



THE ESSENTIAL GUIDE TO

Due Diligence: Mastering Terminology and Principles



Important principles, glossary of terms, definitions and jargon one should know in the purchasing and investing in real estate notes.



Due Diligence Essential Guide Introduction

Note buyers have many objectives when it comes to investing in a note. This booklet's purpose is to alert note buyers to some of the legal issues to be aware of (although please do not take this book as legal advice and always consult your attorney). This guide should also assist with note and contract terminology and potential pitfalls that one might run into along the way.

Note Buying Objective Overview

1. The first objective is to locate the assets to be acquired. This requires research into the market to determine the most attractive notes and to evaluate the chances of collectability.
2. The second objective is to efficiently evaluate the potential for collectability. This requires an in-depth analysis of the note, including a thorough review of the borrower's financial records, credit history, and current employment situation.
3. The third objective is to pay as little as possible for the note. This requires a review of current market trends, an evaluation of the borrower's ability to pay back the loan, and a comparison of the note to others of similar quality.
4. The fourth objective is to collect the note and its collateral in full. Therefore, a note buyer must have a strategy for collecting payment from the borrower and/or guarantor.
5. The fifth objective is the disposition of the collateral to recoup the investment if it goes into default. This usually involves foreclosing and selling the collateral to a third party, auctioning it off, keeping it as a rental, or selling the property using seller-financing so the note becomes viable again.

Content

Checklist Overview

Protect your interests by going through this list and ensuring that all records and documents are collected stored together in a file.

page 4

01 Documents

In the Note and in the Mortgage

page 5

02 Terminology

All the names for the Borrower and the Lender

page 6

03 What Should Be

in the Note, Security Agreement and Note Purchase Contract

page 7-9

04 Due Diligence

Under the Contract, Under the Note and Security Instruments

page 10-11

05 Considerations

Title and Closing Documents

page 12

06 Foreclosure Process

Types and Remedies, Redemption Rights, IRS Liens, Bankruptcy, and Legal Issues from Death of the Borrower

page 13-19

Checklist Overview

01 Neighborhood-Demographics

02 Property Inspection

03 Value – BPO

04 Are Taxes Current

05 Title/Liens

06 Property Condition

07 Occupancy Status

08 HOA Fees (if applicable)

09 Collateral Files

The Documents

Note

- The promissory note – an I.O.U.
- Evidence of the debt
- Need Original Note (Only one original – like a check)
- A negotiable instrument under certain circumstances
- States the amount loaned, the interest rate, and the terms of payment

The Documents

Mortgage

- The security instrument
- It pledges the collateral
- Called different names:
Mortgage, Deed of trust, Trust Deed, Security Agreement
- It should be filed in the public records to put the world on notice of the security interest in the collateral

Terminology



THE BORROWER – SOMETIMES CALLED THE:

Maker
Mortgagor
Debtor
Obligor
Grantor (as the transferor of the collateral)

THE LENDER – SOMETIMES CALLED THE:

Payee
Mortgagee
Beneficiary
Creditor
Endorser (if the instrument has been assigned with recourse)

03

What Should Be in the Note?

MAKE SURE THERE IS THE FOLLOWING:

- Borrower's signature
- Borrower's name and address
- Lender's name and address
- The amount borrowed
- The promise to pay
- Interest rate before default or maturity
- Interest rate after default or maturity
- The amount of the periodic payment
- A reference to the collateral that is being pledged – complete legal description
- A final maturity date
- Default provisions
- Prepayment provision
- Waiver provisions (very important)
- Notice of any kind
- Demand for payment
- Presentation for payment
- Notice of intent to accelerate
- Notice of acceleration
- Maturity
- Protest and notice of protest
- Foreclosure notices that can be waived by law
- Anti-Deficiency statutes
- How payments will be applied
- Late payment provisions

What Should Be in the Security Agreement?

MAKE SURE THERE IS THE FOLLOWING:

- Signature of the debtor
- Acknowledgment before a notary public (this is usually required to record the mortgage)
- Description of the collateral pledged
- Reference in some detail to the indebtedness that is secured by the collateral (borrower, lender, amount, date of loan)
- Power of sale – for states that allow non-judicial foreclosure of the collateral
- Due on sale clause – the right of the lender to call the note due if any interest in the collateral is transferred
- Warranties from the party hypothecating the collateral that it has legal title to such property
- Provisions for payment of property taxes and insurance on the collateral with the lender named as an additional insured (right of lender to require payments of T&I into escrow controlled by the lender)
- Late charge provisions
- Foreclosure procedures detailed In states that provide for a trustee to hold title to the property to secure payment of the debt: Enumeration of the powers of the trustee to foreclose the property at public auction
- The rights of the lender to appoint substitute trustees
- The compensation to be paid to the trustee
- Release provisions when the debt is paid
- Partial release provisions when some portion of the collateral is sold

What Should Be in the Note Purchase Contract?

MAKE SURE THERE IS THE FOLLOWING:

- Purchase and Sale Agreement
- Identify the note
- Independent consideration for the option to purchase the note
- New Title commitment or Update Current Title Policy
- Feasibility period or option to terminate (if Land Contract)
- Loan documents
- Broker Price Opinion (BPO) or Appraisal
- Estoppel certificate from seller
- Payment history schedule
- Names and addresses of makers, guarantors, lienholders
- Notices of claims
- Other security
- Representations and warranties
- Ownership of note
- Due diligence
- Negotiability – holder in due course status [Like being a bona fide purchaser for value without notice (b.f.p.)] To be negotiable
- Must be signed by the maker
- Contain an unconditional promise to pay a sum certain
- Be payable on demand at a stated time
- Be payable to order or bearer
- In good faith
- Without notice that it is overdue or has been dishonored
- Without notice that the note is subject to any claims or defenses

04

Due Diligence Under the Contract

MAKE SURE THERE IS THE FOLLOWING:

- The Promissory Note
- Date of the note should be specific and the same as the date of the delivery of the deed to the maker of the note
- Identity of the maker should be clear, and if a purchase money loan, be consistent with the grantee of the deed, and the grantor of the deed of trust
- Identity of the payee should be consistent with the beneficiary of the deed of trust
- Note should be payable "to the order of" the payee

Under the Note

MAKE SURE THERE IS THE FOLLOWING:

- Interest rate
- Current interest rate
- Default interest rate
- Prepayment privilege or penalty
- Security for the note
- Right to accelerate the note
- Late payment charges or default rate of interest
- Non-waiver provisions – review history to determine if payee has accepted late payments in the past
- Attorney's fees

Due Diligence

The Security Instruments

WHEN RECORDED

- Mortgage, Deed of Trust or Trust Deed
- Date of the lien – EXTREMELY IMPORTANT – when was it recorded – was it signed at the same time as the note it secures
- Accurate identity and address for borrower/maker/grantor of deed of trust/mortgagor/grantee of deed (if purchase money loan)
- Accurate identity and address for guarantor
- Accurate identity and address for lender/beneficiary/mortgagee
- Identity of trustee
- Accurate legal description of property being pledged (mortgaged property)
- Description of the indebtedness (the note) including basic terms such as the original amount of the debt and the maturity date
- Due-on-sale (transfer) or further encumbrance clauses
- The failure to comply with a due-on-sale clause may need to be a default under the deed of trust (as opposed to an ordinary covenant)
- The failure to obtain written consent to a transfer will usually give the lender the option to accelerate the loan
- Escrow deposits for taxes and insurance premiums
- Remedies on default
- Right to foreclose
- Non-judicially / Judicially
- Waiver of Anti-deficiency statute provisions
- Procedures required for acceleration
- Procedures required for foreclosure
- Trustee provisions if Deed of Trust/Trust Deed
- Lender should have the right to appoint a substitute trustee
- Trustee may have a right to a commission
- Condemnation and casualty insurance proceeds
- Non-recourse debt provisions
- Unpaid principal balance
- Interest paid
- Escrow account balances
- Next installment due
- Whether previous acceleration or default

05

Considerations

Title

- Review a current title commitment
- Purchase an endorsement to the original lender's policy (formerly known as a "mortgagee policy")
- Obtain a "nothing further certificate" – what has been filed since the filing of the mortgage/deed of trust, and will show
- A record of notices of lis pendens filed
- Delinquent tax claims
- Inferior liens
- Partial release of a portion of the property
- Mechanics' and materialmen's lien affidavits

Closing Documents

MAKE SURE THERE IS THE FOLLOWING:

- Promissory note or allonge (properly endorsed "payable to the order of purchaser, without recourse")
- Assignment of note and liens
- Endorsements to lender/mortgagee policy of title insurance insuring validity and priority of buyer's lien up to the amount of the outstanding principal balance

06

Foreclosure Process Collecting on the Collateral

- Your loan servicer and/or attorney will start the foreclosure process
- Do not disclose information about the debtor's financial situation to any third party
- Attempt to get information regarding the party's ability to pay the debt
- Consider revising the loan terms to motivate those liable to resume paying the loan
- If those liable won't provide financial information, or fail or refuse to communicate, proceed to either file suit to collect, or to foreclose on the collateral
- If a judicial foreclosure of the collateral is required, a lawsuit will be necessary in any event
- Filing a lawsuit will generally put the creditor in a position to compel those liable on the debt to produce documents that would evidence their ability to pay, and to determine what other obligations are outstanding
- Winning a lawsuit results in a judicial declaration (a judgment) that enables the creditor to pursue certain remedies in addition to foreclosing on the collateral

Two Methods

NON-JUDICIAL FORECLOSURE:

If Deed of Trust/Trust Deed

JUDICIAL FORECLOSURE:

If security instrument is a Mortgage (most common)

Foreclosure procedures are governed by the law of the state where the property is located

The creditor must comply with the terms of the note, the security agreement, and the requirements of state law (statutory and common law requirements)

If the debtor or guarantor have not waived certain common law rights (i.e., notice of intent to accelerate), it may be necessary to jump through those hoops

It is important to read the note and the security agreement

Foreclosure Process

Non-Judicial

Non-judicial foreclosure is typically faster and less expensive than judicial foreclosure

STEPS THAT ARE TYPICALLY REQUIRED OF A NON-JUDICIAL FORECLOSURE

- Notice given in writing to the debtor by certified mail of the specific default, and the opportunity to cure the default within a stated period of time
- Notwithstanding state law requirements, “debt collectors” are required to give the party liable on the debt a thirty day opportunity to “dispute” the debt
- Notice given in writing of the acceleration of the debt
- Notice given in writing to the debtor by certified mail of the foreclosure sale
- Notice given to the public of the foreclosure sale
- Posting notice of the foreclosure sale of the property at a public place in accordance with state law and the terms of the security agreement
- Filing notice of the foreclosure sale with the County Clerk of the county where the property being foreclosed is located
- Compliance with other provisions of state law
- The sale must be conducted between the hours of 10 a.m. and 4 p.m., at the place designated by the county commissioners for the holding of such sales
- The foreclosure is a public auction, and the trustee/substitute trustee conducts the auction
- The notice of the foreclosure sale must state a starting time and the sale must be commenced within three hours after the stated starting time
- All parties must pay cash, at the time of the sale, except for the foreclosing lender, who is entitled to credit bid up to the amount of the deb
- All buyers take the property as is, and subject-to any and all prior liens, without any warranties regarding title from the trustee/substitute trustee
- The warranties in the security agreement provided by the party pledging the collateral are binding on such party
- The trustee may announce conditions for the sale, and all bidders are subject to such reasonable conditions
- The highest bidder (who as a practical matter is most often the holder of the note), receives a trustee’s deed
- Third party bidders pay with cashier’s checks in various denominations made payable to themselves, and then endorse the checks to the trustee

Foreclosure Process

Judicial

If the loan documents or state law do not permit non-judicial foreclosure sales, recourse to the judicial system is necessary to obtain a judgment against those liable on the debt, and for a court order that provides for the foreclosure of the property (sometimes by a public official) in accordance with state law. The cost is typically much greater.

THINGS TO CONSIDER IN A NON-JUDICIAL FORECLOSURE

- Filing fees for the lawsuit
- Fees to have the parties served
- Attorney's fees
- The length of time required to obtain the court's ruling is generally much greater than that required of a non-judicial foreclosure
- Because the lawsuit is served on the debtor, and because it is a formal legal proceeding, there is an increased likelihood that the debtor will hire an attorney and seek to introduce fact issues that may delay the judgment and order for foreclosure
- Some states require that the foreclosure sale be postponed for long periods of time, during which the debtor still owns the property and can theoretically sell and pay off the loan, or refinance and pay off the loan

Deed in Lieu of Foreclosure

Because of the expense and time involved in conducting a non-judicial or judicial foreclosure sale, the note holder should consider the benefits of accepting a deed from the borrower, in lieu of foreclosing. Typically the consideration for the debtor transferring title of the property to the lender is that the lender forgives the debt.

The lender's acceptance of a deed in lieu of foreclosure transfers title from the borrower to the lender, but it does not remove title issues that have been filed of record or of which the lender has knowledge that have arisen since the filing of the lender's security instrument

Therefore, it is necessary to either obtain title insurance in connection with the deed in lieu, or to otherwise be satisfied that there are no intervening liens or clouds on title that could have been extinguished by a foreclosure of the lender's lien

Foreclosure Process

Other Issues

■ DEED IN LIEU OF FORECLOSURE STATUTES

The statutes regulating this agreement vary by state, but generally they allow the lender to accept the transfer of the property in full satisfaction of the outstanding loan balance. The purpose of the deed in lieu of foreclosure statute is to provide an alternative to foreclosure, which can be time-consuming and costly for both the borrower and the lender. The borrower benefits by being able to avoid the negative impact of a foreclosure on their credit, while the lender benefits by being able to recover the property without incurring the expenses of a foreclosure. Some of the key provisions in the deed in lieu of foreclosure statutes include requirements for the borrower to provide clear title to the property, for the lender to provide a release of liability to the borrower, and for the agreement to be in writing and properly recorded.

■ REDEMPTION RIGHTS

In some states, there are common law or statutory rights that enable the borrower to bring payments current even after the foreclosure sale, and reacquire title to the property

Redemption rights range from 30 days to several months, depending upon the state

Right to sue for deficiency following foreclosure

In most states, after the amount bid and paid (by the lender or other third party bidder) is credited towards the debt, the note holder generally has the right to sue the borrower for any remaining debt that has not been satisfied

Some states provide for strict foreclosure, which means that the lender, by foreclosing on the collateral, is precluded from suing the debtor for any other outstanding debt secured by the collateral that has been foreclosed

■ ANTI-DEFICIENCY STATUTES OR STRICT FORECLOSURE ACTS

These aim to protect borrowers by prohibiting lenders from seeking deficiency judgments in certain circumstances, such as when the loan was used to purchase a primary residence. The specific provisions of anti-deficiency statutes vary by state, but they typically apply to first mortgages and prohibit lenders from seeking deficiency judgments when the loan is secured by a residential property. This prevents lenders from seeking to collect a deficiency balance from the borrower after a foreclosure sale of the property has occurred and ensure that the loss from a foreclosure is limited to the value of the property itself.

■ HOLDER IN DUE COURSE

The purchaser of a negotiable instrument such as a promissory note becomes a holder in due course, which means he takes the note free and clear of all defenses that the maker may have, except for fraud in the inducement. This gives the purchaser of the note a very privileged status since all the endorsers of this note, including the primary lender, have guaranteed that the payments will be made on the note.

Foreclosure Process

IRS Liens

IRS LIENS THAT ARE JUNIOR TO THE LIEN BEING FORECLOSED

In order to wipe out a junior IRS lien, a senior lienholder must give the IRS written notice of its intent to foreclose the senior lien 25 days prior to such sale. But even if a foreclosing lender gives the IRS the required written notice prior to the foreclosure sale, a right of redemption exists in the United States for 120 days after the foreclosure sale.

Where taxes are due and owing by a taxpayer to the United States, a general IRS lien may be filed with the real property records in the county where the real property is located, and can be collected by the IRS levying upon the property belonging to the taxpayer. The federal taxpayer which owned the property which is sold can redeem the property sold within 180 days after the sale.

Bankruptcy

CHAPTER 7

An automatic stay (a federal injunction that arises automatically by operation of law when the debtor files a bankruptcy petition) enjoins creditors from proceeding to collect a debt without first applying for an order from the bankruptcy court to permit the collection effort

Foreclosures sales held with or without the knowledge by the foreclosing lender of the bankruptcy are void

If the debtor has no equity in the property, and does not agree to make payments that will adequately protect the lender, the bankruptcy court will typically lift the stay after a motion and a hearing which is typically held within thirty days after the motion is filed

Secured debts may be fully secured, or partly secured, and partly unsecured

Secured creditors may be required to accept cash from the debtor for only the secured portion of the debt (right of debtor to redeem at fair market value of collateral)

All non-exempt property belongs to the Chapter 7 trustee (the trustee abandons his interest if no equity, or be required to pay off the fully secured creditor)

Post-petition income and post-petition debts are not affected by the bankruptcy

Chapter 7 debtors must now pass a "means" test which compare their income and expenses to others in the state, or they will otherwise be denied a Chapter 7 discharge and be left with Chapter 13 as an option

Foreclosure Process

Bankruptcy Continued...

CHAPTER 13

The bankrupt debtor has the right to catch up the pre-petition arrearage on a loan secured by a homestead, with interest, over a period of 3 – 5 years, if the debtor keeps post-petition payments current

The bankrupt debtor has some ability to pay a secured creditor the value of the collateral, with interest, over a period of 3 – 5 years.

The Chapter 13 debtor may be able to pay out an otherwise non-dischargeable debt over a period of 3 – 5 years

The Chapter 13 debtor may be able to keep non-exempt property if the payout from the Chapter 13 plan exceeds what creditors would have received in a Chapter 7 liquidation

CHAPTER 11

Business bankruptcy reorganization

The debtor proposes a plan which is voted on by the creditors

A disclosure statement provides information which the creditors use to base their vote for or against the plan of reorganization

Secured creditors will be paid the fair market value of their collateral

Legal Issues: Death of Borrower

Either: The deceased borrower's heirs probate the estate or the deceased borrower's heirs don't probate the estate

Note: A foreclosure after the death of a borrower could be voidable by a probate court for up to four years if the probate court finds that the foreclosure was improper or violated the rights of the deceased borrower or their heirs, it can set aside the foreclosure and restore the property to the estate.

It may be necessary for the secured creditor to open a probate proceeding in order to foreclose and obtain clear title to the property

Interlineations

writing between the lines should be handled with care to avoid confusion and disputes and can have the following consequences:

1. Evidence of modification: Interlineations may be used as evidence of a modification to the original contract if both parties agree to the changes and sign the document.

Foreclosure Process

Legal Issues Continued..

Interlineations Continued:

2. Evidence of mistake: Interlineations may also be used to prove a mistake in the original contract, which could impact the enforceability of the agreement.

3. Confusing the meaning: Interlineations can also make the meaning of the original agreement unclear, which could make it difficult to determine the intent of the parties and enforce the terms of the contract.

Contra Proferentem Rule

Ambiguity construed against the maker or party that drafted the provision.

This can happen if the language of the provision is not clear and specific. This is a principle known as the contra proferentem rule, which states that ambiguities in contracts are to be interpreted against the party that drafted or made the provision.

Parol Evidence Rule

In the context of a deceased debtor, the parol evidence rule is typically relevant in determining the outstanding obligations and rights of the estate, as well as the obligations and rights of the creditor. The rule helps to ensure that the written terms of the contract are enforceable and that parties cannot unilaterally change the terms of the contract by presenting outside evidence. However, there are exceptions to the rule, such as fraud or duress, that may allow for the introduction of parol evidence to challenge the validity of the contract.

Printed vs. Typed Contracts

The validity and enforceability of a mortgage agreement do not depend on whether it is printed or typed. Both types of contracts are considered written contracts and are generally enforceable under the law, as long as they meet the requirements of a valid contract, such as offer, acceptance, and consideration. Printed contracts, such as pre-printed forms, can be a convenient and standardized way to create a mortgage agreement. Typed contracts, on the other hand, offer more flexibility in terms of customization and may be preferred when the terms of the agreement need to be tailored to specific circumstances. In both cases, the terms of the contract, including the amount of the loan, interest rate, repayment terms, and any other agreed-upon conditions, must be clearly stated and agreed upon by both parties.

Effective Date

The date when the agreement between the lender and the borrower becomes legally binding and marks the point at which the lender and borrower must begin to fulfill their obligations as outlined in the contract.

In Summary

Real estate notes are attractive to investors looking for dependable, low-risk assets that offer higher yields than most other investments. As a note holder or lender, you have the ability to control the terms of the loan and the collateral securing thxse loan, giving you more discretion over your investment. Once you understand the due diligence process and how to navigate through the note investing process, you will feel more secure in your ability to make the best decisions for yourself and your wealth building strategies.

ABOUT THE AUTHOR

Since 1980, W. Eddie Speed has dedicated his professional life to the seller financing and non-performing note industry. Over the years, he has introduced innovative ideas and strategies that have positively impacted the way the industry operates today.

Eddie founded NoteSchool which is a highly recognized training company specialized in the teaching of buying both performing and non-performing discounted mortgage notes. He is the owner and president of Colonial Funding Group LLC, which acquires and brokers discounted real estate secured notes. In addition, he is also a principal in a family of Private Equity funds that acquires bulk portfolios of notes. As a leader and innovator in the Note Business for over 30 years, Eddie will tell you that those 30 plus years have prepared him for the incredible opportunities of this current real estate market.



NoteSchool.com | 888-847-9353 | info@NoteSchool.com



www.youtube.com/@NoteSchool | [Twitter.com/TheNoteSchool](https://twitter.com/TheNoteSchool) | [Facebook.com/TheNoteSchool](https://facebook.com/TheNoteSchool)