must contain the precise language required by statute (Business and Professions Code Sections 10241 and 10241.4). Business and Professions Code Section 10241.4 requires an expanded disclosure should provisions have been made, or will be sought, for either extension, refinancing or renegotiation of a residential mortgage loan (as defined) subject to Article 7 when the loan includes a balloon payment.

Other Restrictions

Other restrictions on mortgage loans subject to Article 7 include:

1. An MLB is prohibited from charging or negotiating any loan servicing or loan collection fees to be paid by the borrower;

2. A consumer/borrower may not be required to purchase credit life or credit disability insurance as a condition of obtaining a loan;

3. An MLB/MLO may collect only one premium for credit life or credit disability insurance provided through duly licensed insurance agents, and only one consumer/borrower whose earnings are reasonably relied upon by the creditor/lender for repayment of the loan may be insured;

4. Regardless of the amount of the loan, charges for late payments of an installment are limited to 10 percent (or $5, whichever is greater) of the principal and interest part of the installment or periodic payment, and if a payment is paid or tendered within ten days of a payment due date, no late charge may be imposed for the payment tendered;

5. No charge may be assessed for a prepayment penalty fee in connection with a prepayment of the principal amount owning made more than seven years from the date of the loan, and if the prepayment

occurs within the first seven years of the origination of the loan, the prepayment penalty may not exceed for any prepayment of principal (during any 12-month period) a fee in excess of six months' advance interest on the amounts prepaid that are greater than 20 percent of the then remaining unpaid principal balance; and,

6. The term of an exclusive right granted to the MLB/MLO by the consumer/borrower to secure financing cannot exceed 45 days.

The late payment charges may not be imposed more than once for each late payment of an installment due and no late charge may be imposed upon any installment which is paid or tendered in full within 10 days after its scheduled due date (even though an earlier maturing installment or a late charge on an early installment may not have been paid in full). A late charge in the authorized amount of 10% (of the monthly or periodic installment of principal and interest) may not be imposed for the failure to timely pay a balloon payment, as defined. Rather, the authorized late-payment charge for a balloon payment is limited to the late charge imposable for a single monthly installment of principal and interest multiplied by the number of months occurring from the date that the balloon payment was due to the date such payment was paid or tendered plus one such monthly late charge.

The prepayment penalty provisions of Article 7 are trumped by the prepayment penalty fees controlled by the provisions of the "High-Cost Loan" or "Covered Loan" and the "Higher-Cost/Priced Mortgage Loan" laws subsequently enacted (if the loan transaction is subject to these laws). The prepayment penalty fees under the "High-Cost Loan" or "Covered Loan" law are controlled by Financial Code Section 4973(2)(C) and such fees under the "Higher-Cost/Priced Mortgage Loan" law are controlled by Financial Code Section 4995.1. While the foregoing late charges and prepayment penalty fees established in Article 7 were intended for single family, owner-occupied dwellings, these provisions apply to any loans negotiated by MLBs (Business and Professions Code Sections 10241.1, 10242.5, 10242.6, 10248, and 10248.1).

Commissioner's Regulations

As previously cited in this section, regarding Article 7, real estate licensees should be familiar with Commissioner's Regulations 2840, 2841, 2841.5, 2842, 2842.5, 2843, and 2844.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA) REGULATION X

Background

The U. S. Congress enacted the Real Estate Settlement Procedures Act (RESPA) in 1974 to provide certain consumers/borrowers with early information about the fees, costs, and expenses involved in real estate transactions that include federally related mortgage loans. RESPA also protects consumers/borrowers from hidden kickbacks and other abusive practices. In residential transactions involving federally related mortgage loans, RESPA requires consumers/borrowers who are refinancing, further encumbering, or purchasing (as the buyers) the intended security property to receive information regarding settlement or closing costs and prepaid expenses (estimates of fees, costs, expenses and "points" to be incurred).

The term "points" as applied in the financial services industry includes loan origination fees; discounts to adjust investor yields or to assist in accomplishing a "rebate" sufficient to pay the required fees, costs, and expenses to settle or close the loan transaction; and to pay the commissions imposed by mortgage brokers (MLBs/MLOs) for services rendered to arrange mortgage loans. In this Chapter, the consumer/borrower is the person applying for a loan and to whom the disclosures and notices of rights are to be delivered.

Federally Related Mortgage Loans

Generally, federally related mortgage loans include loans the proceeds of which are for the purpose of purchasing, refinancing, or further encumbering real property improved with 1 to 4 residential units. The residential real property may be owner occupied or non-owner occupied, and the deed or trust or mortgage securing the repayment of the loan may be recorded senior or junior in priority (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq.).

The specific definition of the term, “federally related mortgage loan”, as set forth in RESPA is any loan (other than temporary financing such as a construction or bridge loan) which:

“(A) is secured by a first or subordinate lien on residential real property (including individual units of condominiums and cooperatives) designed principally for the occupancy of from one to four families, including any such secured loan, the proceeds of which are used to prepay or pay off an existing loan secured by the same property; and

(B) (i) is made in whole or in part by any lender the deposits or accounts of which are insured by any agency of the Federal Government, or is made in whole or in part by any lender which is regulated by any agency of the Federal Government; or

(ii) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by the Secretary or any other officer or agency of the Federal Government or under or in connection with a housing or urban development program administered by the Secretary or a housing or related program administered by any other such officer or agency; or

(iii) is intended to be sold by the originating lender to the Federal National Mortgage Association, the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, or a financial institution from which it is to be purchased by the Federal Home Loan Mortgage Corporation; or

(iv) is made in whole or in part by any “creditor”, as defined in section 103(f) of the Consumer Credit Protection Act (15 USC Section 1602 (f)), who makes or invests in residential real estate loans aggregating more than $1,000,000 per year, except that

for the purpose of this Act, the term “creditor” does not include any agency or instrumentality of any State” (12 USC Section 2602 (1)(B)).

Exemptions from RESPA

RESPA applies to federally related mortgage loans (as defined) except for loans secured by real property consisting of 25 acres or more, vacant land, or for a loan that is primarily for business, commercial, or agricultural purposes. Loan transactions for temporary or short-term purposes (defined as construction or bridge loans) are exempt from the application of RESPA. The temporary financing exemption from RESPA relies upon the definition for such financing included within the regulations promulgated under TILA (12 CFR Section 226.3(a)(1)).

The definition for temporary financing applied under California law is similar to the federal definition with a noted exception that state law imposes, i.e., such loans must have a maturity of one year or less. Further, bridge loans when applied under California law are for the express purpose of financing the acquisition or construction of a dwelling intended to be the consumer’s/borrower’s principal residence (Financial Code Section 4970(d)).

Further, RESPA does not apply to loan “assumptions” (transfers of the title to the security property) without at the same time transferring the liability of the initial maker of the mortgage loan through an *assumption agreement* executed by the transferee and the creditor/lender. Such transfers occur “subject to” the existing mortgage loan and may well be in violation of due–on-sale clauses included within the loan documents. RESPA also does not apply to contemplated conversions of existing loans from one amortization to another or from adjustable to a fixed interest rate residential mortgage loan. Secondary market transactions where the originating creditor/lender sells, endorses or assigns the mortgage loan as an “asset in being” (an asset existing as part of a loan portfolio) to the ultimate investor(s) are also exempt from RESPA (24 CFR Section 3500.5(a) and (b)).

Definitions of “Creditor” and of “Lender”

The Consumer Credit Protection Act, commonly referred to as the Truth-In-Lending Act (TILA), applies to qualifying “creditors” (15 USC Section 1601 et seq. and 12 CFR Section 226 et seq.). Accordingly, federal law applies two distinguishable definitions to the persons or entities that fund and make loans, i.e., “creditors” and “lenders”. RESPA defines the persons or entities that fund or make loans as “lenders”.

Pursuant to TILA, the term "creditor" refers to a person (or entity) that “(1) regularly extends, whether in connection with loans, in sales of property or services, or otherwise extends consumer credit which is payable

by an agreement in more than four installments or for which the payment of a finance charge is or may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness or, if there is no such evidence of indebtedness, by agreement…" (15 USC Section 1601(f) and 12CFR Section 226.2(a)(17)). The conjunctive "and" requires both the extension of credit (funding and making the loan) and being identified as the initial payee on the face of the evidence of indebtedness or the agreement.

Further, a person or entity regularly extends consumer credit, "… only if it extended credit (other than credit subject to the requirements of 226.32) more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. If a person did not meet these numerical standards in the preceding calendar year, the numerical standards are to be applied to the current calendar year. A person regularly extends consumer credit if, in any 12-month period, the person originates more than one credit extension that is subject to the requirements of 226.32 or one or more such credit extensions through a mortgage broker" (15 USC Section 1601(f) and 12 CFR 226.2(a)(17)). The TILA definition of "creditor" has been adopted for RESPA purposes (12 USC Section 2602).

The term "lender" is defined in applicable federal law as persons and entities that regularly make loans and that appear on the promissory note and other evidence of indebtedness as the initial payee. Under federal law, the term "creditor" applies to persons and entities that complete and deliver certain disclosures and notices of rights to consumers/borrowers when making residential mortgage loans. The term "creditor" also applies under federal law to persons or entities that make residential mortgage loans that are subject to various federal mandates, including the completion of demographic and geographic reports, and that otherwise require compliance with consumer/borrower protection objectives. The result of the foregoing is a "two-pronged" definition for those persons and entities engaged in the funding and making of residential mortgage loans, i.e., "lenders" and "creditors".

RESPA Amendments

Significant changes to RESPA were published November 17, 2008. The new regulations became effective over a period of several months, commencing January 16, 2009, and concluding as of January 1, 2010. These changes include (among other technical changes) amending the contents of the booklet, "Shopping for Your Home Loan, HUD's Settlement Cost Booklet"; revisions to the Good Faith Estimate; modifying the HUD-1 and HUD-1A Settlement/Closing Statements; restructuring the Servicing Disclosure Statement; and altering the requirements for the Initial Escrow (Impound) Account Statement. Each of the foregoing amendments, revisions, modifications, alterations, or restructuring is discussed in this Section.

Special Information Booklet

There are six disclosure requirements under RESPA. The first is to provide mortgage loan applicants (consumers/borrowers) with a special information booklet. This booklet entitled, "Shopping for Your Home Loan, HUD's Settlement Cost Booklet", revised in December 2009, is available on the HUD website at www.hud.gov. The booklet is to be delivered to a person from whom the creditor/lender receives or for whom a written application is prepared in connection with a federally related mortgage loan. The special information booklet may be translated into languages other than English when appropriate or as required by applicable law.

When Required

The special information booklet is to be received by the applicant (consumer/borrower) at the earliest possible time; however, the booklet is not required when the applicant is applying for a reverse mortgage. In open-end credit transactions, such as home equity lines of credit (HELOCs), the special information booklet may be replaced with the booklet published by HUD entitled, "When Your Home is on the Line, What You Should Know about Equity Lines of Credit".

Multiple Applicants

When two or more persons (consumers/borrowers) apply together for a loan, the creditor/lender is in compliance if one consumer/borrower receives a copy of the booklet. The creditor/lender may deliver the booklet to the applicant or mail it to the applicant (consumer/borrower) no later than three business days after the application is received or prepared. If the applicant uses a mortgage broker (MLB/MLO), the mortgage broker is to provide the special information booklet relieving the creditor/lender from the responsibility to do so. Further, if the creditor/lender denies the application for credit of the consumer/borrower before the end of

the three-business-day period, then the creditor/lender need not provide the booklet (12 USC Section 2604 and 24 CFR Section 3500.6(c) and (d)).

Time of Delivery
Disclosures required under RESPA are generally to be completed and delivered within a defined number of business days. For RESPA purposes, a business day is defined as a day on which the offices of the person or business entity (creditor/lender or mortgage broker (MLB/MLO)) are open to the public for carrying on substantially all of the entity's business functions (24 CFR Section 3500.2(b)). Notwithstanding the foregoing, Sundays and federal holidays are excluded from the definition of a business day.

Good Faith Estimate
Content, Form, and Delivery
The second required disclosure under RESPA is the Good Faith Estimate (GFE). The GFE is to be completed and delivered to the applicant (consumer/borrower) and it includes an estimate of settlement charges or closing costs and prepaid expenses as well as the prospective material loan terms. RESPA requires that a GFE disclosing the fees, costs, and expenses and the material loan terms be completed and delivered to the consumer/borrower no later than three business days after preparing the loan application or receiving information sufficient to complete an application, whether received by the creditor/lender or the mortgage broker (MLB/MLO) (24 CFR Section 3500.7).

The creditor/lender or the mortgage broker (MLB/MLO) is to provide the GFE to the loan applicant (consumer/borrower) by hand delivery; by placing it in the mail; or, if the applicant agrees, by fax, e-mail, or other electronic means. When the residential mortgage loan is being delivered to the creditor/lender by a mortgage broker (MLB/MLO), it is the obligation of the creditor/lender funding the mortgage loan to verify the GFE was delivered to the consumer/borrower within the three business days as described in this paragraph. If the GFE was timely delivered by the mortgage broker (MLB/MLO), then the creditor/lender need not complete and deliver the GFE. A GFE is not required on home equity lines of credit (HELOCs), or regarding loan applications denied by the creditor/lender or withdrawn by the applicant (consumer/borrower) within the statutory three days. (24 CFR Section 3500.7(a)(3)(i)(ii)).

Tolerances for Amounts Included on the GFE
Neither the creditor/lender nor the mortgage broker (MLB/MLO) may charge, as a condition for providing a GFE, any fee for an appraisal, inspection, or other similar settlement services. The creditor/lender or the mortgage broker (MLB/MLO) may, at its/their option, charge a fee limited to the cost of a credit report. No additional fees may be charged by the creditor/lender or the mortgage broker (MLB/MLO) until after the applicant (consumer/borrower) has received the GFE (24 CFR Sections 3500.7 (a)(4) and (b)(4)). The GFE is deemed received by the consumer/borrower within three calendar days subsequent to the mailing, excluding Sundays and legal holidays specified in applicable federal law (5 USC Section 6103(a) and 24 CFR Section 3500.7 (a)(4) and (b)(4)).

The loan application includes an estimate of the then market value of the intended security property as represented by the applicant (consumer/borrower) or as may be reflected in a purchase and sale agreement (if the loan is to finance the purchase of the intended security property). The creditor/lender or the mortgage broker (MLB/MLO) are advised to research comparable sales and/or listings in the neighborhood where the intended security property is located through on line vendor services, MLS', or through information available from title companies. The purpose of the foregoing is to apply reasonableness tests as the appropriate standard when considering the applicant's estimate of market value or that the proposed sales price of the intended security property bears a relationship to recent comparable sales in that neighborhood.

Limitations on Collection of Fees
The creditor/lender or the mortgage broker (MLB/MLO) may at any time collect from the loan applicant (consumer/borrower) information in addition to the contents of the application (as described and defined), when the creditor/lender is prohibited from requiring such information as a condition for providing a GFE. An example is the applicant (consumer/borrower) may not be required to submit supplemental documentation to verify the information provided on the loan application (24 CFR Section 3500.7 (a)(5) and (b)(5)). However, the creditor/lender may obtain verification from third parties in support of the information included in the application provided no fees, costs, and expenses are imposed on the applicant (consumer/borrower) other than

a credit report fee *in advance* of providing a GFE. As previously mentioned, the foregoing includes (among others) the fee for an appraisal report (24 CFR Section 3500.7 (a)(4) and (b)(4)).

Binding on Loan Originator

It is paramount the GFE contains accurate information. While the GFE is not a commitment to lend by the creditor/lender, the creditor/lender and the mortgage broker (MLB/MLO), as loan originators, are each bound within the tolerances established when completing and delivering the GFE to the consumer/borrower. Some of the fees, costs, and expenses disclosed are subject to zero tolerances and others are subject to the 10 percent tolerance cap on the amounts disclosed in the GFE. Should the loan originator provide a new or revised GFE to the consumer/borrower prior to settlement or the close of the loan escrow, documentation must be included supporting the reasons for the revisions.

The estimate of the charges (fees, costs, and expenses) for settlement services and the loan terms must remain available for at least 10 business days from when the GFE is initially delivered to the consumer/borrower. The loan originator may elect to maintain the GFE and the estimated charges and loan terms for longer than 10 days. Should the loan originator extend the period of availability of the GFE, certain estimated charges or loan terms are not subject to the tolerance requirements. These are the interest rate; the charges and loan terms dependent upon the interest rate (which include the charges for credit to reimburse the fees, costs, and expenses through adjustments in the interest rate chosen); the adjusted origination charges, if any; and the daily or per diem interest (24 CFR Section 3500.7(c)).

If a consumer/borrower does not express an intent to continue with a loan application within 10 business days after the GFE is delivered or during the extended period of availability offered by the loan originator, the creditor/lender or mortgage broker (MLB/MLO) is no longer bound to the initial GFE (24 CFR Section 3700.5 (f)(4)).

Retention of Documents and Disclosures

Loan originators must retain copies of GFEs and documentation of the reasons in support of a new or revised GFE for a minimum of three years after settlement or loan closing (24 CFR Section 3500.7(f)). Mortgage loan brokers (MLBs/MLOs) are required under state law to retain the entire loan file for at least three years subsequent to loan closing or the last action taken, whichever is later (Business and Professions Code Section 10148).

Changed Circumstances

Change in circumstances includes those requested by the consumer/borrower; those affecting the consumer's/borrower's eligibility and/or the ability to qualify for the specific loan terms disclosed; those affecting the anticipated or represented market value of the intended security real property; or those affecting increased costs of settlement services that exceed the tolerances for those charges arising from the foregoing changed circumstances. Should changed circumstances apply, the loan originator should provide a revised GFE to the consumer/borrower. If a revised GFE is delivered to the consumer/borrower, the loan originator must do so within three business days after receiving information to establish the changed circumstances (24 CFR Section 3500.7(f)(1), (2) and (3)).

Distinctions between Federal and State Law

Application of this federal law is not as strict as state law when considering the fiduciary duties owed by the mortgage broker (MLB/MLO), a category of loan originator distinguishable from those who are creditors/lenders or employees/agents of creditors/lenders. As the agent and fiduciary of the consumer/borrower where the contemplated loan is being delivered to a depository institution or a licensed lender (the creditor/lender), the change in circumstances (regardless of cause or reason) must be disclosed by the mortgage broker (MLB/MLO) to the consumer/borrower (Business and Professions Code Section 10240 et seq.; and 10 CCR, Chapter 6, Section 2840 et seq.; Civil Code Sections 2295 et seq. and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c)).

The MLB/MLO is required under California law to complete and deliver to the consumer/borrower a Mortgage Loan Disclosure Statement (MLDS) together with the GFE in a federally related loan transaction, as defined. California law requires the material loan terms, including the estimated fees, costs, and expenses to be disclosed, in writing, as well as any change in the foregoing through the use of the MLDS (and through a

revised GFE to avoid any conflicts between the two required disclosure statements). This means the material loan terms and the estimated fees, costs and expenses and any changes are to be in writing and evidence of such disclosures is to be maintained in the loan file. The purpose is to ensure no misrepresentation occurs and that no false promises have been made to the consumer/borrower by the mortgage loan broker (MLB/MLO) (Business and Professions Code Sections 10176(a), (b) and (c), 10177(d), (g) and (j), 10240 et seq., and 10 CCR, Chapter 6, Section 2840 et seq.; Civil Code Sections 2295 et seq. and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c)).

Generally, state laws that are inconsistent with RESPA are preempted to the extent of the inconsistency. However, the regulations promulgated pursuant to RESPA are not intended to "…annul, alter, affect, or exempt persons subject to their provisions from complying with the law of any state with respect to settlement practices, except to the extent of the inconsistency" (24 CFR Section 3500.13). The requirement under California law to obtain the signature of the loan applicant (consumer/borrower) on the MLDS and to include the GFE for this purpose (prior to becoming obligated to the loan transaction) represents an added responsibility of the MLB/MLO that is *not an "inconsistency"* subject to the preemption (Business and Professions Code Section 10240 and 10 CCR, Chapter 6, Section 2842.5).

Comparison of GFE with HUD-1 or HUD-1A

As aforementioned, charges disclosed on the GFE are compared for accuracy prior to drawing of the loan documents (including instruments, disclosures, notices of rights and escrow instructions) and when funding the loan. The settlement or loan closing statement (HUD-1 or HUD-1A) must be reviewed in advance of settlement or loan closing to ensure no unauthorized changes have occurred to the fees, costs, and expenses. As previously mentioned, once the GFE is completed and delivered to the consumer/borrower, certain charges are subject to a zero tolerance. Charges that cannot change include the origination fee (whether imposed by the creditor/lender or the mortgage broker (MLB/MLO)), the credit or charge ("points") for the specific interest rate chosen after the interest rate is "locked", and transfer taxes (24 CFR Section 3500.7(e)).

A 10 percent tolerance is applied to the sum of the prices for services where either the creditor/lender or the mortgage broker (MLB/MLO) requires the use of a particular provider, or the consumer/borrower uses a provider selected or identified by the loan originator (24 CFR Sections 3500.2 and 3500.7(e)). The charges required by the service providers selected by the loan originator (creditor/lender or the MLB/MLO); the fees imposed for title services including title insurance coverage (lender's and owner's title insurance coverage); and the charges for other required services subject to shopping (when the consumer/borrower selects providers identified by the loan originator) cannot increase by more than 10 percent at settlement or loan closing. Government recording charges are also subject to a 10 percent cap, i.e., they cannot exceed the amount disclosed in the GFE by more than 10 percent.

However, the services for which the consumer/borrower selects a provider (other than a provider identified by the loan originator) are not subject to any tolerance cap and, at settlement or loan closing, would not be included in the sum of the charges on which the 10 percent tolerance is based. Charges of third party service providers can change in addition to those where a service provider chosen by the consumer/borrower is used. Other charges that can change include the initial deposit for an escrow (impound) account, daily or per diem interest charges, and premiums for property insurance coverage (24 CFR Section 3500.7(e)).

While the regulations do not refer to property taxes, the amount of such taxes may change through pro-rations, and the amount of reserves required when establishing an escrow (impound) account may also be subject to change (depending upon the date of settlement or loan closing). California creditors/lenders and mortgage brokers (MLBs/MLOs) should be aware that if the proceeds of the loan are to facilitate the purchase of residential real property, future property taxes may be increased by supplemental tax assessments resulting from the purchase price paid for the security property.

Interest Rate Locks and Loan Commitments

The term "interest rate lock commitment" was defined in the Mortgage Bankers Association Presentation to Bank Regulatory Agency Representatives made on February 20, 2004. This presentation included a definition which in part states, "An interest rate lock commitment represents a lender's agreement to make money available to a borrower within a specified time period at a specified rate for a specified tenor…". When "locking" the interest rate in residential loan transactions, the consumer/borrower may elect to "lock" typically

for periods of 15, 30, 45 or 60 days. Generally, the lock period selected is from 45 to 60 days. Shorter periods are often selected when pre-approval of the loan has been extended by a creditor/lender and in those circumstances when a purchase transaction must close within a short defined period.

"Pre-approve" vs. "Pre-qualify"

Interest rate locks with a commitment to make a loan to a consumer/borrower at a specified rate and terms for an identified period (based upon "pre-approval" subject to specified conditions) is an offer from the intended creditor/lender that may not be made by a mortgage loan broker (MLB/MLO). It is a misrepresentation and a false promise for a MLB/MLO to communicate a "lock" in the rate and terms of a mortgage loan without identifying the source of the "lock of rate and loan terms". The MLB/MLO is obligated to disclose the material facts relevant to the consumer's/borrower's decision to rely upon the "lock", including the identity of the intended creditor/lender (Business and Professions Code Sections 10176 (a),(b), (c), (k) and (l)).

Creditors/lenders may "pre-approve" the loan application of a consumer/borrower whereas mortgage brokers (MLBs/MLOs) may "pre-qualify" but may not "pre-approve." It is a misrepresentation for a mortgage broker (MLB/MLO) to pre-approve or to issue a "lock" and/or "commitment", unless the MLB/MLO is the creditor/lender or the authorized agent for the creditor/lender for such purposes (Business and Professions Code Sections 10176(a),(b),(c) and (k) and 10177 (g) and (j)). It is also unlawful for an MLB/MLO to delay the closing of a mortgage loan to increase fees, costs, or expenses (charges) payable by the consumer/borrower (Business and Professions Code Sections 10176(l) and 10177 (g) and (j)).

Revised GFEs

If the interest rate has not been "locked" or a "locked interest rate" has expired; the charge for the interest rate chosen, the adjusted origination charges, the daily or per diem interest, and the loan terms related to the interest rate lock may change. If the consumer/borrower later requests a "locked interest rate", a revised GFE must be completed and delivered showing the altered interest rate and dependent charges and loan terms. All other charges and loan terms must remain the same as on the original/initial GFE, except as otherwise provided in the event of changes in circumstances (24 CFR Section 3500.7 (f)(5)).

In the event the contemplated loan transaction is to finance a new home purchase and the anticipated settlement or loan closing is to occur more than 60 calendar days from the time the initial GFE is completed and delivered, the loan originator must separately disclose in a clear and conspicuous manner that a revised GFE may be issued to the consumer/borrower. Should a separate disclosure occur in anticipation of a revised GFE, the subsequent disclosure must comply with the required tolerances established by the original/initial GFE, except as to the changed circumstances previously discussed (24 CFR Section 3700.5(f)(6)).

Violations of Section 5 of RESPA Regarding GFEs

Should any charges at settlement or loan closing exceed the fees, costs, and expenses listed on the GFE by more than the permitted tolerances, the loan originator is to cure the tolerance violation by reimbursing the consumer/borrower the excess amounts. The required reimbursement are the amounts by which the tolerances were exceeded at settlement or loan closing, and the reimbursement is to be made either at loan closing or within 30 calendar days thereafter. If the loan originator delivers or places the reimbursement in the U. S. Mail within 30 calendar days after settlement or loan closing, the consumer/borrower is presumed to have timely received the reimbursement.

It may prove to be difficult for a loan originator who is a mortgage broker (MLB/MLO) to cure tolerance violations beyond the scope of the mortgage broker's authority and capacity. Many MLBs/MLOs are pursuing a practice of establishing the amount of the estimated fees, costs, and expenses, and the specific material loan terms through creditors/lenders; with settlement agents, title insurers, title companies or public escrows in advance of issuing the original/initial GFEs (24 CFR Section 3500.7(i)).

Apparently, a HUD omission has occurred regarding enforcement of Section 5 of RESPA. As of this writing, no sanctions or penalties exist for violations of Section 5 other than timely curing any breach of the tolerance limits or conforming the transactional terms to the material loan terms disclosed in the GFE. HUD indicates it plans to seek authority from the U. S. Congress to impose civil monetary penalties and injunctive and equitable relief for such RESPA violations. In the meantime, it is likely banking and other regulators will enforce the new GFE requirements under their regulations. Federal regulators are likely to examine the fees, costs, and expenses

and material loan terms disclosed in the GFE and compare these disclosures to the HUD-1 or HUD-1A and to the loan documents to learn whether compliance with Section 5 has occurred.

Available Instructions
HUD has prepared instructions to assist loan originators in completing and delivering the GFE that are available on the HUD website at http://edocket.access.gpo.gov/cfr_2009/aprqtr/24cfr3500AppC.htm.

HUD-1 or HUD-1A
Required Use
The third disclosure required by RESPA in a federally related loan transaction is either the HUD-1 or HUD-1A. Generally, the HUD-1 is to be used when the security property is being purchased and sold and the HUD-1A when the purpose of the loan is to refinance or further encumber the intended security property (24 CFR Section 3500.8 (a), (b), and (c)).

Form HUD-1 is required in every settlement or closing statement involving a federally related mortgage loan in which there is a borrower (buyer) and a seller. In preparing regulations to implement RESPA, HUD has focused on the borrower even in sales transactions. The borrower and the buyer are generally the same person in such transactions. As previously mentioned, the HUD-1 is the appropriate form when the proceeds of the loan are used to purchase the security property, i.e., a residential property improved by 1 to 4 dwelling units. Creditors/lenders may use the HUD-1 in other transactions such as refinancing loans or loans secured by subordinate liens by simply using the borrower's side of the form. A single HUD-1 may be distributed to multiple borrowers in the same transaction.

Form HUD-1A may be used as the settlement or loan closing statement for loans refinancing or further encumbering the equity of the intended security property, or in other one-party transactions that do not involve transfers of title. Creditors/lenders are not required to use either the HUD-1 or HUD-1A for open-end home equity lines of credit (HELOCs), as long as the applicable provisions of Regulation Z are followed.

Comparison with GFEs
The settlement agent (or the escrow holder) is required to use the HUD-1 or HUD-1A settlement statement in every settlement/escrow involving a federally related mortgage loan. In most cases, in transactions that involve an escrow holder or settlement agent (for example, title insurance companies, underwritten title companies, public escrows, or an attorney acting as a settlement agent), the creditor/lender historically did not have direct statutory responsibility for the accuracy of the HUD-1 or HUD-1A (24 CFR Section 3500.8 (a), (b), and (c)).

However, the imposition of tolerance caps and related issues such as changes in circumstances place a burden on creditors/lenders and mortgage brokers (MLBs/MLOs) to ensure the HUD-1 or HUD-1A is consistent with the settlement charges or closing costs and prepaid expenses as disclosed in the GFE. This burden to ensure consistency and to protect the consumer/borrower also extends to the material loan terms disclosed in the GFE as well as in the disclosures required under Regulation Z of TILA.

Definition of Settlement Agent or Escrow Holder
The federal definition of "settlement agent" includes the creditor/lender if no one is designated by the parties in the transaction to be a *neutral* settlement agent or escrow holder. In California, to function as a settlement agent or escrow holder the person or entity requires licensing under the Public Escrow Law or an exemption from licensing pursuant to this law (Financial Code Sections 17003, 17004 and 17006). The persons or entities that may function as settlement agents or escrow holders without being licensed under the Public Escrow Law include title insurance companies, underwritten title companies, banks, savings and loan associations, savings banks, trust companies, or other licensed insurance carriers that are doing business under applicable laws of the state of California or of the United States. Title insurance companies or underwritten title companies are required to make an offer to issue a title policy as a predicate to conducting an escrow under this exemption.

In addition, persons licensed to practice law in California who are in a bona fide relationship with a principal to a real property or a real property secured transaction may act as the settlement agent or escrow holder through an exemption from the Public Escrow Law, provided the attorney is not actively engaged in business as an escrow agent. Real estate brokers are also exempt from licensure under the Public Escrow Law when acting as an escrow holder, provided the broker is either an agent or party to the real property or real property secured

transaction performing an act requiring a real estate license Financial Code Section 17006(a)(1) through (4), and (b)).

Unlike most other settlement agents or escrow holders, brokers acting as an escrow holder in a real property or a real property secured transaction are *not* functioning as a *neutral* escrow agent (Business and Professions Code Section 10145 and Financial Code 17006). Further, mortgage bankers acting under the Residential Mortgage Lending Act (RMLA) or finance lenders acting under the Finance Lender Law (CFLs) may not act in California as settlement agents or escrow holders.

Obligation for Loan Originator to Review HUD-1 or HUD-1A

When the settlement agent or escrow holder is someone other than the creditor/lender, the creditor/lender should obtain a copy of the HUD-1 or HUD-1A issued to the consumer/borrower from the settlement agent or escrow holder. The purpose is to ensure the settlement agent or escrow holder has complied with the instructions of the creditor/lender, including confirming that the amounts imposed as fees, costs, and expenses are within the applicable tolerances of the estimates disclosed in the GFE. The creditor/lender is also to review the HUD-1 or HUD-1a to ensure the material loan terms disclosed remain unchanged and to accomplish record keeping obligations.

Similar obligations are imposed upon mortgage brokers (MLBs/MLOs) with the added burden of ensuring that conformed copies of the deeds of trust or mortgages have been delivered to the creditor/lender or investor and to the consumer/borrower as required under applicable law (Business and Professions Code Section 10234.5). MLBs/MLOs must also confirm that the consumer/borrower received a copy of the final HUD-1 or HUD-1A Settlement Statement.

Contents of HUD-1/HUD-1A

The HUD-1 settlement statement is a three-page document which has been redesigned to provide the consumer/borrower with the ability to compare the estimates of settlement or closing costs and pre-paid expenses given in the GFE to the actual charges shown on the HUD-1. Further, the HUD-1 includes a third page that was added at the time of this writing to allow the consumer/borrower to determine if the actual charges or closing costs and pre-paid expenses have exceeded the required tolerances and whether a restatement of the same material terms of the loan as set forth in the GFE has occurred.

The GFE for comparison purposes is the last GFE (and when the loan originator is a MLB/MLO, the last MLDS) that was completed and delivered to the consumer/borrower in accordance with applicable federal and state law. The consumer/borrower should receive a final GFE including settlement or closing costs and prepaid expenses that are actually being imposed as well as disclosing the material loan terms actually occurring in the transaction (24 CFR Section 3500.8 (b) and (c) and Business and Professions Code Section 10240 et seq.).

As previously mentioned, the HUD-1A form applies in residential mortgage loan transactions where the purpose of the loan is to accomplish the refinance or the further encumbrance of the intended security property. The HUD1-A is a two-page statement that includes much the same information as the HUD-1, except no information is included for a seller of real property (since no sales transaction is occurring). Again, the information to be included must be sufficient to allow a consumer/borrower to compare the settlement charges or closing costs and prepaid expenses to the fees, costs, and expenses and to the material loan terms as disclosed in the GFE (24 CFR Section 3500.8 (a), (b) and (c)).

Advance Review by Consumer/Borrower

One-day in advance of the anticipated settlement or close of the loan escrow, the settlement agent or escrow holder must permit the consumer/borrower to inspect the proposed HUD-1 or HUD-1A settlement statement as completed, including all items known to the settlement agent or escrow holder at the time of inspection. The one-day prior inspection of the proposed HUD-1 or HUD-1A is to occur during the business day immediately preceding the date on which the contemplated transaction is to be settled or closed. The only items that may be eliminated from the proposed HUD-1 or HUD-1A settlement statement for this advance inspection are those in a sales transaction exclusively concerning the seller (24 CFR Section 3500.10 (a)).

Waiver of Right to Advance Review

The consumer/borrower may waive the right to inspect in advance the proposed HUD-1 or HUD-1A settlement statement. Such waiver must be in a writing executed by the consumer/borrower. In such event, the settlement

agent or escrow holder is to deliver a completed HUD-1 or HUD-1A to the consumer/borrower as soon as practical after the settlement or the close of the escrow (24 CFR Section 3500.10 (b) and (c)). When mailing the HUD-1 or HUD-1A settlement statement, it is to be placed in the U.S. Mail addressed to the consumers/borrowers at the address included within the loan application. A distinguishable address may be used if authorized in writing and executed by the consumer/borrower (24 CFR Section 3500.11).

Neither the settlement agent nor the escrow holder or any other person (whether the creditor/lender, mortgage broker, or a third party service provider) may impose a fee or charge to prepare and deliver the HUD-1 or the HUD-1A settlement statement. This fee or charge prohibition applies to any disclosures or notices of rights required under RESPA or pursuant to TILA (12 USC Section 2601 et seq. and 15 USC Section 1601 et seq.).

Servicing Disclosure Statement

When the Servicing Disclosure Statement is Required

The fourth disclosure required by RESPA in a federally related loan transaction is the Servicing Disclosure Statement. When an application for a federally related mortgage loan is submitted or within 3 business days after submission of the application, the creditor/lender or mortgage broker (MLB/MLO) who anticipates using "table funding" or the dealer who anticipates a first lien dealer loan is to provide a Servicing Disclosure Statement to each loan applicant (consumer/borrower) (24 CFR Section 3500.21 (a), (b), (c), and (d)).

Definition of Mortgage Servicing Loan/Federally Related Mortgage Loan

In the regulations promulgated to implement RESPA, the phrase "mortgage servicing loan" is interchangeable with and is meant to mean a "federally related mortgage loan" (24 CFR Section 3500.2). The objective of providing a Servicing Disclosure Statement is to inform the applicant (consumer/borrower) whether loan servicing of the mortgage servicing loan/federally related mortgage loan may, will, or will not be transferred by the identified loan originator.

As previously discussed, the term loan originator has been redefined in recent amendments to RESPA to include for certain purposes creditors/lenders and mortgage brokers (MLBs/MLOs). A creditor/lender or a mortgage broker in those jurisdictions where "table funding" is acceptable and who anticipates such a transaction are each subject to the obligation of issuing a Servicing Disclosure Statement at the time of an application for a federally related mortgage loan, or within 3 days after submission of the application. A mortgage broker (MLB/MLO) in California may not engage in "table funding" (with a limited exception described below) is not required to issue a Servicing Disclosure Statement (Business and Professions Code Section 10234; 10CCR, Chapter 3, Section 1460; Financial Code Section 50003(o) and (t); and 24 CFR Section 3500.21 (a), (b), (c), and (d)).

"Table Funding" Defined

The issue of "table funding" has been previously discussed in this Chapter. However, for the purposes of completing and delivering the Servicing Disclosure Statement, a further discussion is necessary. Except in narrow circumstances involving California mortgage bankers (licensed under the RMLA) that are relying on funds advanced from an affiliated creditor/lender (as defined), "table funding" is unauthorized under and inconsistent with applicable state law (Business and Professions Code Section 10234; 10CCR, Chapter 3, Section 1460; and Financial Code Section 50003(o) and (t)).

While various references are made to "table funding" in federal regulations promulgated under RESPA or otherwise, the definitions applied to this practice must first be understood to interpret the application of such references to the relationships between creditors/lenders (as one category of loan originator) and mortgage brokers (as another category of loan originator). In the federal regulations implementing RESPA, "table funding" is defined to mean a settlement at which a loan is funded by a contemporaneous advance of loan funds and an assignment of the loan to the person(s) advancing the funds. In California, such transactions are "concurrent assignments". For RESPA purposes, a "table funded" loan is *not a secondary market transaction* (24 CFR Section 3500.2).

Secondary Market Transactions Defined

Secondary market transactions are defined under RESPA as a bona fide transfer of a loan obligation in the secondary market, except as set forth in Section 6 of RESPA and in accordance with 24 CFR Section 3500.21. The aforementioned regulation is relevant to this discussion and distinguishes a secondary market transaction

for the purposes of establishing the actual creditor/lender and thus the obligation to complete and deliver the Servicing Disclosure Statement. While obligated to complete and deliver the Servicing Disclosure Statement, a mortgage broker (MLB/MLO) in a "table funded" transaction (where authorized under federal law in jurisdictions other than California) does not become the creditor/lender (12 USC Section 2602(1); 24 CFR Section 3500.2; 15 USC Section 1602(f); and 12 CFR 226.2(a)(17)).

HUD has stated that in determining what constitutes *a bona fide transfer for a secondary market transaction will depend on the real source of funding and the real interest of the funding creditor/lender*. Further, HUD points out "table funded" mortgage broker transactions are *not* secondary market transactions; and neither is the creation of a dealer loan nor a dealer consumer credit contract, nor is the assignment of such a contract to a creditor/lender (24 CFR Section 3500.5 (b)(7)).

Table Funding Pursuant to California Law
The differences in definitions and use of the term "table funding" between federal and California law are consistent. While applicable federal law does not seek to prohibit "table funding", the previously identified federal statutes and regulations clearly define such transactions as brokering and *not* lending, i.e., other than a secondary market transaction. The mortgage broker (MLB/MLO) when authorized to engage in "table funding" is to complete and deliver the Servicing Disclosure Statement (even though the relationship with the creditor/lender advancing the funds is under applicable federal law other than a secondary market transaction). A secondary market transaction occurs when a residential mortgage loan/a mortgage servicing loan is being sold and assigned from one actual creditor/lender to another.

Rather, in such transactions the mortgage broker (MLB/MLO) is arranging and delivering the loan to the creditor/lender that is the real party at interest while at the same time completing and delivering the Servicing Disclosure Statement to the consumer/borrower. The purpose is for the MLB/MLO to disclose the material facts regarding the transfer of loan servicing. Under California law, a mortgage broker (MLB/MLO) would be misleading the consumer/borrower by claiming to be the creditor/lender when brokering or arranging the loan rather than funding and making the loan. This is a misrepresentation of a material fact and an avoidance of and a breach of fiduciary duty (Business and Professions Code Section 10176(a), (b), and (c); Civil Code Sections 2295 et seq. and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c)).

The purpose of delivering the Servicing Disclosure Statement in "table funded" transactions is to ensure the consumer/borrower is aware of the transfer of loan servicing by the person or entity identified on the promissory note as the payee (24 CFR Section 3500.21 (a), (b), (c) and (d)). The Servicing Disclosure Statement providing for the transfer of loan servicing, as defined, does not in and of itself establish the "table funding" mortgage broker (MLB/MLO) held any loan servicing rights to transfer. California mortgage brokers (MLBs/MLOs) who are unable to engage in "table funding" would not complete and deliver the Servicing Disclosure Statement. Thus, no inconsistency exists with applicable federal law (24 CFR Sections 3500.5(b)(7) and 3500.21 (a), (b), (c) and (d); Business and Professions Code 10234; 10 CCR, Chapter 3, Section 1460; and Financial Code Section 50003 (o) and (t)).

Format for Servicing Disclosure Statement
A format for the Servicing Disclosure Statement appears in the Federal Register, Vol. 73 No 222 68259. The specific language of the Servicing Disclosure Statement is not required to be used. The information set forth in the "Instructions to Preparer" on the Servicing Disclosure Statement need not be included with the information given to applicants (consumers/borrowers), and the material in the square brackets is optional or alternative language.
The model format may be annotated with additional information that clarifies or enhances the model language. The creditor/lender, "table funding" mortgage broker in authorized jurisdictions, or the dealer should use the language that best describes the particular circumstances of each person or entity completing the statement. The format appearing in the Federal Register is as follows:

"Sample language; use business stationery or similar heading"

[Date]

SERVICING DISCLOSURE STATEMENT NOTICE TO FIRST LIEN MORTGAGE LOAN APPLICANTS: THE RIGHT TO COLLECT YOUR MORTGAGE LOAN PAYMENTS MAY BE TRANSFERRED

You are applying for a mortgage loan covered by the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601 et seq.). RESPA gives you certain rights under Federal law. This statement describes whether the servicing for this loan may be transferred to a different loan servicer. ``Servicing" refers to collecting your principal, interest, and escrow payments, if any, as well as sending any monthly or annual statements, tracking account balances, and handling other aspects of your loan. You will be given advance notice before a transfer occurs.

Servicing Transfer Information

[We may assign, sell, or transfer the servicing of your loan while the loan is outstanding.]

[or]

[We do not service mortgage loans of the type for which you applied. We intend to assign, sell, or transfer the servicing of your mortgage loan before the first payment is due.]

[or]

[The loan for which you have applied will be serviced at this financial institution and we do not intend to sell, transfer, or assign the servicing of the loan.]

Method of Delivery
The creditor/lender, authorized "table funding" mortgage broker, or qualifying dealer that anticipates a first lien dealer loan is to deliver the Servicing Disclosure Statement within 3 business days from receipt of the application by hand delivery; by placing it in the U. S. Mail; or, if the applicant agrees, by fax, e-mail, or other electronic means. In the event the consumer/borrower is denied credit within the three business-days (as defined), no Servicing Disclosure Statement is required. If co-applicants indicate the same address for each in their loan applications, one copy delivered to that address is sufficient. If co-applicants (consumers/borrowers) show different addresses on their loan applications, a copy of the Servicing Disclosure Statement is to be delivered to the separate address identified for each of the co-applicants.

Loan Servicing Agreement
In loans made by depository institutions or licensed creditors/lenders, the loan servicing function is either an independent operation or part of the overall operation of the creditor/lender. The objective of the loan servicing operation is to achieve the yield on the mortgage loan investment expected by the creditor/lender; to the extent possible protect the mortgage loan investment from loss; and to provide good, prompt, and acceptable service to the consumer/borrower. A loan servicer should have a written agreement with its principal, the creditor/lender for whom the servicer is acting as an agent and fiduciary (Business and Professions Code Section 10131(d); Civil Code Section 2295 et seq.; and Financial Code Section 50003(h)(6), (k)(4), (q), and (x)).

The servicing agreement should describe the servicer's responsibilities and define the compensation for the performance of the services contemplated. This is applicable even if the servicing operation is part of the creditor/lender's organization. The servicing agreement may discuss collections, forwarding of payments, late charges, defaults, foreclosures, insurance coverage, etc. Written loan servicing agreements are recommended in every fact situation. When loan servicing under a real estate broker's license, a written agreement is required by applicable law (Business and Professions Code Section 10233).

Monthly Collections
A major problem in loan servicing is the flood of payments arriving during the first ten days of each month. Two possible solutions are:

- Computerized processing of loan payments; or,
- Staggering loan payment schedules so that some payments are due on the first or 10th of the month, while others are due on the 15th or 20th, etc.

Delinquencies
Loan servicing software is available to quickly identify loan delinquencies and establish the length of delay in the receipt of the periodic payments. These software applications are capable of identifying and delivering

various notices to consumers/borrowers including pre-notice of default, notice of default and notice of trustee's sale. Recently, amendments to applicable California law require alteration of the software applications and an expanded understanding of loan modifications, forbearances, and foreclosures on the part of loan servicers (Civil Code Sections 2923.5, 2923.52, 2923.53, 2923.54, 2923.55, 2923.6, and 2924 et seq.).

Escrow (Impound) Account Statement

Background

The fifth disclosure statement required by RESPA is the Initial Escrow (Impound) Account Statement, which describes an escrow (impound) account established by a creditor/lender in connection with federally related mortgage loans. Generally, an escrow (impound) account relies on calculations based upon monthly payments and disbursements within a calendar year. Should an escrow (impound) account be subject to biweekly or other periodic payment periods, the escrow (impound) account must be modified accordingly. HUD publishes several guidance documents for use by creditors/lenders and their loan servicers. The HUD Public Guidance Documents include, "Biweekly Payments – Example"; "Annual Escrow Account Disclosure Statement – Example"; and a "Consumer Disclosure for Voluntary Escrow Account Payments". These publications provide model disclosure formats that are encouraged although not required and are to be combined with the Initial Escrow Account Statement (24 CFR Section 3500.17(a) and (g)).

Escrow (Impound) Account Required for "Higher Cost/Priced Mortgage Loans"

It is expressly prohibited for a creditor/lender to extend credit in a form of a loan secured by a first lien on a consumer's/borrower's principal dwelling if the loan is a "Higher Cost/Priced Mortgage Loan" (as previously defined in this Chapter), unless an escrow (impound) account is established for the payment of property taxes and mortgage and property related insurance premiums required by the creditor/lender. The escrow (impound) account is required in connection with qualifying loan applications received on or after April 1, 2010 (12 CFR Section 226.35 and 24 CFR Section 3500.17(a)).

Definition of a "Higher Cost/Priced Mortgage Loan"

As previously defined in this Chapter, a "Higher Cost/Priced Mortgage Loan" is a consumer credit transaction secured by the consumer's/borrower's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction. Concurrent reference to the prime offer rate for conventional loans available in the market place is required to establish whether the contemplated mortgage loan interest rate meets the defined criteria to be a "Higher Cost/Priced Mortgage Loan". If the mortgage loan interest rate is set by 1.5 or more percentage points greater than for loans secured by a first lien on a dwelling or by 3.5 or more percentage points greater than for loans secured by a subordinate lien on a dwelling; the loan fits the aforesaid criteria (12 CFR Section 226.35 and Financial Code Section 4995(a)).

To establish the prime offer rate for a comparable transaction, the Federal Reserve Bank (FRB) is a reference source for such rates applicable to conventional loans available in the market place secured by a deed of trust or mortgage recorded in senior position. As previously indicated, the FRB publishes weekly the H-15 Federal Reserve Statistical Release that includes prime offer rates for senior conventional loans (http://www.federalreserve.gov/releases/h15/update/). As previously noted in this Chapter, "Higher Cost/Priced Mortgage Loans" are also referred to in Section 35 of TILA and in California law (12 CFR Section 226.35 and Financial Code Section 4995 et seq.).

Escrow (Impound) Account Defined

An escrow (impound) account is any account that a creditor/lender or servicer establishes or controls on behalf of a borrower to pay taxes, mortgage or property related insurance premiums (including flood insurance), or other charges with respect to a federally related mortgage loan. This account may also include charges that the consumer/borrower and creditor/lender (loan servicer) have voluntarily agreed that the servicer may collect and pay. The term "servicer" or "loan servicer" applies in this section interchangeably with the term creditor/lender. The loan servicer may be the creditor/lender or an agent of the creditor/lender or of a subsequent holder of the promissory note and deed of trust or mortgage that evidences and secures the debt/loan subject to the escrow (impound) account (24 CFR Section 3500.17(b)).

Exemptions

An escrow (impound) account need not be established for mortgage or property related insurance coverage, unless the insurance is required by the creditor/lender or loan servicer. For example, neither earthquake

insurance coverage nor debt-protection insurance coverage is typically required by the creditor/lender, but are options available to the consumer/borrower. Escrow (impound) accounts are not required for mortgage or property related insurance premiums when the residential mortgage loan is secured by shares in a cooperative or by condominium units, provided the condominium owners' association is obligated to maintain a master policy extending such insurance coverage. The master policy would extend coverage to each condominium unit representing the separate interests of the individual owners/members of the common interest developments (12 CFR Section 226.35(b)(3)(ii)).

However, an escrow (impound) account for the payment of property taxes for each condominium unit (the separate interest) individually assessed is still required. Regarding loans secured by manufactured housing permanently affixed to the security real property, the establishment of an escrow (impound) account is not required until October 1, 2010 (12 CFR Section 226.35(b)(3)(i) and (ii)).

Therefore, the following applies if the residential mortgage loan is a "Higher Cost/Priced Mortgage Loan":

- The loan application date is on or after April 1, 2010;
- The loan is a first lien against the security property;
- The property is the consumer's/borrower's principal dwelling; and,
- The property is a single family dwelling, a condominium unit, or a dwelling within a planned unit development (and a manufactured home permanently affixed to the security property after October 10, 2010); then an initial escrow (impound) account statement must be provided to the consumer/borrower (12 CFR Section 225.35(b)(3)(i) and (ii) and 24 CFR Section 3500.17(b), (g), and (h)).

Such a statement is also required if the loan is FHA insured or VA indemnified or a conventional loan with a loan-to-value ratio such an escrow (impound) account is imposed by the creditor/lender (or loan servicer) or the governmental agency or enterprise involved with the contemplated transaction.

Incorporation of Initial Escrow (Impound) Account Statement in HUD-1 or HUD-1A
The creditor/lender (servicer) may incorporate or direct that the initial escrow (impound) account statement be incorporated into the HUD–1 or HUD–1A settlement statement. If the creditor/lender (servicer) does not incorporate the initial escrow account statement into the HUD–1 or HUD–1A settlement statement, then the creditor/lender (the loan servicer) shall submit the initial escrow account statement to the consumer/borrower as a separate document (24 CFR Section 3500.17(h)(2)).

Delivery of Initial Escrow (Impound) Account Statement
The creditor/lender (servicer) is to perform an initial escrow (impound) account analysis to determine the amount the consumer/borrower is to deposit into the escrow (impound) account. After conducting the escrow (impound) account analysis, the creditor/lender (servicer) is to submit an initial escrow (impound) account statement to the consumer/borrower at settlement or loan closing, or within 45 calendar days of settlement or the close of escrow. The creditor/lender (servicer) may deliver the statement by placing the document in the U. S. Mail, first-class postage paid, addressed to the last known address of the consumer/borrower or by hand delivering it to the consumer/borrower. Generally, the last known address of the consumer/borrower will be set forth in the loan application or in the security instrument, i.e., the deed of trust or mortgage (24 CFR Section 3500.17(g) and (h)).

The initial escrow (impound) account statement is to include the amount of the consumer's/borrower's total monthly mortgage payment, i.e., principal and interest, and the portion of the monthly payment allocated to the amount necessary for the payment of property taxes and the required mortgage or property related insurance coverage when each becomes due and payable. An itemization of the estimated property taxes, mortgage and property related insurance premiums, and other charges the (creditor/lender) servicer reasonably anticipates for discretionary items authorized by the consumer/borrower to be paid from the escrow (impound) account during the escrow account computation year and the anticipated disbursement dates of each of those charges shall be included. This computation is to occur annually thereafter. The initial escrow (impound) account statement

shall also indicate the amount that the (creditor/lender) servicer selects as a cushion. The statement is to include a trial running balance for the account (24 CFR Section 3500.17(b), (c), (d), (f), (g), (h), (i), and (j)).

Escrow Account Analysis and Computation at Creation

Before establishing an escrow (impound) account, the creditor/lender must conduct an escrow account analysis to determine the amount the consumer/borrower must deposit into the escrow (impound) account, and the amount of the consumer's/borrower's periodic payments into the escrow. In conducting the escrow (impound) account analysis, the creditor/lender (servicer) must estimate the disbursement amounts by calculating the amounts sufficient to pay property taxes and mortgage and property related insurance premiums when each become due (24 CFR Section 3500.17(b)).

The "amount sufficient to pay" is computed so that the lowest month end target balance projected for the escrow (impound) account computation year is zero (–0–). The target balance is the estimated month-end balance in an escrow (impound) account that is sufficient to cover the remaining disbursements from the account in the escrow computation year, taking into account the remaining scheduled periodic payments, and a minimum cushion, if any (24 CFR Section 3500.17(b), (c), (g), (h), and (i)(4)).

When establishing the escrow (impound) account, a year is the 12-month period the creditor/lender (loan servicer) utilizes beginning with the consumer's/borrower's initial payment date. If an escrow (impound) account involves biweekly or any other payment period, the account statement is to be modified accordingly (24 CFR Section 3500.17(b) and (i) (4)).

In addition, the creditor/lender (loan servicer) may charge the consumer/borrower an amount sufficient to maintain an authorized minimum cushion. A cushion or reserve means funds that a creditor/lender may require a consumer/borrower to pay into an escrow (impound) account to cover unanticipated disbursements or disbursements made before the consumer/borrower's payments are available in the escrow (impound) account. The cushion cannot be greater than one-sixth (1/6) of the estimated total annual payments from the escrow (impound) account. However, before establishing the amount of the cushion, the creditor/lender (loan servicer) must consider the mortgage loan documents. If the mortgage loan documents provide for lower cushion limits, then the terms of the loan documents control (24 CFR Section 3500.17(c), (d), and (f)).

Subsequent Escrow (Impound) Account Analyses

For each escrow (impound) account, the creditor/lender (loan servicer) must conduct an escrow account analysis at the completion of the "escrow account computation year" to determine the borrower's monthly escrow (impound) account payments for the next computation year, subject to the limitations as set forth in applicable law. In conducting the escrow (impound) account analysis, the creditor/lender (loan servicer) must estimate the disbursement amounts, and is to use a date on or before the deadline to avoid penalties for the failure to timely disburse an escrow item. The creditor/lender (loan servicer) must use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists, and must make any required adjustments to the escrow (impound) account to address the foregoing. Upon completing an escrow account analysis, the servicer must prepare and submit an annual escrow account statement to the consumer/borrower (24 CFR Section 3500.17(b), (c), (d) and (f)).

Some escrow (impound) accounts may include items billed for periods longer than one year. For example, in residential mortgage loans where flood insurance coverage is necessary, creditors/lenders (loan servicers) may need to collect flood insurance or "water purification" escrow funds for subsequent payment every three years. The creditor/lender (loan servicer) is to estimate the escrow payments for the consumer/borrower in contemplation of a full cycle of disbursements. For a flood insurance premium payable every three years, the servicer shall collect the payments reflecting 36 equal monthly amounts. The annual escrow (impound) account statement shall explain this situation. An example is included in the HUD Public Guidance Document entitled "Annual Escrow Account Disclosure Statement—Example" (24 CFR Sections 3500.3 and 3500.17(b), (c), (d), and (f)).

Transfer of Loan Servicing

When loan servicing is transferred to a new servicer and such servicer changes either the monthly payment amount or the accounting method used for the escrow (impound) account by the previous servicer, the new servicer is to provide the consumer/borrower with an initial escrow account statement within 60 days of the

date of transfer. The new loan servicer shall treat shortages, surpluses, and deficiencies in the transferred escrow (impound) account in accordance with applicable law (24 CFR Section 3500.17(b), (c), (d), (e), and (f)).

Format for Initial Escrow (Impound) Account Statement

The format and a completed example for an initial escrow account statement are set out in the HUD Public Guidance Documents entitled, "Initial Escrow Account Disclosure Statement—Format" and "Initial Escrow Account Disclosure Statement—Example", available on the HUD website at www.hud.gov.

APPENDIX G-1: ***INITIAL*** ESCROW ACCOUNT DISCLOSURE STATEMENT –

FORMAT

[Servicer's name, address, and toll-free number]

INITIAL ESCROW ACCOUNT DISCLOSURE STATEMENT

THIS IS AN ESTIMATE OF ACTIVITY IN YOUR ESCROW ACCOUNT DURING THE COMING YEAR BASED ON PAYMENTS ANTICIPATED TO BE MADE FROM YOUR ACCOUNT.

Month	Payments to Escrow Account	Payments from Escrow Account	Description	Escrow Account Balance

Initial deposit: …………………………………………………………………………………..$_______

[A filled-out format follows.]

(PLEASE KEEP THIS STATEMENT FOR COMPARISON WITH THE ACTUAL ACTIVITY IN YOUR ACCOUNT AT THE END OF THE ESCROW ACCOUNTING COMPUTATION YEAR.)

Cushion selected by servicer: $_____________.

[YOUR MONTHLY MORTGAGE PAYMENT FOR THE COMING YEAR WILL BE $__________, OF WHICH $__ WILL BE FOR PRINCIPAL AND INTEREST, $_____________ WILL GO INTO YOUR ESCROW ACCOUNT, AND $__________ WILL BE FOR DISCRETIONARY ITEMS (SUCH AS LIFE INSURANCE, DISABILITY INSURANCE) THAT YOU CHOSE TO BE INCLUDED WITH YOUR MONTHLY PAYMENT.]

[YOUR FIRST MONTHLY MORTGAGE PAYMENT FOR THE COMING YEAR WILL BE $___, OF WHICH $__ WILL BE FOR PRINCIPAL AND INTEREST, $_______ WILL GO INTO YOUR ESCROW ACCOUNT, AND $_________ WILL BE FOR DISCRETIONARY ITEMS (SUCH AS LIFE INSURANCE, DISABILITY INSURANCE) THAT YOU CHOSE TO BE INCLUDED WITH YOUR MONTHLY PAYMENT. THE TERMS OF YOUR LOAN MAY RESULT IN CHANGES TO THE MONTHLY PRINCIPAL AND INTEREST PAYMENTS DURING THE YEAR.]

California Requirements for Escrow (Impound) Accounts

Funds held by the beneficiary/lender/mortgagee of a deed of trust or mortgage in an impound account for the payment of property taxes, insurance premiums or other purposes relating to the security property are to be

retained and deposited in authorized California depository institutions. If funds in the impound accounts are invested (as authorized by applicable law), such funds are to be only invested with California residences or businesses (i.e., branches or subsidiaries of the businesses located in this state). The foregoing requirement is subject to certain exemptions depending upon the identity and status of the creditor/lender (Civil Code Section 2955).

When a depository institution or a creditor/lender (as defined) makes a loan or purchases a promissory note secured by a deed of trust or mortgage on real property located in this state (containing 1 to 4 residential units), and the institution or creditor/lender creates an impound account for the payment of property taxes, insurance premiums, or for other purposes related to the security property; a minimum of at least 2% simple interest per annum shall be paid to the consumer/borrower on the funds maintained in the impound account. No fees or charges are allowed for the maintenance or disbursements of monies received in advance in accordance with the provisions of the escrow (impound) account. An exemption from the payment of the 2% simple interest is provided for moneys that are required by state or federal regulation to be placed in non-interest bearing trust fund accounts. This exemption does not apply to banks (Civil Code Section 2954.8).

Moneys maintained in escrow (impound) accounts represent trust funds held by loan servicers as agents of identified principals. Real estate brokers are required to place such moneys into trust accounts to be established and maintained in accordance with the Real Estate Law. Generally, real estate brokers when acting as mortgage brokers (MLBs/MLOs) maintain trust funds in non-interest bearing accounts. However, if interest is to be paid and disbursed in connection with the trust funds held, the trust accounts are to be segregated by each principal for whom the funds are being held (Business and Professions Code Section 10145 and 10 CCR, Chapter 6, Section 2830.1 et seq.).

Affiliated Business Arrangements

The sixth disclosure that may be required in transactions subject to RESPA is in connection with Affiliated Business Arrangements (ABAs or AFBAs), formerly called Controlled Business Arrangements. ABAs occur when affiliated service providers refer consumers/borrowers to each other in transactions subject to RESPA. ABAs include entities with a defined percentage of common ownership. This common ownership may be held by shareholders or by an entity common to both (e.g., a holding company). ABAs also apply to associated relationships where one entity exercises control over, or shares control with the other (i.e., by joint venture, partnership or, in certain fact situations, a common business plan). If one service provider benefits financially by referring borrowers to another service provider, the cautious approach is to assume that the referral is subject to ABA disclosures (24 CFR Section 3500.15(a), (b), and (c)).

Unless the affiliated entities or associated relationships occur pursuant to an acceptable division of labor or services agreement, the ABA must function through a separate entity that may not be a division of either of the affiliated parties. HUD has required adequately capitalized separate entities to be either corporations or partnerships. Depending upon the activities of the service provider and unless a professional license is required (as defined), it is possible under California law to structure separate entities as Limited Liability Companies (LLCs) or Limited Liability Partnerships (LLPs). The preferred option is that of a corporation. The separate entity must accept its own business risk, obtain licensing as required; and have, among other attributes, its own facilities, management, and employees (24 CFR Section 3500.15(b) and (c)).

An ABA, whether a separate entity or structured pursuant to an acceptable division of labor agreement, may receive payment for performing compensable loan services when engaged in loan originations subject to RESPA. HUD has made it clear that *sham* entities will not be recognized and considered *ploys* for avoiding the unauthorized payment of referral fees. The only thing of value that may be received from an ABA (other than payments of fees, salaries, compensation or other forms of payment authorized pursuant to 24 CFR Section 3500.14(g)) is a return on an ownership interest or through a franchise relationship from the affiliated entity. This may include bona fide dividends and distributions of capital or equity. Bona fide business loans, advances, and capital or equity contributions among entitles in an affiliated relationship are not prohibited so long as they are for ordinary business purposes and are not for fees for referral of settlement services, or fees that are unearned (24 CFR Section 3500.15(a), (b), and (c)).

A return on ownership interests does not include any payment that has as a basis of calculation no apparent business motive other than distinguishing among recipients payments predicated on the amount of the actual,

estimated, or anticipated referrals. Further, payments that vary according to the relative amount of referrals by different recipients of similar payments; or that are based on an ownership, partnership, or a joint venture share that has been adjusted for previous relative referrals by recipients of similar payments are also excluded from the definition of a return on an ownership interest (24 CFR Section 3500.15(b)(3)).

When a face-to-face interview occurs with or when a written or electronic referral is offered to a consumer/borrower**,** the ABA disclosure must be delivered at or before the time of the referral and the creditor/lender must keep a record of the delivery to the consumer/borrower. The ABA disclosure must be in a separate writing and may be delivered at the time the GFE is completed and delivered (whether separately or with disclosures required pursuant to TILA). After a face-to-face interview, the creditor/lender must attempt to obtain a written receipt from the consumer/borrower for the ABA disclosure. If the consumer/borrower refuses to sign the receipt, the creditor/lender must note the refusal in the business records which must be maintained for this purpose for five years after the date of execution (24 CFR 3500.15(b) and (d)).

If an ABA referral is made telephonically, the substance of the ABA disclosure must be given during the conversation, together with an explanation that a separate written disclosure will follow within three business days of the conversation. A record of the telephone discussion and mailing of the ABA disclosure must be included in the records of the creditor/lender. Further, if a referral is made by a creditor/lender to an affiliated creditor/lender, the ABA disclosure is to be delivered to the borrower at the time of the referral or no later than three business days thereafter. The earliest point for delivery of the ABA disclosure is when the booklet entitled, "Shopping for Your Home Loan, HUD's Settlement Cost Booklet" is delivered. Again, the creditor/lender should retain a record of this as well as any other delivery of the ABA disclosure (24 CFR Section 3500.15(b) and (c)).

When a referral is made by an attorney or law firm to a client who is a consumer/borrower to a particular title insurance agent, the ABA disclosure must be provided no latter than at the time the attorney or law firm is engaged by the client. A creditor/lender may require the use of a particular provider of settlement services or a business incident thereto when the provider is an attorney, credit reporting agency, or a real estate appraiser chosen to represent the interests of the creditor/lender in the real estate transaction (24 CFR Section 3500.15(b)(1) and (2)).

Prohibition against Kickbacks and Unearned Fees

No person is to give and no person may accept any fee, kickback or other thing of value pursuant to any agreement or understanding, oral or otherwise, in connection with a settlement service involving a federally related mortgage loan transaction for the referral of such service to any other person (including an entity). A thing of value is defined broadly to include, among others: moneys; things; discounts; salaries; commissions; duplicate payments of a charge; stock; dividends; distributions of partnership profits; franchise royalties; credits representing moneys that may be paid at a future date; the opportunity to participate in a money-making program; payment of retained or increased earnings; increased equity in a parent or subsidiary; special bank deposits or accounts; special or unusual banking terms; services, sales, or rentals at special prices or rates including free rates, leases or rental payments based all or in part on the amount of business referred; providing trips or the payment of expenses of another person; or reductions in credit against existing obligations.

HUD indicates the term "payment" as used in the context of the prohibition against kickbacks and unearned fees is intended to be synonymous with the giving and receiving of any "thing of value" and does not require the transferring of money from one person or entity to another. The payment of fees or other compensation (including thing of value) must be reasonably related to the value of the goods and facilities provided and of the services rendered (24 CFR Section 3500.14 and .15).

Division of Labor Agreements

In February 1995, HUD responded by letter to an inquiry from the Independent Banker's Association of American (IBAA) regarding agreements dividing loan origination services and compensation between IBAA members and other service providers. HUD provided an opinion letter which allowed division of labor or service agreements between service providers in certain fact situations. Before this letter, HUD generally refused to recognize any cooperative mortgage brokerage agreements in loan transactions subject to RESPA. Mortgage loan brokers (MLBs/MLOs) may now share the performance of compensable services when originating RESPA loans.

A written agreement is necessary between mortgage brokers (MLBs/MLOs) describing the services each will perform. Each MLB/MLO must perform at least six identifiable functions (e.g., 5 plus the loan application for the broker representing the borrower). The division of compensation among cooperating brokers (MLBs/MLOs) must be reasonably related to the value of the services each performs. Likewise, agreements between brokers (MLBs/MLOs) and creditors/lenders to share origination functions must be based upon performance of compensable services for fees that are reasonably related to the value of the services provided. Such agreements will not work in transactions that are FHA insured.

Cooperating Brokers (MLBs/MLOs)

RESPA contemplates the parties to a loan transaction would include the creditor/lender, a mortgage broker, a borrower, and a security property. RESPA did not contemplate the use of two mortgage brokers (MLBs/MLOs) in the same loan transaction. Notwithstanding the foregoing, on February 14, 1995, HUD issued a letter to the IBAA in response to inquiries regarding cooperative brokering arrangements. The letter described when compensation paid to more than one mortgage broker in a loan transaction subject to RESPA would not be in violation of Section 8 (i.e., a "Division of Labor"). This letter provided a "safe harbor" to creditors/lenders and to mortgage brokers (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq.). In the IBAA letter, HUD identified the following services typically performed in the "origination" of a federally related mortgage loan:

(a) Taking information from the Borrower and filling out the loan application;
(b) Analyzing the prospective Borrower's income and debt and pre-qualifying the prospective Borrower to determine the maximum mortgage that the prospective Borrower can afford;

(c) Educating the prospective Borrower in the home buying and financing process, advising the Borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;

(d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;

(e) Initiating/ordering VOEs (verifications of employment) and VODs (verifications of deposit);

(f) Initiating/ordering requests for mortgage and other loan verifications;

(g) Initiating/ordering appraisals;

(h) Initiating/ordering inspections or engineering reports;

(i) Providing disclosures (truth in lending, good faith estimate, others) to the Borrower;

(j) Assisting the Borrower in understanding and clearing credit problems;

(k) Maintaining regular contact with the Borrower, Realtors, Lender, between application and closing to apprise them of the status of the application and gather any additional information as needed;

(l) Ordering legal documents;

(m) Determining whether the Security Property was located in a flood zone or ordering such service; and,

(n) Participating in the loan closing" (24 CFR Section 3500.14(b), (c), (d), (e), (f), and (g)).

HUD indicates it would generally be satisfied that no RESPA violation had occurred if it found that:

"The lender's agent or contractor (i.e., mortgage broker or cooperating broker) took the application information under item (a);

The mortgage broker or cooperating broker performed at least five additional items on the list above, i.e., (a) through (n); and,

The fees imposed by mortgage brokers are reasonably related to the value of the services performed."

When two mortgage brokers (MLBs/MLOS) act in a loan transaction subject to RESPA, the mortgage broker who solicited and/or initially undertook to represent the consumer/borrower to procure a creditor/lender to

extend credit and make a loan are the agents and fiduciaries of the consumer/borrower. The mortgage broker (MLB/MLO) may perform (among others) each of the services described in (a) through (n) above. The mortgage broker (MLB/MLO) may also delegate to a cooperating broker (as the subagent) the performance of some of the aforedescribed settlement services. When such delegation lawfully occurs, and the consumer/borrower acknowledges and consents to the appointment of the cooperating broker, the latter becomes the subagent and fiduciary of the consumer/borrower and may be for certain limited purposes the agent of the delegating mortgage broker (Business and Professions Code Sections 10176(d) and 10177(q); Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c)).

When one mortgage broker (MLB/MLO) performs the settlement services of taking the loan application plus five additional items, the other mortgage broker (MLB/MLO) must perform each of the remaining items on the list included in the IBAA letter. Accordingly, the settlement services to be performed by each mortgage broker must be memorialized in writing in a document executed by both mortgage brokers (MLBs/MLOs). HUD is particularly concerned the additional services of the second mortgage broker (MLB/MLO) are not limited to "counseling-type" activities that result in unauthorized "steering" of the consumer/borrower. To engage in meaningful counseling and to avoid "steering", the "counseling-type" services, i.e., (b), (c), (d), (j), and (k) on the list in the IBAA letter when performed by the mortgage broker (MLB/MLO) must meet the following standards:

- “The "counseling" gave the Borrowers the opportunity to consider products from at least three different approved lender(s);
- The broker performing the "counseling" is to receive the same compensation regardless of which approved lender(s)' product is ultimately selected; and,
- Any payment made for the ‘counseling-type’ services is reasonably related to the value of the services performed and not based on the amount of loan business referred.”

Bona Fide HUD Employee Exemptions

In 1997 HUD modified the limitations imposed on payment of referral fees or fee-splitting in RESPA loan transactions. The modifications apply to payments which are made by employers to bona fide employees, (recipients of W-2 tax forms). The employer/employee relationship must be neither a *sham* nor established on a temporary basis to *circumvent* the intent of the regulation. HUD has outlined the following general exemptions for payments made by employers to bona fide employees:

- Payments for generating business for the employer, or for providing services in the loan origination process;
- Payments to marketing employees and managerial employees (employees not providing services) for referrals to the employer or another provider within an ABA. (The latter must include an ABA notice); and,
- Payments to managerial employees based upon criteria relating to performance, as long as the payments are not on a per loan basis” (24 CFR Section 3500.14(f) and (g)).

Independent Contractor Limitations

Independent contractor relationships are not subject to the same exemptions. Accordingly, loan representatives who are independent contractors of a mortgage firm must be licensed and registered as MLBs/MLOs and are to perform compensable loan services to be compensated in RESPA loan transactions. The compensation paid to independent contractors must be reasonably related to the services they provide and should be evidenced by a division of labor agreement between the mortgage firm and its independent contractors (24 CFR Section 3500.14(b), (c), (d), (e), (f), and (g)).

Affiliated Business Disclosure Statement Format

To:
From:

Property:
Date:

This is to give you notice that [referring party] has a business relationship with [settlement services providers(s)]. [Describe the nature of the relationship between the referring party and the providers(s), including percentage of ownership interest, if applicable.] Because of this relationship, this referral may provide [referring party] a financial or other benefit.

[A.] Set forth below is the estimated charge or range of charges for the settlement services listed. You are NOT required to use the listed provider(s) as a condition for [settlement of your loan on] [or] [purchase, sale, or refinance of] the subject property. THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THESE SERVICES.

[provider and settlement service] [charge or range of charges]

____

____

[B.] Set forth below is the estimated charge or range of charges for the settlement services of an attorney, credit reporting agency, or real estate appraiser that we, as your lender, will require you to use, as a condition of your loan on this property, to represent our interests in the transaction.

[provider and settlement service][charge or range of charges]

____

____

ACKNOWLEDGMENT

I/we have read this disclosure form, and understand that [referring party] is referring me/us to purchase the above-described settlement service(s) and may receive a financial or other benefit as the result of this referral.

.......[signature]

Computerized Loan Origination (CLO)

Prior to June 7, 1996, mortgage brokers benefited from an exemption permitting them to charge fees for limited borrower services: pre-qualifying, counseling, and matching available loan products to consumer/borrower qualifications and needs. The CLO had to meet certain federal standards and was to be accompanied by the delivery of an advance notice describing the intended services and fees. If the required standards were met, the mortgage broker was able to charge a negotiated fee without direct regard to the relationship of the value of the services provided (except as otherwise limited by California law as an agent and fiduciary). HUD has withdrawn from CLOs the required notice and the qualified exemption for payment of compensation to mortgage brokers.

Accordingly, the use of limited service CLOs has disappeared from the origination of federally related mortgage loans. However, commencing a loan application through an electronic means has become commonplace and is included in the services of loan originators when making or arranging federally related mortgage loans. Face-to face or telephonic interviews typically follow an electronic loan application. Regardless of the goods or facilities provided or the services rendered, the compensation of mortgage brokers (MLBs/MLOs) (whether acting individually or in cooperation with another broker) must be reasonable related to the value of the foregoing. Further, as agents and fiduciaries under California law (unless specific authority exists to negotiate the commission), the general rule is that the commissions, fees, costs, and expenses must be reasonably earned and actually incurred (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq.; Business and Professions Code Sections 10176(a), (b), (c), (g), (i), and (l), 10177(g), (j), and (q); 10 CCR,

Chapter 6, Section 2843; Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c)).

RESPA Statute of Limitations
A borrower has three years from the date of occurrence to bring an action against a lender for failure to timely disclose transfer of loan servicing and other loan servicing issues. The limit is one year from the date of occurrence for a lender's unauthorized payment of referral fees (kickbacks) or the forced use of a title insurance company.

RESPA Enforcement Policy
It is the policy of the Secretary regarding RESPA enforcement matters to cooperate with Federal, State, or local agencies having supervisory powers over creditors/lenders, mortgage brokers (MLBs/MLOs), or other persons with responsibilities under RESPA. Federal agencies with supervisory powers over creditors/lenders may use their powers to require compliance with RESPA. In addition, failure to comply with RESPA may be grounds for administrative action by the Secretary under 2 CFR part 2424 concerning debarment, suspension, ineligibility of contractors and grantees, or under the authority of the HUD Mortgagee Review Board. The remedies described in this paragraph are cumulative and are not intended to limit any other form of enforcement that may be legally available (24 CFR Section 3500.19).

TRUTH IN LENDING ACT

Background
Congress enacted the Truth in Lending Act (TILA) based on findings that economic stability would be enhanced and competition among creditors/lenders would be strengthened by the informed use of credit resulting from the awareness by consumers/borrowers of the true cost of credit. Further, among the stated purposes of TILA were procedural and substantive protections for consumers/borrowers.

TILA became effective July 1, 1969. The principal purpose of TILA is to promote the informed use of consumer credit by increasing consumer understanding about the true costs of financing, including the effective interest rates imposed for extensions of credit. TILA authorizes the Federal Reserve Board (FRB) to prescribe regulations to carry out the purposes of the statute (15 USC Section 1604(a)). The FRB adopted Regulation Z to implement TILA. TILA requires extenders of credit to disclose the credit terms to enable consumers/borrowers to make meaningful comparisons between various creditors/lenders (12 CFR Section 226 et seq.).

A principal objective of TILA is to promote the informed use of consumer credit by requiring disclosures about material loan terms and the fees, costs, and expenses of the extensions of credit. TILA requires creditors/lenders to disclose the cost of credit as a dollar amount (the finance charge) and as an annual percentage rate (APR), i.e., the effective interest rate. TILA requires in certain loan transactions that consumers/borrowers receive the opportunity to cancel or rescind the contemplated loan to be secured by their principal dwelling (15 USC Section 1635 and 12 CFR Section 226.23).

After a decade of experience subsequent to the enactment of TILA and the adoption of Regulation Z, it became clear to practitioners this law placed too great a burden on creditors/lenders, provided too many disclosures for consumers/borrowers, and fostered too much litigation. This prompted Congress to amend TILA in 1980 by passing the Truth in Lending Simplification and Reform Act. To reflect these amendments to TILA, the FRB undertook the first of several substantive revisions to Regulation Z. Compliance with the TILA Simplification and Reform Act and the related revised Regulation Z became mandatory on October 1, 1982.

When the first revisions of TILA were promulgated, the FRB adopted model disclosure forms for closed-end transactions such as purchases and refinances of real property. The FRB also adopted model language for certain other TILA disclosures and notice of rights. The FRB also announced that its staff would no longer provide written responses to individual requests for interpretations of Regulation Z, but would issue from time to time Official Staff Commentaries to address questions of interpretation. When preparing the Official Staff Commentaries, the FRB receives input from the Federal Trade Commission (FTC) through the offering of suggestions and the making of recommendations to enhance consumer protection.

Since the enactment of the TILA Simplification and Reform Act, further amendments to TILA have been implemented that were primarily directed at loan transactions with fees, costs, and expenses that when calculated with the nominal interest rate results in APRs (the effective interest rates) exceeding certain prescribed limits. In addition, loan transactions with points and fees exceeding certain prescribed percentages of the loan amount are among the extensions of credit that have been identified as "high-cost". These amendments applied to transactions known in the industry as "high cost" mortgage loans, which occurred in 1995, 1996; 2001 and 2007; and with the latest amendments being subject to a mandatory compliance date of October 1, 2008 (later extended to July 30, 2009).

Among the most recent amendments is a defined additional category of mortgage loans known as "higher-cost/priced mortgage loans". The earlier amendments added new disclosure requirements and altered the definition of creditor in residential mortgage loan transactions subject to TILA. The latest amendments added prohibited acts and practices in connection with "higher-cost/priced mortgage loans" (15 USC Section 1602 and 12 CFR Sections 226.2, 226.31, 226.32, 226.35, and 226.36).

This Section reviews TILA, Regulation Z, and various amendments to each, including residential mortgage loan transactions subject to 12 CFR Sections 226.32 and 226.35 (commonly known as "Section 32" and "Section 35" loan transactions). Also discussed is the role of the real estate broker/mortgage broker (MLB/MLO) when making or arranging residential mortgage loans (as defined). Included is a brief review of loan transactions subject to "Section 32" and Section 35".

The Role of Mortgage Brokers

Real Estate Brokers acting as mortgage loan brokers (MLBs/MLOs) are able to negotiate loans for consumers/borrowers who are or expect to become property owners. These loans include conventional residential mortgage loans, residential loans insured or indemnified by HUD/FHA or VA, and alternative mortgage loans or non-traditional loan products often securitized through Wall Street. These residential mortgage loans have been delivered by MLBs/MLOs to financial depository institutions and to licensed lenders sometimes referred to in this Chapter as non-banks.

MLBs/MLOs also negotiate residential mortgage loans on behalf of consumers/borrowers delivered to private investors/lenders as previously discussed in this Chapter. Mortgage brokers (MLBs) may also negotiate mortgage loans secured by other than 1 to 4 residential units that are delivered to private investors/lenders or to financial depository institutions that are willing to accept commercial loan packages prepared by these brokers.

Creditors

As previously discussed in this Chapter, the terms "lender" and "creditor" are distinguishably defined in federal law. The term "lender" is the person or entity that regularly makes loans and whose name appears on the promissory note (evidence of indebtedness) as the initial payee or that meets a defined status (12 USC Section 2601 et seq.). The term "creditor" is the person or entity that, among other defined disclosure responsibilities and reporting obligations, extends credit to consumers/borrowers in transactions subject to TILA. Accordingly, the federal definition is two-pronged, i.e., "creditor" for the purpose of making disclosures and delivering notices of rights pursuant to TILA, and "lender" describing persons that regularly make loans and whose names appear on the promissory note (evidence of indebtedness) as the initial payee and on the security device/instrument (deed of trust or mortgage) as the beneficiary/lender/mortgagee (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq.; 15 USC Section 1602, and 12 CFR Sections 226.2, 226.31, 226.32, 226.35, and 226.36).

The creditor is responsible for furnishing TILA disclosures to the consumer/borrower. Regulation Z defines a creditor as a person (including an entity) that extends consumer credit more than 25 times or more than 5 times for transactions secured by a dwelling during the preceding calendar year. If the person (or entity) did not meet these numerical standards in the preceding calendar year, the same standards are to apply to the current calendar year. Further, the creditor's name must appear on the promissory note or evidence of indebtedness as the initial payee.

The credit extended must be subject to a finance charge or is to be payable by a written agreement requiring more than four installments. The definition of creditor has been expanded to include any person (or entity) originating two or more "Section 32" or reverse mortgages in any 12 month period, or any person (or entity)

originating one or more of these types of mortgages through a MLB/MLO (15 USC Section 1602, and 12 CFR Sections 226.2 and 226.32).

As a part of the TILA Simplification and Reform Act, the definition of "creditor" was revised to exclude the "arranger of credit". TILA as initially enacted defined the term "arranger of credit" as a person (or entity) that arranged for the extension of credit made by persons (including entities) whether such persons met the "creditor" definition. The objective was to ensure consumers/borrowers received disclosures and notices of rights required by TILA and the implementing Regulation Z, regardless of whether the lender making the loan met the definition of creditor.

Arrangers of credit (mortgage brokers (MLBs)) are for purposes of the SAFE Act (previously discussed in this Chapter) mortgage loan originators (MLOs). These brokers are identified as MLBs/MLOs throughout this Chapter in connection with residential mortgage loan transactions. MLBs/MLOs are *not* "creditors" for the purposes of TILA or Regulation Z (although they may be "creditors" for other purposes as defined in applicable federal law). Congress resolved this question in 1982 in the Federal Depository Institutions Act (the Garn-St. Germain Act), which included amendments to TILA that deleted "arranger of credit" from the definition of ''creditor."

To implement this change, the FRB revised Regulation Z by, among other amendments, removing the "arranger of credit" from the definition of "creditor". The effect of the FRB's action was to release real estate/mortgage brokers (MLBs/MLOs) or other "arrangers of credit" from the responsibility of providing TILA/Regulation Z disclosures and notices of rights. This release occurred approximately 30 years ago and is consistent with recent holdings in a cited federal district case that was subject to appeal (Vallies v. Sky Bank, 432 F. 3d 493 – 2006; Vallies v. Sky Bank, 583 F. Supp. 2d 687 – 2008; and Vallies v. Sky Bank, 591 F. 3d 152 – 2009).

While MLBs/MLOs as "arrangers of credit" are not obligated to complete and deliver disclosures and notices of rights, such brokers must remain informed about each of the requirements imposed upon "creditors" by TILA and Regulation Z. Mortgage brokers (MLBs/MLOs) as fiduciaries of consumers/borrowers who have applied for residential mortgage loans through such brokers (whether to be delivered to financial depository institutions, licensed lenders or private investors/lenders) are obligated to disclose and explain the material terms of the contemplated loan transaction (Business and Professions Code Sections 10131(d) and (e), 10176(a), (b), (c), and (d), 10177(q), and 10237 et seq.; Civil Code Sections 2295 et seq., 2349 et seq., and 2923.1; Corporations Code Sections 25100(e) and 25206; Corporations Commissioner's Regulations 10CCR, Chapter 3, Sections 260.115 and 260.204.1; and Financial Code Sections 4979.5, 4995(c) and (d) and 4995.3(c), among others).

In addition, MLBs/MLOs are required to complete and deliver the California required Mortgage Loan Disclosure Statement (MLDS) and in most fact situations will be completing and delivering the RESPA required Good Faith Estimate (GFE). To complete the MLDS and the GFE and to represent properly consumers/borrowers in residential loan transactions requires MLBs/MLOs to understand TILA and Regulation Z.

Exempt Transactions

Three basic types of credit transactions directly or indirectly involving real property are exempt from coverage under TILA and Regulation Z. The first exemption is for credit extended primarily for a business, commercial, or agricultural purpose (other than for a personal, family or household purpose, i.e., a consumer purpose). This exemption includes organizational credit as well as credit extended to governments, or to governmental agencies or instrumentalities.

Should the creditor/lender extend credit for the sole purpose of acquiring, improving, or maintaining a rental property (that neither is currently nor intended to become owner occupied, regardless of the number of family units); the transaction is presumably for a business purpose. If the consumer/borrower intends the use of the proceeds of the loan to be for both business and personal use, the primary use of the proceeds governs whether the loan is subject to TILA and to Regulation Z. For example, if 51 percent of more of the loan proceeds are used for business purposes, the loan is generally exempt from TILA and Regulation Z. An inquiry is necessary to identify the purpose of the loan and the use of the loan proceeds as represented in writing by the

consumer/borrower. Further, the creditor/lender should obtain sufficient supporting documentation to confirm the consumer/borrower's representations.

If the consumer/borrower declares the purpose for the extension of credit is to finance an acquisition of the security property, factors to consider when determining whether the loan is for a business or commercial purpose (as opposed to a consumer purpose) include:

- The relationship of the borrower's primary occupation to the acquisition (the more closely related, the more likely it is to be a business purpose);
- The degree to which the borrower will personally manage the acquisition (the more personal involvement the more likely it is a business purpose);
- The ratio of income from the acquisition to the total income of the borrower (the higher the ratio, the more likely it is to be a business purpose);
- The size of the transaction (the larger the transaction in loan amount and property value, the more likely it is to be a business purpose);
- The borrower's statement of purpose for the loan (it is preferable to have this statement in the handwriting of the borrower or directly from the borrower through electronic means); and,
- The use of loan funds in connection with the borrower's occupation (e.g., a substantial portion of the loan proceeds are applied to the working capital required by the self-employed borrower would suggest a business purpose).

While the factors above were included in the FRB Official Staff Commentaries for loans to finance the acquisition of the real property, they are useful as well to determine the purpose of the extension of credit when refinancing or further encumbering the intended security property. Further, special rules apply for credit to acquire, improve, or maintain rental property that is or will become owner occupied within a year from consummation of the loan transaction.

The Official Staff Commentaries suggest credit extensions to acquire rental property consisting of more than two housing units are presumably for business purposes. TILA as amended, Regulation Z, and the Official Staff Commentaries describe dwellings as consisting of 1 to 4 residential units and, therefore, credit extended to improve or maintain the rental property may not be for business purposes (unless the security real property contains more than four residential units). The foregoing distinction between acquisition as compared to improvement or maintenance of rented residential real property at loan consummation may be confusing and could lead to an inappropriate characterization for the extension of credit.

The amended TILA statute defines the term dwelling as "… a residential structure or mobile home [sic] which contains one to four family units, or individual units of condominiums or cooperatives". Accordingly, the amended statute establishes that 1 to 4 residential units would constitute a dwelling and, therefore, an apparent presumption of consumer purpose. This means TILA and Regulation Z required disclosures are to be completed and delivered to the consumer/borrower and the right of rescission for the credit extended in other than acquisition loan transactions is preserved.

The Official Staff Commentaries are not entirely clear about whether the transaction is for a business or commercial purpose. Therefore, the practitioner should review the factors described above and the specific facts of the loan transaction prior to identifying a business or commercial purpose, when the intended security property is from 1 to 4 residential units (15 USC Sections 1601(f),(h) and (v), and 1603, 12 CFR Sections 226.1 and 226.2 (a)17 and 19; and the FRB Official Staff Interpretations 3(a) and 4).

When the purpose of the extension of credit is to acquire, improve, or maintain the intended security property consisting of other than 1 to 4 residential units, a business or commercial purpose will generally apply to the loan transaction. These rules do not prevent an extension of credit secured by real property consisting of less than four residential units from being considered for a business or commercial purpose. However, if at any time during the calendar year a consumer/borrower occupies the intended security property for more than 14 days, regardless if it is rented for the remainder of the year, the security property will be considered owner

occupied and, therefore, a loan transaction in such event will not qualify for a business or commercial purpose exemption.

Even when a business or commercial purpose is determined to be operative for an extension of credit, the Official Staff Commentaries suggest that later rewriting or refinancing of the loan transaction may result in re-characterization as a consumer credit transaction. This occurs if the existing obligation is satisfied and replaced with a new extension of credit undertaken by the same consumer/borrower for consumer purposes. The possibility of a novation in the context of loan modifications, extensions or forbearances should be considered when establishing the purpose of the extension of credit (15 USC Section 1601(f),(h) and (v) and Section 1603; 12 CFR Sections 226.1 and 226.2 (a)17 and 19; and the FRB Official Staff Interpretations 3(a) 4 and 5).

The Official Staff Commentaries also apply the term organizational credit to establish an exemption from TILA and Regulation Z disclosures and notices of rights. The organizational credit exemption extends to "…transactions in which the person is not a natural person and [sic] applies, for example, to loans to corporations, partnerships, associations, churches, unions and fraternal organizations". This exemption also applies to governments, or governmental agencies or instrumentalities. Further, the exemption is operative regardless of the purpose of the extension of credit and irrespective of whether a natural person guarantees the debt/obligation or provides security in the transaction for the borrowing entity.

Notwithstanding the foregoing, consideration must be given to the amount of the security and the nature and use of the security property offered by the natural person. It should be noted that under existing California law, Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs) are to be treated depending upon the facts and the applicable law as corporations for certain defined purposes and as partnerships for certain defined purposes (FRB Official Staff Interpretations 7; and Corporations Code Section 17000 et seq.).

The second exemption is for extensions of credit over $25,000. The dollar limitation does not apply if the loan/extension of credit is secured by real property that is used or expected to be used as the consumer's principal dwelling.

The third exemption has an indirect impact on transactions involving real property. This exemption is for transactions in securities or commodities by broker-dealers registered with the Securities and Exchange Commission (SEC). The investment vehicle for the securities may be equities or fee interests in real property or interests in deeds of trust or mortgages secured by liens against real property. Accordingly, this exemption would apply to transactions involving interests in real property when the securities are issued through or sold by registered broker-dealers.

While real estate brokers performing as mortgage brokers are defacto broker-dealers when issuing/selling securities qualified by exemption or registration under California law, these brokers are not typically registered with the SEC or the DOC as broker-dealers. Accordingly, unregistered defacto broker-dealers would not benefit from this exemption (15 USC Section 1603 and 12 CFR Section 226.3; Business and Professions Code Section 10131.3, Corporation Code Section 25206, and 10 CCR, Chapter 3, Sections 260.115 and 260.204.1).

Finance Charges

The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable by the consumer/borrower or required by the creditor/lender, whether directly or indirectly as an incident to or a condition of the extension of credit. Such charges include the fees imposed by MLBs/MLOs and other third party service providers, unless expressly exempt in accordance with the requirements established by TILA and Regulation Z.

Finance charges that are prepaid (paid prior to or at settlement or loan closing, sometimes referred to as settlement charges) may be *included* or *excluded* from the calculation of the APR, i.e., the effective interest rate for the extension of credit (pursuant to the provisions of TILA and Regulation Z). The annual percentage rate (APR) is *a measure of the cost of credit expressed as a yearly rate, that relates the amount and timing of value received by the consumer/borrower to the amount and timing of payments made*. The APR is to be determined in accordance with either the actuarial method or the United States Rule method (12 CFR Section 226.22).

The finance charges to be included in the calculation of the APR are numerous and varied:

1. Among these charges are fees, costs, and expenses representing amounts imposed by third parties (charges imposed by someone other than the creditor/lender) if the creditor:

- Requires the use of a third party as a condition of or an incident to the extension of credit, even if the consumer/borrower can choose the third party; or,
- Retains a portion of the third-party charge to the extent of the portion retained.

2. Fees charged by closing or settlement agents (such as an attorney, escrow holder, title company, public escrow or another escrow agent authorized to conduct escrows by applicable state law) are included if the creditor:

- Requires the particular services for which the consumer/borrower is charged;
- Requires the imposition of the charge; or
- Retains a portion of the third-party charge, to the extent of the portion retained.

3. Regarding fees imposed by mortgage brokers (MLBs/MLOs), such fees are included within the finance charge whether paid by the consumer/borrower directly to the mortgage broker or to the creditor/lender for delivery to the broker. The fees of mortgage brokers (MLBs/MLOs) are finance charges included in the calculation of the APR, even if the creditor/lender does not require the consumer/borrower to use the services of such brokers and whether the creditor/lender retains any portion of the charge.

4. Further examples of finance charges *included* when calculating the APR are:

- Interest, time price differential (e.g., interest imposed in a seller carry-back), and any amount payable under an add-on or discount system of additional charges (other than simple interest);
- Service, transaction, activity, and carrying charges, including any fees imposed on a checking or other transaction account to the extent the amount exceeds the charge for a similar account without a credit feature;
- Points (typically defined to include origination fees, commissions, and loan discounts), any other loan fees, assumption fees, finder's fees, and similar charges;
- Appraisal, investigation, and credit report fees (unless otherwise specifically excluded in real estate related transactions);
- Premiums or other charges for any guarantee or insurance coverage protecting the creditor/lender against the consumer/borrower's default or other credit loss (e.g., mortgage insurance coverage), unless otherwise specifically excluded by Regulation Z;
- Charges imposed on a creditor/lender by another person for purchasing or accepting a consumer/borrower's debt/obligation, if the consumer/borrower is required to pay the charges in cash as an addition to the debt/obligation, or as a deduction from the proceeds of the debt/obligation;
- Premiums or other charges for credit life, accident, health, or loss-of-income insurance, written in connection with a credit transaction as authorized by applicable federal and state law and provided that each of the required disclosures are made and delivered to the consumer/borrower who has elected and freely selected the source of such coverage (unless otherwise specifically excluded by Regulation Z);
- Premiums or other charges for insurance against loss of or damage to or against liability arising out of the ownership or use of the security property written in connection with a credit transaction, unless otherwise specifically excluded by Regulation Z;
- Discounts for the purpose of inducing payment by a means other than the use of credit; and,
- Charges or premiums paid for debt cancellation agreements or insurance coverage (including debt payment suspension agreements) written in connection with a credit transaction, whether the coverage is determined insurance under applicable federal and state law (unless otherwise specifically excluded by Regulation Z) (15 USC Section 1605 and 12 CFR Section 226.4).

The prepaid finance charges that are excluded are generally (although not entirely) fees, costs, and expenses that would be imposed in a cash transaction in which no third party financing is required (15 USC Section 1605 and 12 CFR Section 226.4).

1. The prepaid finance charges to be *excluded* from the calculation of the APR are:

- Application fees charged to all applicants for credit, whether or not credit is actually extended (under California law such fees may not be charged by MLBs/MLOs without an advanced fee agreement previously approved by the Commissioner of the DRE);
- Charges for actual unanticipated late payments, for exceeding a credit limit, or for delinquencies, defaults or similar occurrences;
- Charges imposed by a financial depository or other financial institution authorized to maintain or issue accounts for paying items that overdraw accounts, unless the payment of such items and the imposition of the charges were previously agreed to in writing;
- Fees charged for participation in a credit plan, whether assessed on an annual or other periodic basis;
- Seller's points (percentage of loan amounts in the form of discounts paid to the creditor/lender by the seller to adjust investment yields); and,
- Interest forfeited because of an interest reduction on a time deposit used as security for an extension of credit (e.g., interest earned on a cash collateral account).

2. Notwithstanding the previous discussion in this Section regarding finance charges to be *included*, real estate related fees are *excluded* (as defined), if they are bona fide and reasonable in amount (i.e., reasonably earned and actually incurred or reasonably related to the value of the goods and facilities provided and to the services rendered):

- Fees for title examination, abstract of title, title insurance, property survey, and for similar purposes;
- Fees for preparing loan related documents such as deeds, deeds of trust, mortgages, reconveyances, or settlement documents (e.g., escrow instructions and loan closing or settlement statements);
- Fees for notary acknowledgments or credit reports;
- Property appraisal fees or fees for inspections to assess the value or condition of the security property, if the service is performed prior to settlement or loan closing (including fees related to pest infestation or flood hazard determination); and,
- Amounts required to be paid into escrow or impound accounts held in trust provided the amounts are not otherwise expressly included in the finance charge (examples of excluded amounts are advanced deposits for mortgage insurance premiums, property taxes, casualty and hazard insurance premiums, and other real property related matters such as dues and assessments imposed by homeowners associations, but excluding prepaid interest).

3. Discounts offered to induce payments for a purchase by cash, check or other means as described in TILA and Regulation Z (typically occurring in personal property transactions).

4. Voluntary insurance premiums for various forms of coverage if each of the following conditions are met:

- Premiums for life, accident, or health insurance are excluded from the finance charge if the coverage is *not required* by the creditor/lender and this fact is disclosed in writing, the premium for the initial term of the insurance coverage is specifically disclosed, and additional required disclosures for the insurance coverage and the premiums to be paid are also made and delivered to the consumer/borrower in accordance with TILA and Regulation Z (including that such coverage may only be obtained at the election of and pursuant to the choice of the consumer/borrower from persons [insurers or through agents/brokers] other than the creditor/lender or a subsidiary or an affiliate thereof);

- Premiums for insurance coverage for loss or damage or for liability arising from the ownership or use of the intended security real property (provided that required disclosures are made and delivered to the consumer/borrower, including that such coverage may be obtained from insurers and agents/brokers selected by the consumer/borrower whether from persons other than the creditor/lender or a subsidiary or an affiliate thereof); and,
- In connection with credit life, accident, health or loss-of-income insurance coverage obtained in compliance with applicable federal and state law, the consumer/borrower must sign or initial an affirmative written request for the coverage after receiving the previously mentioned disclosures required by TILA and Regulation Z.

5. Fees for voluntary cancelation agreements (as authorized under TILA and Regulation Z) or for insurance coverage that provides for cancelation of all of the consumer/borrower's liability or in part for amounts exceeding the value of the collateral securing the debt/obligation; or in the event of the loss of life, health, or income, or in the case of an accident when the foregoing agreements/coverage are not required by the creditor/lender and the following conditions are met:

- The debt cancellation agreement or coverage is not required by the creditor/lender and this fact is disclosed in writing to the consumer/borrower;
- The fee or premium for the initial term of coverage is disclosed in writing, and if the term of coverage is less than the term of the credit transaction, the limited term of coverage shall also be separately disclosed;
- The fee or premium may be disclosed on a unit-cost basis only in open-end credit transactions, and closed-end credit transactions are to be disclosed by mail or telephone under 12 CFR Section 226.17(g) as well as certain closed-end credit transactions involving a debt cancellation agreement that limits the total amount of indebtedness subject to the coverage;
- The following additional disclosures, as applicable, are made and delivered to the consumer/borrower in the event the coverage is for debt suspension, i.e., the obligation to pay loan principal and interest is only suspended for the identified period and that interest will continue to accrue during such period of suspension; and,
- The consumer/borrower signs or initials an affirmative written request for coverage after receiving the specified disclosures.

6. If itemized and disclosed, as required under Regulation Z, the following charges to protect the security interests of the creditor/lender may be excluded from the finance charge:

- Taxes and fees prescribed by law that actually are or will be paid to public officials for determining the existence of or for perfecting, releasing, or satisfying a security interest;
- The premiums for insurance in lieu of perfecting a security interest to the extent the premiums do not exceed the fees described above that otherwise would be payable to public officials; and,
- Taxes levied on security instruments or on documents evidencing indebtedness if the payment of such taxes is a requirement for recording the device/instrument securing the evidence of indebtedness.

7. If interest, dividends, or other income is received or to be received by the consumer/borrower on deposits or investments, the amounts thereof shall *not* be deducted in computing the finance charge (15 USC Section 1605 and 12 CFR Section 226.4).

Timing of Required Disclosures

Distinguishable disclosures are required pursuant to TILA and Regulation Z depending upon whether the loan transaction is for "open-end credit" or "closed-end credit". Open-end credit to be extended in connection with an owner occupied dwelling is a Home Equity Plan or a Home Equity Line Of Credit (HELOC). Whether in the form of a conventional loan, a HUD/FHA insured or VA indemnified loan, or an alternative mortgage loan (referred to as a nontraditional loan product); such mortgage loans secured by 1 to 4 residential units are examples of closed-end credit.

The creditor/lender must make disclosures before consummation of the loan transaction. In certain mortgage loan transactions, special timing requirements are included in 12 CFR Section 226.19(a). Consummation is defined as the time that a consumer/borrower becomes contractually liable on a credit obligation as determined by state law. Special timing requirements for variable-rate disclosures (other than fixed interest rate loans) are included in 12 CFR Sections 226.19(b) and 226.20(c). Certain variable-rate disclosures must be provided at an earlier point in time than loan consummation. In addition, early disclosures made pursuant to 12 CFR Sections 226.17(b) and (f) are required and may be subject to the provisions of Sections 226.19(a)(2) and 226.19(a)(5)(iii).

In 2008, Congress enacted the Mortgage Disclosure Improvement Act (MDIA) as an amendment to TILA. The MDIA amends the disclosure requirements pursuant to Regulation Z for closed-end mortgage transactions secured by a consumer/borrower's dwelling when the loan transaction is subject to the RESPA (15 USC Section 1601 et seq. and 12 USC Section 2601 et seq.). The MDIA is contained in Sections 2501 through 2503 of the Housing and Economic Recovery Act of 2008 (HERA), Public Law 110-289, enacted on October 3, 2008. The Emergency Economic Stabilization Act of 2008, Public Law 110-343, also enacted on October 3, 2008, amended the MDIA.

Among the amendments to TILA and Regulation Z included in MDIA were the early disclosure requirements codified in 15 USC Section 1638 (b)(2) and in 12 CFR 226.17. The effective date for the provisions of MDIA was July 30, 2009. On July 30, 2008, the FRB published a final rule amending Regulation Z (July 2008 Final Rule (73 FR 44522)). This rule requires, among other objectives, that creditors/lenders provide early TILA disclosures, even when the loan is not to finance the purchase or initial construction of the consumer/borrower's principal dwelling.

Subsequent to the adoption of this rule change, disclosures of material loan terms including the APR (as required under TILA and Regulation Z) must be completed and delivered to the consumer/borrower concurrently with the RESPA required GFE as implemented by Regulation X. Accordingly, early disclosures must be given in purchase, initial construction, refinance or loan transactions further encumbering the intended security property that is or expected to become the consumer/borrower’s principal dwelling (15 USC Section 1638, 12 CFR Sections 226.5(b), 226.17 , 226.18, 226.19, 226.20, and 226.22; 12 USC 2601 et seq. and 24 CFR Section 3500.7).

The specific regulatory changes adopted by the FRB to implement the MDIA *early disclosure* requirements became effective on July 30, 2009 included:

1. The requirement that early disclosures be given for all “dwelling-secured” residential mortgage loans rather than only for “residential mortgage transactions" to finance the purchase or initial construction of the dwelling (12 CFR Section 226.17(f) and 226.19(a)(1)(i) and associated Official Staff Commentaries); and,

2. That early disclosures be given before consumers pay any fee other than a fee for obtaining the consumer/borrower's credit history (12 CFR Section 226.19(a)(1)(ii) and (iii) and associated Official Staff Commentaries).

The July 2008 Final Rule also requires TILA and RESPA GFE *disclosures to be completed and delivered to the consumer/borrower before the payment of fees to any party, including Mortgage Brokers (MLBs/MLOs) or Appraisal Management Companies.* If the required disclosures are delivered through the U.S. Mail to the consumer/borrower, the required disclosures are considered to have been received *three (3) business days after mailing.* As noted above, a bona fide and reasonable credit report fee may be collected in advance of the delivery of the required disclosures.

The definition of a business day for early disclosures is a day on which the creditor/lender's offices are open to the public for carrying on substantially all of its business functions. This is an important distinction as the definition of a business day alters for subsequent disclosures including corrected disclosures, for rescission waiting periods, and for certain home mortgage transactions pursuant to Regulation Z (12 CFR Sections 226.2,

226.15, 226.17, 226.19(a)(1)(ii), 226.19(a)(2), 226.23 and 226.31). The same standards apply to mortgage brokers (MLBs/MLOs) directed by creditors/lenders to deliver the early disclosures to consumers/borrowers.

However, it is important to note *many creditors/lenders no longer require MLBs/MLOs to complete and deliver the TILA and RESPA early disclosures. TILA and Regulation Z disclosures are the obligation of creditors/lenders and not of mortgage brokers (MLBs/MLOs) who are "arrangers of credit" excluded from the definition of "creditor"*. The liability for the contents and the timing of these disclosures rests primarily with creditors/lenders.

MDIA also imposes additional requirements not contained in the July 2008 Final Rule. Included is the requirement that *creditors/lenders must deliver or mail the early disclosures at least seven (7) business days before consummation of the loan transaction.* Should a material loan term that was disclosed in the early disclosures become inaccurate, *creditors/lenders are to re-disclose by providing corrected disclosures the consumer/borrower must receive at least three (3) business days before consummation of the loan transaction.*

An example of a material change in loan terms contained in an early disclosure is the APR. As previously discussed, the APR is the calculated effective interest rate typically altered by a change in loan terms. The required disclosures are to inform consumers/borrowers they are not obligated to complete the loan transaction simply because disclosures were completed and delivered or otherwise provided, or because an application has been submitted for a residential mortgage loan.

The term business day for the seven (7) day disclosure and for the three (3) day corrected disclosure means all calendar days except Sundays and the legal public holidays specified in applicable federal law, i.e., New Year's Day, the Birthday of Martin Luther King, Jr., Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans Day, Thanksgiving Day, and Christmas Day (5 USC Section 6103(a)).

The MDIA imposes different requirements for early disclosures in closed-end mortgage transactions secured by a consumer/borrowers interest in a timeshare plan. The MDIA also contains additional disclosure requirements for variable-rate transactions (other than non-fixed interest rate residential mortgages) that will not become effective until January 30, 2011, unless the FRB establishes an earlier compliance date.

If the consumer/borrower determines the extension of credit is needed to meet a bona fide personal financial emergency, the consumer may modify or waive the seven (7) business day or three (3) business day waiting periods required by Regulation Z after receiving the required disclosures. The consumer/borrower must deliver to the creditor/lender a dated written statement bearing the signature of each consumer/borrower who is liable under the legal obligation in the loan transaction describing the emergency and specifically modifying or waiving the waiting period. Printed forms for this purpose are prohibited (12 CFR Sections 226.17(a)(2) and 226.18).

General Disclosure Requirements

TILA and Regulation Z require disclosures concerning the credit sale or residential mortgage loans to be grouped together and segregated from other information. Regulation Z prohibits the inclusion of any information not directly related to the required disclosures. It also provides that any itemization of the amount financed be made separately from the other required disclosures and, in recent amendments, consumers/borrowers are to receive the GFE concurrently with the TILA required disclosures for purposes of the itemization of the fees, costs, and expenses and related material loan terms (the early disclosures previously discussed). In addition, Regulation Z currently requires the terms "finance charge" and APR be more conspicuous than other required disclosures (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq. and 15 USC Section 1601 et seq. and 12 CFR Section 226.17).

As previously mentioned, the FRB has published model TILA/Regulation Z disclosure forms and notices of rights for over 25 years. The most recent model forms included within Regulation Z (as promulgated by the FRB) may be found at the Government Printing Office (GPO) website using the following link:

http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=7e4061234f6f19d7d81f66741aecd35f&rgn=div9&view=text&node=12:3.0.1.1.7.7.8.10.24&idno=12

The FRB published recent amendments to some of the model forms on June 26, 2010. The amendments were made to the model forms promulgated in connection with Regulation Z (12 CFR 226 et seq.). The link to the most recent published amendments is http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=7e37b455429ed4bacfed9ee128d12794;rgn=div2;view=text;node=20100629%3A1.22;idno=12;cc=ecfr;start=1;size=25

The following is the list of the model forms for open-end and closed-end credit transactions that are operative as of this writing:

Appendix G to Part 226—Open-End Model Forms and Clauses

1. G–1 Balance Computation Methods Model Clauses (Home-equity Plans) (Sections 226.6 & 226.7);
2. G–1(A) Balance Computation Methods Model Clauses (Plans other than Home-equity Plans) (Sections 226.6 & 226.7);
3. G–2 Liability for Unauthorized Use Model Clause (Home-equity Plans) (Section 226.12);
4. G–2(A) Liability for Unauthorized Use Model Clause (Plans Other Than Home-equity Plans) (Section 226.12);
5. G–3 Long-Form Billing-Error Rights Model Form (Home-equity Plans) (Sections 226.6 & 226.9);
6. G–3(A) Long-Form Billing-Error Rights Model Form (Plans Other Than Home-equity Plans) (Sections 226.6 & 226.9);
7. G–4 Alternative Billing-Error Rights Model Form (Home-equity Plans) (Section 226.9);
8. G–4(A) Alternative Billing-Error Rights Model Form (Plans Other Than Home-equity Plans) (Section 226.9);
9. G–5 Rescission Model Form (When Opening an Account) (Section 226.15);
10. G–6 Rescission Model Form (For Each Transaction) (Section 226.15);
11. G–7 Rescission Model Form (When Increasing the Credit Limit) (Section 226.15);
12. G–8 Rescission Model Form (When Adding a Security Interest) (Section 226.15);
13. G–9 Rescission Model Form (When Increasing the Security) (Section 226.15);
14. G–10(A) Applications and Solicitations Model Form (Credit Cards) (Section 226.5a(b));
15. G–10(B) Applications and Solicitations Sample (Credit Cards) (Section 226.5a(b));
16. G–10(C) Applications and Solicitations Sample (Credit Cards) (Section 226.5a(b));
17. G–10(D) Applications and Solicitations Model Form (Charge Cards) (Section 226.5a(b));
18. G–10(E) Applications and Solicitations Sample (Charge Cards) (Section 226.5a(b));
19. G–11 Applications and Solicitations Made Available to General Public Model Clauses (Section 226.5a(e));
20. G–12 Reserved;
21. G–13(A) Change in Insurance Provider Model Form (Combined Notice) (Section 226.9(f));
22. G–13(B) Change in Insurance Provider Model Form (Section 226.9(f)(2));
23. G–14A Home-equity Sample;
24. G–14B Home-equity Sample;
25. G–15 Home-equity Model Clauses;
26. G–16(A) Debt Suspension Model Clause (Section 226.4(d)(3));
27. G–16(B) Debt Suspension Sample (Section 226.4(d)(3));
28. G–17(A) Account-opening Model Form (Section 226.6(b)(2));
29. G–17(B) Account-opening Sample (Section 226.6(b)(2));
30. G–17(C) Account-opening Sample (Section 226.6(b)(2));
31. G–17(D) Account-opening Sample (Section 226.6(b)(2));
32. G–18(A) Transactions; Interest Charges; Fees Sample (Section 226.7(b));
33. G–18(B) Late Payment Fee Sample (Section 226.7(b));
34. G–18(C)(1) Minimum Payment Warning (When Amortization Occurs and the 36-Month Disclosures Are Required); (Section 226.7(b));
35. G–18(C)(2) Minimum Payment Warning (When Amortization Occurs and the 36-Month Disclosures Are Not Required) (Section 226.7(b));
36. G–18(C)(3) Minimum Payment Warning (When Negative or No Amortization Occurs) (Section 226.7(b));

37. G–18(D) Periodic Statement New Balance, Due Date, Late Payment and Minimum Payment Sample (Credit cards); (Section 226.7(b));
38. G–18(E) [Reserved];
39. G–18(F) Periodic Statement Form;
40. G–18(G) Periodic Statement Form;
41. G–18(H) Deferred Interest Periodic Statement Clause;
42. G–19 Checks Accessing a Credit Card Account Sample (Section 226.9(b)(3));
43. G–20 Change-in-Terms Sample (Increase in Annual Percentage Rate) (Section 226.9(c)(2));
44. G–21 Change-in-Terms Sample (Increase in Fees) (Section 226.9(c)(2));
45. G–22 Penalty Rate Increase Sample (Payment 60 or Fewer Days Late) (Section 226.9(g)(3));
46. G–23 Penalty Rate Increase Sample (Payment More Than 60 Days Late) (Section 226.9(g)(3));
47. G–24 Deferred Interest Offer Clauses (Section 226.16(h));
48. G–25(A) Consent Form for Over-the-Limit Transactions (Section 226.56); and,
49. G–25(B) Revocation Notice for Periodic Statement Regarding Over-the-Limit Transactions (Section 226.56).

Appendix H to Part 226— Closed-End Model Forms and Clauses

1. H–1 Credit Sale Model Form (Section 226.18);
2. H–2 Loan Model Form (Section 226.18);
3. H–3 Amount Financed Itemization Model Form (Section 226.18(c));
4. H–4(A) Variable-Rate Model Clauses (Section 226.18(f)(1));
5. H–4(B) Variable-Rate Model Clauses (Section 226.18(f)(2));
6. H–4(C) Variable-Rate Model Clauses (Section 226.19(b));
7. H–4(D) Variable-Rate Model Clauses (Section 226.20(c));
8. H–5 Demand Feature Model Clauses (Section 226.18(i));
9. H–6 Assumption Policy Model Clause (Section 226.18(q));
10. H–7 Required Deposit Model Clause (Section 226.18(r));
11. H–8 Rescission Model Form (General) (Section 226.23);
12. H–9 Rescission Model Form (Refinancing (with Original Creditor)) (Section 226.23);
13. H–10 Credit Sale Sample;
14. H–11 Installment Loan Sample;
15. H–12 Refinancing Sample;
16. H–13 Mortgage with Demand Feature Sample;
17. H–14 Variable-Rate Mortgage Sample (Section 226.19(b));
18. H–15 Graduated-Payment Mortgage Sample;
19. H–16 Mortgage Sample;
20. H–17(A) Debt Suspension Model Clause; and,
21. H–17(B) Debt Suspension Sample.

During 2009, the FRB published a series of proposed model TILA/Regulation Z disclosure forms (including samples with the required disclosures included within the forms) for open-end and closed-end credit transactions. The proposed model disclosure forms with samples have been the subject of press releases and staff commentaries. A requirement applicable to the historic model forms is that they appear on a single page.

An essential predicate to the proposed model forms is the amendment to Regulation Z allowing such disclosures to be continued from one page to another, although the disclosures must remain separated from other transactional documents. These proposed model forms and samples of required disclosures represent a substantial departure from the historic model disclosure forms and notices of rights. Their long advance publication and ongoing amendments to Regulation Z resulted in some industry confusion concerning the appropriate use of model forms. Apparently, the proposed model forms and samples will not formally replace the historic forms for approximately 6 to 8 months following the writing of this Chapter. The reader should undertake to determine which model forms are appropriate for use prior to proceeding with residential mortgage loan transactions subject to TILA and Regulation Z.

The proposed TILA/Regulation Z amended model disclosure forms with sample illustrations or required disclosures may be found at http://www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm. The model forms and related sample forms are as follows:

Regulation Z—Open-end Mortgages (HELOCs):

1. G-14(A) Early Disclosure Model Form (Home-equity Plans);
2. G-14(B) Early Disclosure Model Form (Home-equity Plans);
3. G-14(C) Early Disclosure Sample (Home-equity Plans);
4. G-14(D) Early Disclosure Sample (Home-equity Plans);
5. G-14(E) Early Disclosure Sample (Home-equity Plans);
6. G-15(A) Account-Opening Disclosure Model Form (Home-equity Plans);
7. G-15(B) Account-Opening Disclosure Sample (Home-equity Plans);
8. G-15(C) Account-Opening Disclosure Sample (Home-equity Plans);
9. G-15(D) Account-Opening Disclosure Sample (Home-equity Plans);
10. G-24(A) Periodic Statement Transactions; Interest Charges; Fees Sample (Home-equity Plans);
11. G-24(B) Periodic Statement Sample (Home-equity Plans);
12. G-24(C) Periodic Statement Sample (Home-equity Plans);
13. G-25 Change-in-Terms Sample (Home-equity Plans); and,
14. G-26 Rate Increase Sample (Home-equity Plans).

Regulation Z--Closed-end Mortgages:

1. H–4(B) Adjustable-Rate Loan Program Model Form;
2. H–4(D) Adjustable-Rate Loan Program Sample (Hybrid ARM);
3. H–4(E) Adjustable-Rate Loan Program Sample (Interest Only ARM);
4. H–4(F) Adjustable-Rate Loan Program Sample (Payment Option ARM);
5. H-4(G) Adjustable-Rate Adjustment Notice Model Form;
6. H–4(I) Adjustable-Rate Adjustment Notice Sample (Interest Only ARM);
7. H–4(J) Adjustable-Rate Adjustment Notice Sample (Hybrid ARM);
8. H–4(K) Adjustable-Rate Annual Notice Model Form;
9. H–4(L) Negative Amortization Monthly Disclosure Model Form;
10. H-19(A) Fixed Rate Mortgage Model Form;
11. H-19(B) Adjustable-Rate Mortgage Model Form;
12. H-19(C) Mortgage with Negative Amortization Model Form;

13. H-19(D) Fixed Rate Mortgage with Balloon Payment Sample;
14. H-19(E) Fixed Rate Mortgage with Interest Only Sample;
15. H-19(F) Step-Payment Mortgage Sample;
16. H-19(G) Hybrid Adjustable-Rate Mortgage Sample;
17. H-19(H) Adjustable-Rate Mortgage with Interest Only Sample; and,
18. H-19(I) Adjustable-Rate Mortgage with Payment Option Sample.

Use of Model Forms and the Most Important Items Disclosed

The model forms including samples are structured to provide disclosures for distinguishable loan transactions. The contemplated loan transactions may include fixed interest rate mortgages, variable or adjustable rate mortgages, graduated payment mortgages, hybrid mortgages, and loan assumptions, among other mortgage loan options. Creditors/lenders may duplicate the model forms for use in residential mortgage loan transactions. Any changes made to the model forms must be consistent with applicable federal law by including the appropriate disclosures required for the contemplated extension of credit.

Creditors/lenders must make those disclosures that are relevant to the particular loan transaction contemplated. Regulation Z requires the use of descriptive phrases for the most important items disclosed. Verbatim use of these phrases is not necessary (12 CFR Sections 226.17, 226.18, 226.19, and 226.20, among others).

In the model forms operative at the time of this writing (e.g., the H-2), the most important items to be disclosed include the APR, the finance charge, the amount financed, and the total of payments. Regulation Z defines the term "finance charge," as the total dollar amount the extension of credit will cost, including the prepaid finance charge (the settlement charges) plus the interest for the term of the loan (if each payment is made as scheduled). The prepaid finance charge included when calculating the APR consists of those charges that add to the cost of obtaining the loan (12 CFR Section 226.4).

The amount financed describes the arithmetic residual of the amount borrowed (the original loan amount) and the prepaid finance charge includable (the settlement charges). The total of payments is the summation of all required payments, assuming each payment is made as scheduled (12 CFR Sections 226.2, 226.4, and 226.18).

Regarding the proposed model forms and the related samples (e.g., the H-19(A)), the important items disclosed include the loan summary (a summary of the loan amount, term, type, features and settlement charges); the APR and a comparison to the average available APR on similar conforming loans offered to consumers/borrowers (applicants) with excellent credit; a representation of the range of APRs within the "high cost zone"; the nominal interest rate, and the monthly/periodic scheduled principal and interest payments; and the estimated periodic payments for the escrow/impound account. In addition, the important disclosures include whether an escrow/impound account is required; the total of payments including the total amount imposed for interest during the term of the loan; and the amount of the settlement charges (formerly described as the prepaid finance charge includable) (12 CFR Sections 226.17, 226.18, 226.19, 226.20, and 226.22).

The proposed TILA disclosure model forms include a new category of disclosures, i.e., key questions about risk. The questions include whether the interest rate may increase, whether the required monthly/periodic payments will increase, and whether a prepayment penalty is due in the event of an early termination of the residential mortgage loan. The proposed forms include the amended Regulation Z disclosures informing the consumer/borrower no obligation exists to accept the loan as the result of the receipt of the disclosures.

Further, a disclosure is required informing the consumer/borrower the inability to make the scheduled payments on the loan could result in the loss of the home through foreclosure. The consumer/borrower is also to receive a disclosure there is no guarantee a refinance loan will be available with a lower interest rate and monthly payments to pay off the existing loan; and if the loan obtained exceeds the value of the security property, the extra amount may not be deductible for federal income tax purposes (12 CFR Sections 226.17, 226.18, 226.19, 226.20, and 226.22).

Basis of Disclosures and Use of Estimates
The disclosures shall reflect the terms of the legal obligation of the mortgage loan transaction between the creditor/lender and the consumer/borrower. If any information necessary for an accurate disclosure is unknown to the creditor/lender, the disclosure is to reflect the best information reasonably available when the disclosure is provided to the consumer/borrower. The disclosures are to clearly state they are estimates, as applicable.

For a transaction in which a portion of the interest is determined on a per-diem basis and collected at loan consummation, the per-diem interest disclosed will be considered accurate (if the disclosure relies on information known to the creditor/lender when the disclosure documents are prepared for consummation of the loan transaction) (12 CFR Sections 226.17, 226.18, 226.20, and 226.22).

The creditor/lender may disregard the effects of the following in making calculations and completing disclosures:

1. Payments must be collected in whole cents;
2. Dates of scheduled payments and advances are subject to change because the scheduled date is not a business day, as defined;
3. Months have different numbers of days;
4. The occurrence of a leap year alters the number of days in the month of February; and,
5. When making calculations and completing disclosures, the creditor/lender may disregard any irregularity in the first period that falls within the limits described and any payment schedule irregularity that results from the irregular first period as follows:

    - For transactions in which the term is less than 1 year, a first period not more than 6 days shorter or 13 days longer than a regular period;
    - For transactions in which the term is at least 1 year and less than 10 years, a first period not more than 11 days shorter or 21 days longer than a regular period; and,
    - For transactions in which the term is at least 10 years, a first period shorter than or not more than 32 days longer than a regular period (12 CFR Section 226.17).

If an obligation is payable on demand, the creditor/lender shall make the disclosures based on an assumed maturity of one (1) year. If an alternate maturity date is identified in the legal obligation between the creditor/lender and the consumer/borrower, the disclosures are to be based on that date. A series of advances under an agreement to extend credit up to a certain amount may be considered as a single loan transaction. When a multiple-advance loan to finance the initial construction of the intended dwelling of the consumer/borrower is joined with permanent financing extended by the same creditor/lender, the construction phase and the permanent phase of the financing may be treated either as a single transaction or as more than one loan transaction (12 CFR Section 226.17).

Multiple Creditors/lenders; Multiple Consumers/Borrowers
If a transaction involves more than one creditor/lender, only one set of disclosures need be delivered to the consumer/borrower, and the creditors/lenders are to agree among themselves which creditor/lender must comply with the requirements of Regulation Z. Should there be more than one consumer/borrower; the disclosures may be made to a consumer/borrower primarily liable for the debt/obligation. If the transaction is rescindable under 12 CFR Section 226.23, the disclosures are to be delivered to each consumer/borrower who has the right to rescind (12 CFR Section226.17).

Effect of Subsequent Events and Required Subsequent Disclosures
Should a disclosure become inaccurate due to an event that occurs after the creditor/lender delivers the required disclosures and no violation of the tolerance limits has occurred, the inaccuracy is not in violation of Regulation Z. However, new or subsequent disclosures are required (12 CFR Sections 226.17(f), 226.18, 226.19, and 226.20). If the APR disclosed in a transaction secured by a real property dwelling varies from the actual rate determined in accordance with the actuarial method or the United States Rule method by more than the tolerances described below, re-disclosure is required (12 CFR Section 226.22(a)(1), (2), (3), (4), and (5)).

When subsequent events make early disclosures inaccurate, the creditor/lender must re-disclose three (3) days before loan consummation (12 CFR Sections 226.17(e), (f)(i) and (ii), 226.19(a)(2) and 226.19(a)(5)(iii)). The re-disclosures are to include:

1. Any changed term, unless the term was based on and labeled as an estimate in accordance with 12 CFR Section 226.17(c)(2), and the change does not exceed the acceptable tolerances pursuant to applicable federal law; and,
2. All changed terms, if the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than 1/8 of 1 percentage point in a regular transaction, or more than 1/4 of 1 percentage point in an irregular transaction (as defined), and the change is not in violation of the acceptable tolerances pursuant to applicable federal law (12 CFR Sections 226.17(e), (f)(i) and (ii), and 226.22(a)).

After loan consummation, three additional events require the creditor/lender to make subsequent disclosures, i.e., a refinancing, an assumption, and adjustments in variable-rate feature loans:

<u>A Refinancing.</u> A "refinancing" is a separate transaction requiring new disclosures to the consumer/borrower. Refinancing occurs when an existing obligation is satisfied and replaced for the same consumer/borrower. Regulation Z provides examples of what does not constitute a refinancing, including among others: (l) a renewal of a single payment obligation with no change in the original terms; (2) a reduction in the APR with a corresponding change in the payment schedule; and (3) a change in the payment schedule or a change in collateral requirements as a result of the consumer/borrower's default or delinquency. As previously mentioned, consolidation of an exiting loan by the same creditor/lender with no new money advanced would not constitute a refinancing.

<u>Assumption.</u> An "assumption" is a new transaction requiring new disclosures to the consumer/borrower, and that an assumption occurs when a new person becomes obligated as a subsequent maker on an existing debt/obligation. Whenever a creditor/lender agrees in writing to accept a new consumer/borrower as a subsequent maker on an existing residential mortgage loan transaction (an assumption of the existing debt/obligation), the creditor/lender must make new disclosures based on the remaining debt/obligation. The mere addition of a guarantor to an existing debt/obligation for which the consumer/borrower remains primarily liable does not constitute an "assumption" (12 CFR Sections 226.17(e), 226.18, 226.19 and 226.20).

<u>Variable-rate adjustments.</u> New disclosures are required when an adjustment is made to the interest rate (with or without an accompanying change in the payment rate) in a variable-rate loan transaction (other than a fixed-interest rate loan) secured by the consumer/borrower's principal dwelling and with a loan term of greater than one year. The creditor/lender must provide the following information in a disclosure at least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25 but not more than 120 calendar days before a periodic payment is due at a new level:

1. The current and prior interest rates;
2. The index values on which the current and prior interest rates are based;
3. The extent to which the creditor/lender has foregone any interest rate increase;
4. The contractual effects of the adjustments, including the new payment amount and the loan balance; and,
5. The payment (if different from the payment previously disclosed) that would be required to fully amortize the loan at the new interest rate over the remaining loan term (12 CFR Section 226.19).

Content of Disclosures

<u>Information and Manner of Disclosure</u>. Consumer/borrowers are to receive the following information and in the manner described as part of the TILA and Regulation Z disclosures:

1. The identity/name of the creditor/lender and the loan originator (MLO) unique identifier;

2. The disclosures are to be in writing, clearly and conspicuously set forth, and in a form that the consumer/borrower may keep;

3. The disclosures may be provided in electronic form, subject to compliance with the "consumer consent" and other applicable provisions of the Electronic Signatures in Global and National Commerce Act, the E-Sign Act (15 USC Section 7001 et seq.);

4. The disclosures required by 12 CFR Sections 226.17(g), 226.19(b), and 226.24 may be provided to the consumer/borrower in electronic form without regard to the "consumer's consent" or other provisions of the E-Sign Act *when the disclosures are made in compliance with the foregoing sections of Regulation Z*;
5. The disclosures are to be grouped together, segregated from everything else, and may not contain any information except that which is directly related thereto as required by Regulation Z (12 CFR Sections 226.17, 226.18, 226.19, 226.20, and 226.24, among others);

6. The disclosures may include an acknowledgment of receipt, the date of the transaction; and the name, address, and account number of the consumer/borrower (12 CFR Sections 226.17 and 226.18); and,

7. The identity of the following payees may be included in the disclosures using generic or other general terms:

   - Public officials or government agencies;
   - Credit reporting agencies;
   - Appraisers; and,
   - Insurance Companies.

<u>The Most Important Disclosures Required in Historic Model Forms</u>. The following represents the four (4) most important required disclosures in the model forms historically promulgated by the FRB pursuant to Regulation Z (12 CFR Section 226.18(a), (b), (d), and (e):

1. The term finance charge is to be more conspicuous than any other disclosure except for the APR and the name and identity of the creditor/lender and the MLO unique identifier, and a brief description of this term is to be included such as "the dollar amount the credit will cost you" (whether payable directly or indirectly by the consumer/borrower and whether imposed directly or indirectly by the creditor/lender as an incident to the extension of credit);

2. The APR (annual percentage rate) is to be more conspicuously disclosed than any other disclosure except for the term finance charge and the name and identity of the creditor/lender and the MLO unique identifier, and a brief description of this term is to be included such as "the cost of your credit as a yearly rate";

3. The term total of payments (calculated by the sum of the payments disclosed in the payment schedule, i.e., the monthly/periodic payments of principal and interest) as well as a brief description such as "the amount you will have paid when you have timely made all scheduled payments;" and,

4. A brief description of the amount financed as the amount of credit provided to or on behalf of the consumer/borrower calculated by:

   - Determining the principal loan amount or the cash price (subtracting any down payment);
   - Adding any other amounts that are financed by the creditor/lender that are not part of the finance charge; and,
   - Subtracting any prepaid finance charge.

<u>The Itemization of the Amount Financed</u>. A written itemization of the amount financed to which the consumer/borrower is entitled and separated from other required disclosures may be accomplished as part of the *early disclosures* through the use of a good faith estimate of settlement charges (GFE) pursuant to RESPA

and to recent amendments of Regulation Z (12 USC Section 2601 et seq. and 24 CFR Section 3500 et seq. and 15 USC 1601 et seq. and 12 CFR Section 226 et seq., specifically Section 226.18(c)(1) and (2)). The itemization is to include disclosures of the:

- Amount of any proceeds distributed directly to the consumer/borrower;
- Amount credited to the consumer/borrower's account with the creditor/lender; and,
- Any amounts paid to other persons by the creditor/lender on the consumer/borrower's behalf with such persons identified in the disclosures.

Variable-Rate Transactions. Should the residential mortgage loan transaction be subject to a *variable interest rate* (other than a fixed interest rate) and the APR is scheduled to increase within a term of one year or less after loan consummation in a transaction secured by the consumer/borrower’s principal dwelling, the following disclosures must be included (12 CFR Sections 226.18(f)(1) and (2) and 226.19(b):

- The circumstances under which the rate may increase;
- Any limitations on the increase;
- The effect of an increase; and,
- An example of the payment terms that would result from an increase.

Should the APR increase within a term greater than one year after loan consummation in a transaction secured by the consumer/borrower’s principal dwelling, the following disclosures must be included:

- The fact that the transaction contains a variable-rate feature; and,
- A statement that variable-rate disclosures have been previously provided.

Should the consumer/borrower’s principal dwelling be the intended security property for a loan with a term of greater than one year and a variable-rate feature is included providing for an increase in the APR after loan consummation (whether scheduled to occur prior to or subsequent to one year thereafter), the following disclosures must be provided at the time of loan application or before the consumer/borrower pays a non-refundable fee, whichever is earlier:

1. The booklet entitled *Consumer Handbook on Adjustable Rate Mortgages* published by the FRB, or a suitable substitute; and,

2. A loan program disclosure consistent with the applicable model forms for each variable-rate program in which the consumer/borrower expresses an interest including the following (12 CFR Section 226.19(b)(1) and (2)):

- The fact that the interest rate, payment, or term of the loan can change;
- The index or formula used in making adjustments, and the source information about the index or formula;
- An explanation of how the interest rate and payment will be determined, including an explanation of how the index is adjusted, such as by the addition of a margin;
- A statement that the consumer/borrower should ask about the current margin value and current interest rate;
- The fact that the interest rate will be discounted, and a statement that the consumer/borrower should ask about the amount of the interest rate discount;
- The frequency of interest rate and payment changes;
- Any rules relating to changes in the index, interest rate, payment amount, and outstanding loan balance including, for example, an explanation of interest rate or payment limitations, negative amortization, and interest rate carryover; and,
- At the option of the creditor/lender, either of the following:

1. A historical example, based on a $10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program disclosure. The example is to reflect the most recent 15 years of index value and all significant loan program terms, such as negative amortization, interest rate carryover, interest rate discounts, and interest rate and payment limitations to be or that would have been affected by the index movement during the period; or,

2. The maximum interest rate and payment for a $10,000 loan originated at the initial interest rate (index value plus margin, adjusted by the amount of any discount or premium) in effect as of an identified month and year for the loan program disclosure, assuming the maximum periodic increases in rates and payments under the program; and the initial interest rate and payment for that loan and a statement that the periodic payment may increase or decrease substantially depending on changes in the rate.

- An explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on either:

  A. The most recent payment shown in the historical example as described above in item 1; or
  B. The initial interest rate used to calculate the maximum interest rate and payment as described above in item 2.

- The fact that the loan program contains a demand feature;
- The type of information that will be provided in notices of adjustments and the timing of such notices; and,
- A statement that disclosure forms are available for other variable-rate loan programs offered by the creditor/lender.

<u>Schedule of Payments</u>. The creditor/lender must disclose the number, amounts, and timing of payments scheduled to repay the debt/obligation. Regulation Z provides for an abbreviated disclosure of the payment schedule for transactions in which a series of payments vary solely because of the application of a finance charge to the unpaid principal balance. This situation arises most frequently in graduated payment mortgages or in mortgages where mortgage insurance premiums are determined by the unpaid principal balance (12 CFR Section 226.18(g)).

In a demand obligation with no alternative maturity date, the creditor/lender is to disclose the due dates or payment periods of any schedule interest payments for the first year. In a transaction in which a series of payments varies because a finance charge is applied to the unpaid principal balance, the creditor/lender is to disclose the following information:

1. The dollar amount of the largest and smallest payments in the series; and,

2. The reference to the variations in other payments in the series.

As previously mentioned, the total of payments is the amount the consumer/borrower will have paid when all scheduled payments are timely made. However, in a transaction involving a single payment, the creditor/lender need not disclose the total of payments (12 CFR Section 226.18(g) and (h)).

<u>Demand Feature</u>. Regulation Z requires that if the obligation has a demand feature, this fact must be disclosed. This disclosure is required only for a demand feature contemplated as part of the legal obligation for the mortgage loan transaction between the creditor/lender and the consumer/borrower. Transactions that convert to a demand status due to the consumer/borrower's default are not within the purview of this requirement, as is neither a due-on-sale nor a due on further encumbrance clause (12 CFR Sections 226.17(c)(5) and 226.18(i)).

<u>Total Sale Price.</u> In a credit sale (a sale in which the seller is a creditor) Regulation Z requires the use of the term "total sale price" together with a brief description such as "the total price of your purchase on credit, including your down payment of $___." (12 CFR Section 226.18(b)(2), (d) and (j)).

Prepayment Penalties and Rebates. Creditors/lenders are required to make a disclosure of the existence of a penalty on prepayments of the amount owing prior to the maturity date. Even if a creditor/lender does not charge a prepayment penalty, a statement to that effect must be included. However, this disclosure is only required if the finance charge is computed from time to time by application of a rate to the unpaid principal balance. In any other type of transaction, a statement must be included indicating whether the consumer/borrower is entitled to a rebate of any portion of the finance charge in the event of prepayment. It is no longer necessary to disclose a particular method of rebate, such as the rule of 78s (12 CFR Section 226.17(k)).

Late Payment Charge. A disclosure is required only for those charges imposed before maturity due to a late payment. The disclosure may reflect the fact that late charges may be determined as either a percentage or a specified dollar amount (12 CFR Section 226.18(l)).

Security Interest. Regulation Z requires the creditor/lender to disclose what security interest is or will be retained in the property purchased in the transaction or other security property. In transactions in which the credit is being extended to purchase the collateral, the creditor/lender is required to give only a general identification such as "the property purchased in this transaction." The security interest in after-acquired property need not be disclosed (12 CFR Section 226.18(m)).

Insurance. If charges for credit life, accident, health, or loss-of-income insurance are excluded from the finance charge, there must be a disclosure of the premium and that the insurance is not required to obtain credit, and the consumer must sign or initial a request for the insurance. If the charges for property insurance are excluded from the finance charge there must be a disclosure setting forth the cost of the insurance if obtained from the creditor/lender and stating that the insurance may be obtained from a person of the consumer/borrower's choice. The disclosure may be made on the disclosure form, or, at the creditor/lender's option, on a document different from the disclosure form (12 CFR Sections 226.4(d) and 226.18(n)).

Certain Security Charges. If disclosed, taxes and fees paid to a public official with respect to a security interest may be excluded from the finance charge. The charges may be aggregated, or may be broken down by individual charge. No special form is required for this disclosure, which could be labeled "filing fees and taxes". This disclosure may be made on the disclosure form, or, at the creditor/lender's option, on a document different from the disclosure form (12 CFR Section 226.4(a) and (e) and Section 226.18(o)).

Reference to Contract Terms. Regulation Z requires that creditors/lenders include in their disclosures a statement that refers consumers/borrowers to appropriate contract documents for information about non-payment, default, the right to accelerate the maturity of the obligation, and prepayment rebates or penalties. At the creditor/lender's option, the statement can also include a reference to the contract for more information about security interests and the creditor/lender's assumption policy (12 CFR Section 226.18(p) and (q)).

Assumption Policy. In a residential mortgage loan transaction, the creditor/lender must state whether a subsequent purchaser of the dwelling who acquired the property from the consumer/borrower may be permitted (if qualified) to assume the remaining debt/obligation on its original terms (12 CFR Section 226.18(q).

Required Deposit. An example of a required deposit is a savings account created as a condition of a loan. If a creditor/lender requires the consumer/borrower to maintain the deposit as a condition of the extension of credit, the creditor/lender must state the annual percentage rate (APR) does not reflect the effect of the required deposit including any interest that may accrue therefrom (12 CFR Section 226.18(r)).

Consumer/Borrower's Right to Rescind

Notice of Right to Rescind. Creditors/lenders must provide each consumer/borrower entitled to rescind with two (2) copies of the notice of the right to rescind (one copy to each if the notice is in electronic form in accordance with the "consumer consent" and other applicable provisions of the E-Sign Act). The rescission notice is to be given to any consumer/borrower with an "ownership interest" in the principal dwelling, i.e., the security property for the loan transaction (even when the consumer/borrower is not personally liable under the terms of the promissory note and the deed of trust or mortgage). In the case of a mortgage loan being made to a family trust, the beneficiaries of the trust own the interest in the security property. Therefore, if the beneficiaries occupy the property as their principal dwelling, they are entitled to receive the notice of the right to rescind.

The notice is to be on a separate document that identifies the transaction that clearly and conspicuously discloses the following:

- The retention or acquisition of a security interest in the consumer/borrower's principal dwelling;
- The consumer/borrower's right to rescind the transaction;
- How the consumer/borrower may exercise the right to rescind with a form for that purpose designating the address of the creditor/lender's place of business;
- The effects of rescission, as described in Regulation Z; and,
- The date the rescission period expires.

To satisfy the notice and disclosure requirements in connection with the right to rescind, the creditor/lender is to provide the appropriate model form or a notice and disclosure with substantially similar language. The FRB has published a model rescission form previously listed and identified on page ___ of this Section that meets these requirements. When more than one consumer/borrower in a transaction has the right to rescind, the exercise of the right by any one consumer/borrower is also effective as to the remaining consumers/borrowers (12 CFR Section 226.23).

Rescission Period. The consumer/borrower has the right to rescind until midnight of the third business day (as defined) subsequent to the last to occur of the following events:

1. Consummation of the loan transaction;
2. Delivery of all material TILA disclosures; or
3. Delivery of the notice of right to rescind (12 CFR Section 226.23(a)).

For this purpose, a business day is any calendar day, except Sundays and federal legal holidays (5 USC 6103(a)).

Waiver of right to rescind. Regulation Z provides that the consumer/borrower may waive the right to rescind, if the consumer/borrower determines that the extension of credit is needed to meet a bona fide personal financial emergency. In such event, the consumer/borrower must give the creditor/lender a dated and written statement (executed by the consumer/borrower) that describes the emergency and specifically waives the right to rescind (preferably in the handwriting of the consumer/borrower). Unless specifically authorized by applicable law, Regulation Z prohibits the use of preprinted waiver forms (12 CFR Section 226.23(e)).

The need of the consumer/borrower to obtain funds immediately is considered a bona fide personal financial emergency if the dwelling securing the extension of credit is located in a declared major disaster area by the federal government. In such event, creditors/lenders may use printed forms for the consumer/borrower to waive the right to rescind. This exemption regarding the procedures required to waive the right to rescind generally expires one (1) year from the date an area was declared a major disaster (42 USC Section 5170 and 12 CFR Section 226.23(e)(1)).

Transactions Subject to the Right to Rescind. Generally, the right of rescission applies to all consumer/borrower credit transactions where the debt/obligation is secured by a lien against the consumer/borrower's principal dwelling. A consumer/borrower can have only one "principal dwelling" at a time. Since the definition of a dwelling is not limited to real property, loan transactions involving mobile homes can be rescindable, even if they are treated as personal property under state law (12 CFR Section 226.23, and a parallel provision exists in 12 CFR Section 226.15 for liens against principal dwellings securing open-end credit).

Exempt Transactions- A residential mortgage loan transaction in which the loan proceeds fund the acquisition or initial construction of the intended security property that is to become the principal dwelling of the consumer/borrower is not subject to the right to rescind. This exemption applies regardless of the priority of the lien established through recording the security devise/instrument (a deed of trust or mortgage). Accordingly,

neither a senior or junior deed of trust or mortgage securing a loan from the acquisition or initial construction of the intended security property would be subject to a right of rescission (12 CFR Section 226.23(a) and (f)).

Another exemption is for a refinancing by the same creditor/lender of a loan secured by the consumer/borrower's principal dwelling, provided no new money is advanced (a refinance consolidation of an extension of credit already secured by the principal dwelling). If new money is advanced, the transaction is rescindable to the extent of the new money if the loan is secured by the consumer/borrower's principal dwelling. This exemption is most likely to arise in connection with renewals, extensions, or refinancing of balloon notes (12 CFR Section 226.23(f)).

Further, the right to rescind does not apply to a loan transaction in which a state agency is a creditor/lender. A loan advance, other than an initial advance, in a series of single-payment debts/obligations treated as a single transaction under 12 CFR Section 226.17(c)(6) is not subject to the right to rescind. However, the notice of the right to rescind and all material disclosures must be given to the consumer/borrower in connection with the initial advance (12 CFR Section 226.23(b) and (f)).

While an addition (an increase in the principal balance) to an existing debt/obligation of a security interest in a consumer/borrower's principal dwelling is a transaction, the right of rescission applies only to the addition of the security interest and not to the existing debt/obligation. Renewal of optional insurance coverage is not a refinancing and, therefore, is not subject to the right to rescind (12 CFR Sections 226.20(a)(5) and 226.23(f)).

By restricting the right of rescission to transactions in which the secured property is currently used as the consumer/borrower's principal dwelling, Regulation Z has exempted from the rescission requirements loans secured by property that is expected to be used as other than a principal dwelling, such as vacant lots, vacation homes, and retirement homes (12 CFR Section 226.23(a) and (f)).

<u>The Rescission Period.</u> Delivery of the required notice and disclosure begins the rescission period. To exercise the right to rescind, the consumer/borrower is to notify the creditor/lender of the rescission by mail, or other means of written communication. Notice is considered given if mailed, when filed for telegraphic transmission or, if sent by other means, when delivered to the creditor/borrower's designated place of business. Regulation Z was amended to allow the creditor/lender to deliver the notice and disclosure in an electronic form in accordance with the "consumer consent" and other applicable provisions of the E-Sign Act. Accordingly, the consumer/borrower should be able to respond to the notice and disclosure in the same manner it was delivered (i.e., electronically) when seeking to timely rescind the contemplated loan transaction (12 CFR Section 226.23(a) and (b)).

The consumer/borrower may exercise the right to rescind until midnight of the third business day (as defined) following loan consummation, delivery of the notice of right to rescind, or delivery of required material disclosures, whichever occurs last. If the required notice or material disclosures are not delivered, the right to rescind will expire three (3) years after loan consummation, upon transfer of all of the consumer/borrower's interest in the property, or upon sale of the property, whichever occurs first (12 CFR Section 226.23(a), (b), and (c)).

The term "material disclosures" means the required disclosures of the annual percentage rate (APR), the finance charge, the amount financed, the total of payments, the schedule of payments, and the applicable disclosures and limitations referred to in connection with "high-cost" and "higher-cost/priced" mortgages (12 CFR Sections 226.32 (c) and (d) and 226.35(b)(2)).

<u>Delay of Creditor/Lender's Performance</u>. Unless a consumer/borrower properly waives the right of rescission due to a personal emergency, no money is to be disbursed (other than a deposit in an escrow), no services are to be performed, and no materials are to be delivered to the intended security property until the rescission period has expired and the creditor/lender is reasonably satisfied that the consumer/borrower has not rescinded (12 CFR Section 226.23(c)).

<u>Effects of Rescission</u>. When a consumer/borrower rescinds a transaction, the security interest subject to the right of rescission becomes void and the consumer/borrower is not liable for any amount, including any finance charge regarding the contemplated loan transaction. Within 20 calendar days after receipt of a notice of

rescission, the creditor/lender is to return any money or property transferred to anyone in connection with the transaction.

In addition, the creditor/lender is to take any action necessary to reflect the termination of the security interest. If the creditor/lender has delivered any money or property, the consumer/borrower may retain possession until the creditor/lender has met its previously described obligations. When the creditor/lender has complied with applicable law, the consumer/borrower is to tender the money or property to the creditor/lender or, where the latter would be impracticable or inequitable, tender its reasonable value. At the consumer/borrower's option, tender of property may be made at the location of the property or at the consumer/borrower's residence. Tender of money must be made at the creditor/lender's designated place of business.

If the creditor/lender does not take possession of the money or property within 20 calendar days after the consumer/borrower's lawful tender, the consumer/borrower may keep it without further obligation. A court of competent jurisdiction may modify the procedures and remedies outlined and discussed to accomplish properly the rescission of a contemplated loan transaction (12 CFR Section 226.23(c)).

Tolerances for Accuracy. The tolerances for accuracy are subject to specific standards in the context of the consumer/borrower’s right to rescind. The finance charge and other disclosures affected by the finance charge (such as the amount financed and the APR) are considered accurate for purposes of the right to rescind if the disclosed finance charge:

- is understated by no more than 1/2 of 1 percent of the face amount of the note or $100, whichever is greater; or
- is greater than the amount required to be disclosed.

When refinancing a residential mortgage loan transaction with a new creditor/lender that does not include a new advance or a consolidation of existing loans (other than a transaction covered by 12 CFR Section 226.32, i.e., a “high-cost” mortgage), the finance charge and other disclosures affected by the finance charge (such as the amount financed and the APR) are considered accurate for purposes of the right to rescind, if the disclosed finance charge:

- is understated by no more than 1 percent of the face amount of the note or $100, whichever is greater; or
- is greater than the amount required to be disclosed (12 CFR Section 226.23(g)).

Special Rules for Foreclosures. After the initiation of foreclosure on the consumer/borrower's principal dwelling that secures the debt/obligation, the consumer/borrower shall have the right to rescind the transaction if:

- A mortgage broker fee that should have been included in the finance charge was not included; or
- The creditor/lender did not provide the properly completed appropriate model form promulgated by the FRB, or a substantially similar notice of rescission(12 CFR Section 226.23(h)(1)).

Further, after the initiation of foreclosure on the consumer/borrower's principal dwelling that secures the debt/obligation, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the APR) shall be considered accurate for purposes of the right to rescind, if the disclosed finance charge:

- is understated by no more than $35; or
- is greater than the amount required to be disclosed (12 CFR Section 226.23(h)(2)).

Advertising Consumer Credit

General Requirements. Anyone placing an advertisement regardless of media (including through a website or other electronic means) for consumer credit must comply with the advertising requirements of TILA and

Regulation Z. An "advertisement" is any commercial message in a medium that promotes, directly or in directly, a consumer credit transaction. Thus, real estate brokers (including mortgage brokers) and homebuilders, among others; who place ads must comply with TILA and Regulation Z, even if they are not creditors/lenders in the financing being advertised (12 CFR Section 226.24(a)).

Disclosures in advertisements for credit extensions must be made clearly and conspicuously. This standard requires that disclosures be made in a reasonably understandable form, but does not prescribe the specific type or font size or the placement of disclosures in the ad (12 CFR Section 226.24(b) and (f)(2)).

An advertisement of a creditor/lender may state specific credit terms only if the person (or entity) identified is actually prepared to offer those terms. If the advertisement is placed by other than the creditor/lender, the person (or entity) identified in the ad (a real estate broker including a mortgage broker or a homebuilder) must have available evidence of a creditor/lender's willingness to offer the terms described and of the identity of the creditor/lender from whom the loan will be obtained. Loan terms offered for only a limited period or that will become available at a future date may be advertised, if the foregoing conditions are clearly set forth in the ad copy (12 CFR Section 226.24(i)).

Advertising the Rate of Finance Charge. If an advertisement states a rate of finance charge, the rate must be stated as an "annual percentage rate" using that term. The advertisement is to state if the annual percentage rate may be increased after loan consummation. If an advertisement is for credit secured by a dwelling, the advertisement may not state any other rate than the annual percentage rate, except that a simple annual rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate (12 CFR Section 226.24(c)).

Advertisement of Terms that Require Additional Disclosures. If any one the following terms (referred to as triggering terms) is set forth in an advertisement, additional disclosures are required:

- The amount or percentage of any down payment;
- The number of payments or period of repayment;
- The amount of any payment; and,
- The amount of any finance charge.

When the advertisement includes any one of the foregoing triggering terms, the following disclosures, as applicable, must be included within the copy of the ad:

- The amount or percentage of the down payment;
- The terms of repayment which reflect the repayment obligations over the full term of the loan, including any balloon payment; and,
- The annual percentage rate, using that term, and, if the rate may be increased after consummation, a disclosure of that fact (12 CFR Section 226.24(d)).

Disclosure of Rates and Payments in Advertisements for Credit Secured by a Dwelling. Specific requirements apply to any advertisement for credit secured by a dwelling, other than television or radio advertisements, including promotional materials accompanying applications. If an advertisement for credit secured by a dwelling states a simple annual rate of interest and more than one simple annual rate of interest will apply over the term of the advertised loan, the advertisement is to disclose in a clear and conspicuous manner the following:

- Each simple annual rate of interest that will apply; and in variable-rate transactions, a rate determined by adding an index and margin is to be disclosed based on a reasonably current index and margin;

- The period of time during which each simple annual rate of interest will apply; and,
- If such rate is variable, the annual percentage rate shall comply with the accuracy standards in 12 CFR Sections 226.17(c) and 226.22 (12 CFR Section 226.24(f)).

The foregoing disclosures are to be made clearly and conspicuously. This means the disclosures of the required information as described above must be presented in the ad with equal prominence and in close proximity to any advertised rate that triggered the required disclosures. The APR may be disclosed with greater prominence than the other information (12 CFR Section 226.24(f)).

Disclosure of Payments. In addition to the requirements regarding the disclosure of the APR and the finance charge, if an advertisement for credit secured by a dwelling includes the amount of any payment, the ad is to disclose the following in a clear and conspicuous manner:

- The period of time during which each payment will apply;
- The amount of each payment that will apply over the payment of the loan, including any balloon payment; and,
- In an advertisement for credit secured by a first lien on a dwelling, the fact that the payments do not include amounts for taxes and insurance premiums, if applicable, and that the actual payment obligation will be greater (12 CFR Section 226.24(f)(3)).

Envelope Excluded. The disclosure requirements included in advertisements disclosing rates and payments do not apply to an envelope in which an application or solicitation is mailed, or to a banner advertisement or pop-up advertisement linked to an application or solicitation provided electronically (12 CFR Section 226.24(f)(4)).

Alternative Disclosures -Television or Radio Advertisements. An advertisement made through television or radio including any of the terms requiring additional disclosures as previously discussed above may comply by either by:

- Stating clearly and conspicuously each of the additional disclosures required under 12 CFR Section 226.24(d)(2); or,
- Stating clearly and conspicuously the disclosures required under 12 CFR Section 226.24(d)(2) and listing a toll-free telephone number, or any telephone number that allows a consumer/borrower to reverse the phone charges when calling for information, along with a reference that such number may be used by consumers/borrowers to obtain additional information about the cost of a loan (12 CFR Section 226.24(f)(4).

Tax Implications. If an advertisement distributed in paper form or through the Internet (rather than by radio or television) is for a loan secured by the consumer/borrower's principal dwelling (and the advertisement states that the advertised extension of credit may exceed the fair market value of the dwelling), the advertisement copy is to clearly and conspicuously include:

- The interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for Federal income tax purposes; and,
- The consumer/borrower should consult a tax adviser for further information regarding the deductibility of interest and charges (12 CFR Section 226.24(h)).

Prohibited Acts or Practices in Advertisements for Credit Secured by a Dwelling. The following acts or practices are misleading or constitute a misrepresentation and, therefore, are prohibited in advertisements for credit secured by a dwelling:

1. Advertising of “fixed" rates and payments. Using the word “fixed" to refer to rates, payments, or to the credit transaction in an advertisement for variable-rate transactions or other transactions where the payment will increase, unless (depending upon the fact situation):

    - The phrase “Adjustable-Rate Mortgage,” “Variable-Rate Mortgage,” or “ARM” appears in the advertisement with equal prominence as any use of the term “fixed”, “fixed-rate mortgage”, or similar terms; and further, appears before the first use of the word “fixed” and is at least as conspicuous as any use of the word “fixed” in the advertisement; and,

    - Each use of the word “fixed” referring to a rate, payment, or to the credit transaction is accompanied by an equally prominent and closely proximate statement of the time period for which the rate or payment is fixed, the fact that the rate may vary or the payment may increase after that period, and a reference to the transactions for which the rates are fixed and to which transactions that the variable-rate applies, among other disclosures (12 CFR Section 226.24(i)(1)).

2. Misleading comparisons in advertisements. Making any comparison in an advertisement between actual or hypothetical credit payments or rates and any payment or simple annual rate that will be available under the advertised product for a period less than the full term of the loan, unless:

- The advertisement includes a clear and conspicuous comparison to the information required to be disclosed under Sections 226.24(f)(2) and (3); and,

- If the advertisement is for a variable-rate transaction, and the advertised payment or simple annual rate is based on the index and margin that will be used to make subsequent rate or payment adjustments over the term of the loan, the advertisement includes an equally prominent statement in close proximity to the payment or rate that the payment or rate is subject to adjustment and the time period when the first adjustment will occur (12 CFR Section 226.24(i)(2)).

3. Misrepresentations about government endorsement. Making any statement in an advertisement that the product offered is a “government loan program”, “government-supported loan”, or is otherwise endorsed or sponsored by any federal, state, or local government entity, unless the advertisement is for an FHA loan, VA loan, or similar loan program that is, in fact, endorsed or sponsored by a federal, state, or local government entity (12 CFR Section 226.24(i)(3)).

4. Misleading use of the current creditor/lender's name. Using the name of the consumer/borrower's current creditor/lender in an advertisement that is not sent by or on behalf of the consumer/borrower's current lender, unless the advertisement:

- Discloses with equal prominence the name of the person or creditor/lender making the advertisement; and,

- Includes a clear and conspicuous statement that the person making the advertisement is not associated with, or acting on behalf of, the consumer/borrower's current creditor/lender (12 CFR Section 226.24(i)(4)).

5. Misleading claims of debt elimination. Making any misleading claim in an advertisement that the mortgage product offered will eliminate debt or result in a waiver or forgiveness of a consumer/borrower's existing loan terms with, or obligations to, another creditor/lender (12 CFR Section 226.24(i)(5)).

6. Misleading use of the term “counselor”. Using the term “counselor” in an advertisement to refer to a for-profit mortgage broker or mortgage creditor, its employees, or persons working for the broker or creditor/lender that are involved in offering, originating, or selling mortgages (12 CFR Section 226.24 (i)(6)).

7. Misleading foreign-language advertisements. Providing information about some trigger terms or required disclosures, such as an initial rate or payment, only in a foreign language in an advertisement, but providing

information about other trigger terms or required disclosures, such as information about the fully-indexed rate or fully amortizing payment, only in English in the same advertisement (12 CFR Section 226.24 (i)(7)).

Examples of Advertising Requirements for Other than Fixed Interest Rate Mortgages. If the APR offered may be increased after consummation of the transaction, the advertisement must state that fact. An advertisement for a variable rate mortgage with an initial APR of 6% that may vary after settlement without any limit could be advertised as “6% APR, subject to increase after settlement.” However, a review of the most recent amendments to Regulation Z and to the Official Staff Commentaries must be undertaken before proceeding with such an advertisement. The regulatory trend may well impose a “worst case example” when making such disclosures.

The foregoing disclosure may be used subject to the caution noted for any type of mortgage instrument with a variable interest rate. It may not be used in advertisements of graduated payment mortgages that have a fixed interest rate and payments that may increase on a pre-set basis during the term of the loan. Fixed-rate “buydowns” and “step-rate” mortgages are also *not* variable rate mortgages. These mortgages involve different interest rates in effect during the life of the loan, all of which are known at settlement or loan closing. A variable rate transaction involves future interest rates unknown at settlement.

The Official Staff Commentary to Regulation Z, includes special rules for advertising rates other than simple annual or periodic rates, i.e., for “buydowns” and “payments” or “effective” rates. A seller or creditor/lender may advertise a reduced simple interest rate resulting from a “buydown” so long as the advertisement shows the limited term to which the reduced rate applies, the simple interest rate that applies to the balance of the term, as well as the APR that is determined in accordance with the Commentaries to 12 CFR Section 226.17(c) of Regulation Z. Where more than one reduced rate applies, the advertisement must show each rate and the respective term for which each rate is effective. The advertisement may also show the effect of the “buydown” on the payment schedule without triggering additional disclosures under 12 CFR Section 226.24(c) of Regulation Z.

Adjustable rate mortgages (ARMs) often have a first-year “discount” or “teaser” feature in which the initial rate is substantially reduced. In these loans, the first year’s rate is not computed in the same way as the rate for later years. Often the “spread” or “margin” that is normally added to an “index” (such as the one-year Treasury-note rate) to determine changes in the interest rate in the future is not included in the first year of a discounted ARM offered by a creditor/lender. Special rules, similar to those for “buydowns”, apply to advertising a discounted variable rate.

An advertisement for this type of plan can show the simple interest rate during the discount period, as long as it also shows the APR. However, in contrast to “buydowns”, it may not be necessary to show in the ad the simple interest rate applicable after the discount period. Again, a review of the most recent amendments to Regulation Z and to the Official Staff Commentaries is required before concluding how the previous disclosures are to be made. Assuming, the disclosure may proceed as suggested, an example would include a plan with a lower first year’s interest rate (6%), but with a 8.25% rate in subsequent years and with additional credit costs. This plan could be advertised as follows: “6% first-year financing. APR 8.41%; APR subject to increase after settlement or loan closing.”

As in “buydowns”, the APR in discounted plans is a composite figure that must take into account the interest rates that are known at closing. In the above example, the disclosed APR must reflect the 6% rate for the first year, as well as, for example, the 8.25% rate applicable for the remainder of the term, plus any additional credit costs (such as the consumer/borrower’s points). An ad for a discounted variable-rate loan, like an ad for a “buydown”, may show the effect of the discount on the payment schedule during the discount period *without* triggering other disclosures (subject to revisions to Regulation Z and the Official Staff Commentaries). An example of a disclosure that complies with Regulation Z is: “Interest rate of 6% first year. APR 8.50% subject to increase. With this discount, your monthly payments for the first year will be $____.”

In some transactions, particularly some graduated payment loans, the consumer/borrower’s payments for the first few years of the loan may be based upon an interest rate lower than the rate for which the consumer/borrower is liable (a situation referred to as “negative amortization”). As with “buydowns”, special rules apply when the “effective” or “payment” rates are advertised for such transactions. Again, the regulatory

trend is to limit or otherwise control "negative amortization". Prior to proceeding with such a loan plan, a review of the then applicable provisions or Regulation Z as well as the Official Staff Commentaries is required. Currently, the following information must be included in any advertisements containing effective rates: (1) the "effective" or "payment" rate; (2) the term of the reduced payments; (3) the "note rate" at which interest is actually accruing; and (4) the APR.

The advertised APR must take into account the interest for which the consumer/borrower is liable, even though it is not paid by the consumer/borrower during the period of reduced payments. This type of financing could be advertised as: "An effective first-year rate of 6-1/2 percent. Interest being charged at 8-1/2 percent. 8-3/4% APR." In contrast to an ad for a "buydown" or a discounted variable rate, an ad for an "effective" or "payment" rate may *not* show the monthly payments without triggering the disclosures required in 12 CFR Section 226.24(d).

In addition to the Official Staff Commentaries published by the FRB, the Federal Trade Commission (FTC) publishes a manual for business entitled "How to Advertise Consumer Credit: Complying with the Law." This manual is available from the U.S. Government Printing Office.

Record Retention

General Rule. A creditor/lender is to retain evidence of compliance with TILA and Regulation Z (other than advertising requirements under 12 CFR Sections 226.16 and 226.24) for two (2) years after the date disclosures are required to be made or action is required to be taken. The administrative agencies responsible for enforcing the regulation may require creditors/lenders under their jurisdictions to retain records for a longer period if necessary to carry out enforcement responsibilities as authorized under Section 108 of TILA (12 CFR Section 226.25).

Inspection of Records. A creditor/lender is to permit the agency responsible for enforcing TILA and Regulation Z with respect to that creditor/lender to inspect its relevant records for purposes of compliance.

Language of disclosures

Disclosures required by TILA and Regulation Z may be made in a language other than English, provided that the disclosures are made available in English upon the consumer/borrower's request. This requirement for providing English disclosures on request does not apply to advertisements subject to Sections 226.16, 226.24., and 226.27. When negotiating a transaction in a language other than English (as defined), California law requires disclosures and transactional documents to be made and provided in the language through which the transaction was negotiated. These languages include Spanish, Chinese, Tagalog, Vietnamese, or Korean (Civil Code Section 1632).

Effect on State Laws

Inconsistent Disclosure Requirements. State Law requirements that are inconsistent with Chapter 1, General Provisions; Chapter 2, Credit Transactions; Chapter 3, Credit Advertising; and, Chapter 4, Credit Billing of TILA are pre-empted by the federal law to the extent of any inconsistency. The pre-emption of federal law extends to Regulation Z. A state law is inconsistent if it requires a creditor/lender to make disclosures or take actions that contradict the requirements of federal law. A state law is contradictory if it requires the use of the same term to represent a different amount or a different meaning than federal law, or if it requires the use of a term different from that required in the federal law to describe the same item (12 CFR Section 226.28).

If state law provides rights, responsibilities, or procedures for consumers/borrowers or creditors/lenders that are different from those required by federal law regarding the correction of billing errors or the regulation of credit reports, such requirements are pre-empted by federal law. However, a state law that allows consumers/borrowers to inquire about an open-end credit account and imposes on creditors/lenders an obligation to respond to such inquiry after the time allowed in federal law for consumers/borrowers to submit written notices of billing errors is not pre-empted.

In any situation where the period for submitting a notice under Regulation Z has expired, consumers/borrowers are to receive a notice that reliance on the longer time available under state law may result in the loss of important rights that may be preserved by acting more promptly under federal law. A creditor/lender, state, or other interested party may request the FRB to determine whether a state law requirement is inconsistent or

contradictory to federal law. After the FRB determines that a state law is inconsistent or contradictory, a creditor/lender may not make disclosures using the inconsistent term or form, or take or pursue contradictory action (12 CFR Section 226.28(c)).

Equivalent Disclosure Requirements. If the FRB determines that a disclosure required by State Law (other than a requirement relating to the finance charge, annual percentage rate (APR), or the disclosures required for "high-cost mortgages" under Section 226.32 is substantially the same in meaning as a disclosure required under TILA or Regulation Z, creditors/lenders in that state may make the state disclosure in lieu of the federal disclosure. A creditor/lender, state, or other interested party may request the FRB to determine whether a state disclosure is substantially the same in meaning as a federal disclosure (12 CFR Section 226.28(b)).

State Exemptions. A state may apply to the FRB to exempt a class of transactions within the state from the requirements of Chapter 2, Credit Transactions, or Chapter 4, Credit Billings of TILA and the corresponding provisions of Regulation Z. The FRB is to grant an exemption if it determines that:

- The state law is substantially similar to the federal law or, in the case of Chapter 4, Credit Billing, affords the consumer/borrower with greater protection than the federal law; and,
- There is adequate provision for enforcement under state law (12 CFR Section 226.29).

Administrative Enforcement

The Federal Trade Commission (FTC) enforces TILA and Regulation Z with respect to real estate brokers, mortgage loan brokers, mortgage bankers, and other creditors/lenders and advertisers are regulated by the following federal agencies, which have jurisdiction over the indicated financial institutions:

- Office of the Comptroller of the Currency (OCC) - national banks;
- Federal Deposit Insurance Corporation (FDIC) - insured banks that are not members of the Federal Reserve System;
- Federal Reserve Board (FRB) - state member banks of the Federal Reserve System;
- Office of Thrift Supervision (OTS) - Federally-insured savings institutions and members of the Office of Thrift Supervision System not insured by FDIC; and,
- National Credit Union Administration (NCUA) - federally chartered credit unions.

The FTC may determine that a creditor/lender or advertiser has violated the law and order the creditor/lender or advertiser to cease and desist from further violations. Violations of such an administrative order may result in an $11,000 civil penalty each day the violation continues. Further, if creditors/lenders or advertisers engage in practices which they know the FTC has previously determined to be unfair or deceptive, the FTC may file an action in federal district court seeking penalties of up to $11,000 for each violation.

In addition, where a creditor/lender inaccurately discloses an APR or a finance charge, the FTC can require the creditor/lender to adjust the accounts of persons to whom credit was extended to assure the obligors will not be required to pay a finance charge in excess of the finance charge actually disclosed or the dollar equivalent of the disclosed APR, whichever is lower. Section 108(e) of TILA sets forth the conditions under which these administrative restitution cases may be brought, as well as defenses the creditor/lender can assert in such cases (15 USC Section 1607).

Civil Liability

In addition to any actual damage sustained by a consumer/borrower because of the failure of the creditor/lender to comply with TILA and Regulation Z, the creditor/lender may be liable to a consumer/borrower for a statutory penalty of twice the amount of the finance charge, with a minimum of $100 and a maximum of $1,000. In the case of an individual action relating to a credit transaction not under an open end credit plan

secured by real property or a dwelling, a creditor/lender may be liable to a consumer/borrower for not less than $400 or greater than $4000.

Generally, statutory liability applies to seven specific violations:

- Failing to properly disclose the right of rescission, where applicable; and,
- The improper disclosure of the amount financed, the finance charge, the APR, the total of payments, the payment schedule, or of the security interest taken by the creditor/lender.

In case of any successful action to enforce the foregoing liability or in any action in which a person (consumer/borrower) is determined to have a right of rescission, the creditor/lender is liable for the costs of the action, together with a reasonable attorney's fee as determined by the court. In the case of a failure to comply with any requirement under 15 USC Section 1639 ("Section 32 Mortgages"), the creditor/lender is liable in amount equal to the sum of all finance charges and fees paid by the consumer/borrower, unless the creditor/lender demonstrates that the failure to comply is not material (15 USC Section 1640(a)).

In addition, the creditor/lender is liable for actual damages suffered by the consumer/borrower and, if the consumer/borrower prevails, for the reasonable attorney's fees and costs of the consumer/borrower. The creditor/lender can avoid such liability if it notifies the consumer/borrower within 60 days after discovering the error and adjusts the account to reflect the correct APR or finance charge, provided the consumer/borrower has not instituted suit or the creditor/lender has not received written notice of its error, prior to its notification to the consumer/borrower.

In the case of a class action, the creditor/lender will be liable for such amount as the court may allow, except that as to each member of the class no minimum recovery will be applicable, and the total recovery in any class action or series of class actions arising out of the same failure to comply by the same creditor/lender will not be more than $500,000 or 1% of the net worth of the creditor/lender, whichever is less.

Creditors/lenders are not liable for violations that were unintentional and resulted from bona fide errors. An adequate showing must be made procedures were in place that reasonably prevented such errors. Examples of bona fide errors include clerical, calculation, computer malfunction/programming, and printing errors. Errors of legal judgment do not qualify as bona fide.

The multiple failure to disclose to any person (consumer/borrower) information required under TILA or Regulation Z to be disclosed in connection with a single account under an open end consumer credit plan, other single consumer credit sale, consumer/borrower loan, and consumer lease, or other extension of consumer credit, will entitle the person (consumer/borrower) to a single recovery but continued failure to disclose after a recovery has been granted will give rise to rights to additional recoveries (15 USC Section 1640(d)).

Creditors/lenders are deemed to be in compliance with the non-numerical disclosure provisions of TILA if the creditor/lender: (l) uses any appropriate model form or clause as published by the FRB; or (2) uses any such model form or clause and changes it by (a) deleting any information that is not required by TILA, or (b) rearranging the format, if in making such deletion or in the rearranging of the format, the creditor/lender does not affect the substance, clarity, or meaningful sequence of the disclosures (Sections 105(b) and 130 of TILA, 15 USC Sections 1604 and 1640).

Creditor/Lender Defenses

A creditor/lender or assignee has no liability under 15 USC Sections 1607, 1611 and 1640 for any failure to comply with any requirement imposed under TILA or Regulation Z, if within 60 days after discovering an error (whether pursuant to a final written examination report or notice issued under 15 USC Section 1607(e)(1), or through the creditor/lender's or assignee's own procedures); and prior to the institution of an action under 15 USC Section 1640, or the receipt of written notice of the error from the consumer/borrower, the creditor/lender or assignee:

1. Notifies the person (consumer/borrower) concerned of the error; and,

2. Makes whatever adjustments in the appropriate account are necessary to assure that the person (consumer/borrower) will not be required to pay an amount in excess of the charge actually disclosed, or the dollar equivalent of the APR actually disclosed, whichever is lower (15 USC Section 1640(b))

Unintentional Violations; Bona Fide Errors. As previously mentioned, a creditor/lender or assignee may not be held liable in any civil action for a violation of TILA or Regulation Z if the creditor/lender or assignee shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error (15 USC Section 1640(c))

Criminal Liability

A creditor/lender is also subject to a fine of not more than $5,000 or imprisonment for not more than one year, or both, for willfully and knowingly violating TILA or Regulation Z. The violations may include giving false or inaccurate information, failing to provide required disclosures, using any chart or table authorized by the FRB in such a manner as to consistently understate the APR, or otherwise failing to comply with any requirement imposed by TILA or Regulation Z (Section 112 of TILA, 15 USC Section 1611).

Assignee Liability

General Liability. Except as otherwise specifically provided in TILA or Regulation Z, any civil action for a violation or administrative proceeding which may be brought against a creditor/lender may be maintained against an assignee of the creditor/lender only if the violation for which such action or proceeding is brought is apparent on the face of the required disclosure statement, except where the assignment was involuntary. A violation apparent on the face of the disclosure statement includes, but is not limited to:

1. Disclosures which can be determined to be incomplete or inaccurate from the face of the disclosure statement or other documents assigned; or,

2. A disclosure which does not use the terms required to be used by TILA or Regulation Z (15 USC Section 1641(a), (e)(1) and (e)(2)).

Proof of Compliance with Statutory Provisions. Except as provided in 15 USC Section 1635(c), in any action or proceeding by or against any subsequent assignee of the original creditor/lender without knowledge to the contrary by the assignee when the assignee acquires the obligation, written acknowledgement of receipt by a person to whom a statement or disclosure is required to be given will be conclusive proof of the delivery thereof and, except as provided above, of compliance with TILA or Regulation Z (15 USC Section 1641(b)).

Right of Rescission. Any borrower who has the right to rescind a transaction may rescind the transaction as against any assignee of the obligation (15 USC Section 1641(c)).

Additional Disclosures Required for “High-Cost”, “Higher-Cost/Priced” Mortgages

The “Home Ownership and Equity Protection Act of 1994” amended TILA and Regulation Z to establish new requirements for certain loans secured by the consumer/borrower’s principal dwelling in which either:

1. The APR at loan consummation will exceed by more than 8 percentage points for loans secured by first liens, or more than 10 percentage points for loans secured by junior liens (deeds of trust or mortgages) the yield on U. S. Treasury Securities having comparable periods of maturity to the maturity of the contemplated loan as of the 15th day of the month immediately preceding the month in which the application or the extension of credit is received by the creditor/lender; or,

2. The total points and fees payable by the consumer/borrower at or before settlement or loan closing will exceed the greater of 8 percent of the total loan amount or $400 (the dollar amount to be adjusted annually by the FRB, based on changes in the Consumer Price Index that was reported on the preceding June 1 – the adjusted dollar amount for 2009 is $583).

The Official Staff Commentaries should be consulted annually to determine the applicable adjusted dollar

amount, i.e., the comment in 12 CFR Section 226.32(a)(1)(ii) for the most current year's adjusted figure. As previously mentioned in this Chapter and in this Section, loans subject to 12 CFR Section 226.32 are known as “Section 32” or “high-cost” mortgage loans.

Exemptions. Exempted from the requirements for “high-cost” mortgage loans are the following transactions:

- A residential mortgage transaction (as defined for this purpose);
- A reverse mortgage transaction subject to 12 CFR Section 226.33; and,
- Open end credit plans or open end credit lines (HELOCs).

Definitions. For the purposes of “Section 32”, the terms points and fees means:

- All items required to be disclosed under 12 CFR Sections 226.4(a) and 226.4(b), except interest or the time-price differential;
- All compensation paid to mortgage brokers (MLOs);
- All items listed in 12 CFR Section 226.4(c)(7) (other than amounts held for future payment of taxes) unless the charge is reasonable, the creditor/lender receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor/lender; and,
- Premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer's liability in the event of the loss of life, health, or income or in the case of accident, written in connection with the credit transaction.

The term affiliate means any company that controls, is controlled by, or is under common control with another company, as set forth in the Bank Holding Company Act of 1956 (12 USC Section 1841 et seq.).

Disclosures. In addition to other disclosures required, in a “Section 32” mortgage loan, the creditor/lender is to disclose the following in conspicuous type size:

1. Notices. The following statement: “You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the creditor/lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan."
2. Annual percentage rate. The annual percentage rate (APR).
3. Regular payment; balloon payment. The amount of the regular monthly (or other periodic) payment and the amount of any balloon payment. The regular payment disclosed is to be treated as accurate if it is based on an amount borrowed that is deemed accurate and is disclosed under 12 CFR Section 226.32(c)(5).
4. Variable-rate. For variable-rate transactions, a statement that the interest rate and monthly payment may increase, and the amount of the single maximum monthly payment, based on the maximum interest rate required to be disclosed under 12 CFR Section 226.19(b)(2)(viii)(B).
5. Amount borrowed. For a mortgage refinancing, the total amount the consumer/borrower will borrow, as reflected by the face amount of the note; and where the amount borrowed includes premiums or other

charges for optional credit insurance or debt-cancellation coverage, that fact is to be stated, grouped together with the disclosure of the amount borrowed. The disclosure of the amount borrowed shall be treated as accurate if it is not more than $100 above or below the amount required to be disclosed.

Limitations. A mortgage transaction subject to this section is *not* to include the following terms:

1. Balloon payment. For a loan with a term of less than five years, a payment schedule with regular periodic payments that when aggregated do not fully amortize the outstanding principal balance.

    - Exception. The limitation above does not apply to loans with maturities of less than one year, if the purpose of the loan is a “bridge" loan connected with the acquisition or construction of a dwelling intended to become the consumer/borrower's principal dwelling.

2. Negative amortization. A payment schedule with regular periodic payments that cause the principal balance to increase.

3. Advance payments. A payment schedule that consolidates more than two periodic payments and pays them in advance from the loan proceeds.

4. Increased interest rate. An increase in the interest rate after default.

5. Rebates. A refund calculated by a method less favorable than the actuarial method (as defined by Section 933(d) of the Housing and Community Development Act of 1992, 15 USC Section 1615(d)), for rebates of interest arising from a loan acceleration due to default.

6. Prepayment penalties. Except as allowed under 12 CFR Section 226.32(d)(7), a penalty for paying all or part of the principal before the date on which the principal is due. A prepayment penalty includes computing a refund of unearned interest by a method that is less favorable to the consumer than the actuarial method, as defined by Section 933(d) of the Housing and Community Development Act of 1992 (15 USC Section 1615(d).

7. Prepayment penalty exception. A mortgage transaction subject to “Section 32” may provide for a prepayment penalty (including a refund calculated according to the rule of 78s) otherwise permitted by law if, under the terms of the loan:

    - The penalty will not apply after the two-year period following consummation;

    - The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor/lender or an affiliate of the creditor/lender;

    - At consummation, the consumer/borrower's total monthly debt payments (including amounts owed under the mortgage) do not exceed 50 percent of the consumer's monthly gross income, as verified in accordance with 12 CFR Section 226.34(a)(4)(ii); and,

    - The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

8. Due-on-demand clause. A demand feature that permits the creditor/lender to terminate the loan in advance of the original maturity date and to demand repayment of the entire outstanding balance, except in the following circumstances:

    - There is fraud or material misrepresentation by the consumer/borrower in connection with the loan;

- The consumer/borrower fails to meet the repayment terms of the agreement for any outstanding balance; or,

- There is any action or inaction by the consumer that adversely affects the creditor/lender's security for the loan, or any right of the creditor/lender in such security.

Prohibited Acts or Practices

The prohibited acts or practices in connection with credit extended subject to 12 CFR Section 226.32 are found in 12 CFR Section 226.34.

General prohibitions and practices. Creditors/lenders are prohibited from engaging in a pattern or practice of lending based on the collateral value of the security property without regard to the consumer/borrower's ability to repay the loan. In addition, proceeds for home improvement loans must be disbursed either directly to the consumer/borrower, jointly to the consumer/borrower and home improvement contractor or through an authorized escrow agent, in accordance with terms established in a written agreement signed by and at the election of the consumer/borrower.

Notice to assignee. Sell or otherwise assign a "Section 32" mortgage loan without furnishing the following statement to the purchaser or assignee: "Notice: This is a mortgage subject to special rules under TILA and Regulation Z. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the mortgage that the consumer/borrower could assert against the creditor/lender."

Loan refinances within a one-year period. Within one year of having extended credit subject to 12 CFR Section 226.32, refinance any loan to the same consumer/borrower into another loan subject to "Section 32", unless the refinancing is in the consumer/borrower's interest. An assignee holding or servicing an extension of mortgage credit subject to 12 CFR Section 226.32, is *not* to refinance any loan subject to "Section 32" for the remainder of the one-year period following the date of origination of the credit to the same consumer/borrower into another loan subject to 12 CFR Section 226.32, unless the refinancing is in the consumer/borrower's interest.

Certain prohibited practices and fees. A creditor/lender (or assignee) is prohibited from engaging in acts or practices to evade this provision, including a pattern or practice of arranging for the refinancing of its own loans by affiliated or unaffiliated creditors/lenders, or modifying a loan agreement (whether or not the existing loan is satisfied and replaced by the new loan) and charging a fee therefor.

Repayment ability. The creditor/lender is not to extend credit subject to 12 CFR Section 226.32 to a consumer/borrower based on the collateral without regard to the consumer/borrower's repayment ability, including the consumer/borrower's current and expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations. The creditor/lender is presumed to have violated this provision if the creditor/lender fails to verify and document the consumer/borrower's repayment ability, expected income or assets, current obligations, and the consumer/borrower's mortgage related obligations. The standards for verification include reviewing the consumer/borrower's IRS form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer/borrower's income, assets or obligations.

Exclusions from presumption of compliance. Notwithstanding the previous paragraph, no presumption of compliance is available to the creditor/lender for a transaction for in which:

- The regular periodic payments for the first seven (7) years would cause the principal balance to increase; or,

- The term of the loan is less than seven (7) years and the regular periodic payments when aggregated do not fully amortize the outstanding principal balance.

Exemption. The previous paragraph does *not* apply to temporary or "bridge" loans with terms of twelve months or less, such as a loan to purchase a new dwelling where the consumer/borrower plans to sell a current dwelling within twelve months.

Prohibited acts or practices for dwelling-secured loans, open end credit plans (HELOCs). In connection with credit secured by the consumer/borrower's dwelling that does not meet the definition in 12 CFR Section 226.2(a)(20), a creditor/lender shall not structure a home-secured loan as an open end plan (HELOC) to evade the requirements of 12 CFR Section 226.32.

Prohibited Acts or Practices In Connection with "Higher-Cost/Priced" Mortgage Loans
Effective October 1, 2009, amendments were made to TILA and Regulation Z regarding "higher-cost/priced" mortgage loans (12 CFR Sections 226.34 and 226.35). These loans are also known as "Section 35" or "high-cost/priced" mortgage loans that are defined as follows:

- A consumer credit transaction secured by the consumer/borrower's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for loans secured by a first lien on a dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling.
- "Average prime offer rate" means an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors/lenders for mortgage transactions that have low-risk pricing characteristics. The FRB publishes average prime offer rates for a broad range of types of transactions in a table updated at least weekly as well as the methodology the FRB uses to derive these rates in the publication, H-15, among others.

Same standards as 12 CFR Sections 226.32 and 226.34. The disclosure and prohibited acts or practices standards that apply to "Section 32" mortgage loans generally apply as well to Section 35 mortgage loans.

Exemption. The term "higher-cost/priced" mortgage loan does not include a transaction to finance the initial construction of a dwelling, a temporary or "bridge" loan with a term of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months, a reverse-mortgage transaction subject to 12 CFR Section 226.33, or a home equity line of credit (HELOC) subject to 12 CFR Section 226.5b.

Rules for "higher-cost/priced" mortgage loans. "Higher-cost/priced" mortgage loans are subject to the following restrictions:

1. Repayment ability. A creditor/lender is *not* to extend credit based on the value of the consumer/borrower's collateral without regard to the consumer/borrower's repayment ability as of loan consummation as provided in 12 CFR Section 226.34(a)(4).

2. Prepayment penalties. A loan may not include a penalty described in 12 CFR Section 226.32(d)(6) unless:

    - The penalty is otherwise permitted by law, including 12 CFR Section 226.32(d)(7) if the loan is a mortgage transaction described in 12 CFR Section 226.32(a); and,

    - Under the terms of the loan:

        A. The penalty will not apply after the two-year period following consummation;

        B. The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor/lender or an affiliate of the creditor/lender; and,

        C. The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

3. Escrows or impound accounts. A creditor/lender may not extend a loan secured by a first lien on a principal dwelling, unless an escrow or impound account is established before loan consummation for payment of property taxes and premiums for mortgage-related insurance required by the creditor/lender, such as insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property, or insurance protecting the creditor/lender against the consumer/borrower's default or other credit loss subject to the following exemptions:

   - Loans secured by shares in a cooperative and for certain condominium units; and,

   - Insurance premiums need not be included in escrow or impound accounts for loans secured by condominium units, where the condominium association has an obligation to the condominium unit owners to maintain a master policy insuring the condominium units or separate interests of each member/owner.

   A creditor/lender or servicer may permit a consumer/borrower to cancel the escrow or impound account in response to a consumer/borrower's dated written request to cancel the escrow account if received no earlier than 365 days after loan consummation. An “escrow account" or “impound account” is to have the same meaning as in 24 CFR Section 3500.17(b), as amended. Compliance with the “escrow account” or “impound account” is mandatory for “high-cost/priced” mortgage loans as of 4/1/2010 (10/1/2010 for higher-cost/priced mortgage loans secured by manufactured housing). 73 Federal Register 44595 and Official Staff Interpretations to 12 CFR Section 226.1(d)(5).

4. Evasion; open end credit (HELOC). In connection with credit secured by a consumer/borrower's principal dwelling that does not meet the definition of open end credit in 12 CFR Section 226.2(a)(20), a creditor/lender is *not* to structure a home-secured loan as an open end plan (HELOC) to evade the requirements of “Section 35”.

Prohibited Acts or Practices In Connection With Credit Secured by a Consumer/Borrower's Principal Dwelling

Effective 10/1/2009, 12 CFR Section 226.36 was amended to provide:

Mortgage broker defined. The term ``mortgage broker" means a person, other than an employee of a creditor/lender, who for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person. The term includes a person meeting this definition, even if the consumer credit obligation is initially payable to such person, unless the person provides the funds for the transaction at consummation out of the person's own resources, out of deposits held by the person, or by drawing on a bona fide (independent) warehouse line of credit.

Misrepresentation of the value of the consumer/borrower's dwelling

1. Coercion of appraiser. In connection with a consumer credit transaction secured by a consumer/borrower's principal dwelling, no creditor or mortgage broker, and no affiliate of a creditor/lender or mortgage broker shall directly or indirectly coerce, influence, or otherwise encourage an appraiser to misstate or misrepresent the value of such dwelling.

   - Examples of actions that violate this provision include:

     A. Implying to an appraiser that current or future retention of the appraiser depends on the amount at which the appraiser values a consumer/borrower's principal dwelling;

     B. Excluding an appraiser from consideration for future engagement because the appraiser reports a value of a consumer/borrower's principal dwelling that does not meet or exceed a minimum threshold;

C. Telling an appraiser a minimum reported value of a consumer/borrower's principal dwelling that is needed to approve the loan;

D. Failing to compensate an appraiser because the appraiser does not value a consumer/borrower's principal dwelling at or above a certain amount; and,

E. Conditioning an appraiser's fee or compensation on loan consummation.

- Examples of actions that do not violate this provision include:

A. Asking an appraiser to consider additional information about a consumer/borrower's principal dwelling or about comparable properties;

B. Requesting that an appraiser provide additional information about the basis for a valuation;

C. Requesting that an appraiser correct factual errors in a valuation;

D. Obtaining multiple appraisals of a consumer/borrower's principal dwelling, so long as the creditor adheres to a policy of selecting the most reliable appraisal, rather than the appraisal that states the highest value;

E. Withholding compensation from an appraiser for breach of contract or substandard performance of services as provided by contract; and,

F. Taking action permitted or required by applicable federal or state statute, regulation, or agency guidance.

2. When extension of credit is prohibited. In connection with a consumer credit transaction secured by a consumer's principal dwelling, a creditor who knows, at or before loan consummation, of a violation of this provision in connection with an appraisal is *not* to extend credit based on such appraisal, unless the creditor/lender documents that it has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.
3. Appraiser defined. An appraiser is a person who engages in the business of providing assessments of the value of dwellings. The term “appraiser” includes persons that employ, refer, or manage appraisers and affiliates of such persons.

<u>Servicing practices.</u> In connection with a consumer credit transaction secured by a consumer/borrower's principal dwelling, no servicer is to:

- Fail to credit a payment to the consumer/borrower's loan account as of the date of receipt, except when a delay in crediting does not result in any charge to the consumer/borrower or in the reporting of negative information to a consumer reporting agency, or except as provided in 12 CFR Section 226.36(c)(2);

- Impose on the consumer/borrower any late fee or delinquency charge in connection with a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on an earlier payment, and the payment is otherwise a full payment for the applicable period and is paid on its due date or within any applicable grace period; or,

- Fail to provide, within a reasonable time after receiving a request from the consumer/borrower or any person acting on behalf of the consumer/borrower, an accurate statement of the total outstanding balance that would be required to satisfy the consumer/borrower's obligation in full as of a specified date.

If a servicer specifies in writing requirements for the consumer/borrower to follow in making payments, but accepts a payment that does not conform to the requirements, the servicer shall credit the payment as of 5 days after receipt. The terms "servicer" and "servicing" have the same meanings as provided in 24 CFR 3500.2(b), as amended. 12 CFR Section 226.34 does not apply to a home equity line of credit (HELOC) subject to 12 CFR Section 226.5b.

Assignment of "Section 32" and "Section 35" Mortgage Loans

Any person who purchases or is otherwise assigned a "Section 32" mortgage loan will be subject to all claims and defenses with respect to that mortgage that the consumer/borrower could assert against the creditor/lender of the mortgage. This transfer of liability applies unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not determine (based on the documentation required by TILA or Regulation Z),including the itemization of the amount financed and other disclosure of disbursements that the mortgage was a "Section 32" mortgage.

The liability of an assignee pursuant a Section 32 mortgage will generally extend to an assignee of Section 35 mortgages. This is because Section 35 mortgages will likely qualify as well as Section 32 mortgages. The foregoing does not affect the rights of a consumer/borrower under any provision of TILA or Regulation Z (15 USC Section 1641(d)(1)).

Notwithstanding any other provision of law, relief provided because of any action made permissible by the foregoing provisions may not exceed:

1. With respect to actions based upon a violation of TILA or Regulation Z, the amount specified in 15 USC Section 1640 (civil liability); and,

2. With respect to all other causes of action, the sum of:

   (A) The amount of all remaining indebtedness; and,

   (B) The total amount paid by the consumer/borrower in connection with the transaction (15 USC Section 1641(d)(2)).

The amount of damages that may be awarded under item (2) above will be reduced by the amount of any damages awarded under item (1) above (15 USC Section 1641(d)(3).

Conclusion

The foregoing summary of TILA and Regulation Z incorporates the amendments to TILA and Regulation Z and the revisions of FRB's Official Staff Commentaries issued to June 2010. The practitioner should be advised TILA and Regulation Z are undergoing continued amendments and revisions to be followed by revised Official Staff Commentaries. Accordingly, prior to proceeding to rely on this Section on TILA, review of the latest operative amendments and revisions is necessary.

Anyone needing additional information may contact the Federal Trade Commission (FTC), 11000 Wilshire Blvd., Suite 13209, Los Angeles, California 90024. Telephone number: 1-877-FTC-HELP (1-877-382-4357). Further, the Federal Reserve Board may be contacted at www.federalreserve.gov.

California Housing Finance Agency

The California Housing Finance Agency (CalHFA) is a self-supporting state government agency, established in 1975, that finances mortgage loans to low and moderate income first-time homebuyers. The Agency, which until 2002 was known as CHFA, is not a direct lender, but offers its products through a network of approved, private lenders. CalHFA loan products are typically priced at reduced, fixed interest rates and often add down payment assistance. CalHFA also partners with other housing authorities to help borrowers secure additional assistance for a lower monthly mortgage payment.