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Private Money Real Estate Loans: An Overview of Good Reasons

Due Diligence Makes Seconds Come First

Phone Tips To Move Your Note Holders To Action

Buying The Tail of A Note

Key Questions About NPNs

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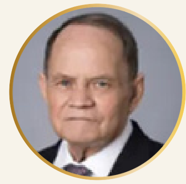
The Voice of the Note Business

NOTE INVESTING

Buying The Tail of A Note

TOM HENDERSON



Buying future payments of a partial is a common scenario for note investors and brokers.

> *"Are you contacting your note sellers who have sold partials to ask them if they would like to sell more payments?"*

Since purchasing partials is the preferred method of many note investors, it would be wise (whether you are a note broker or investor) to know what to expect should the note sellers want to sell more payments before the end of the partial period. In other words, say you or your investor purchased 72 payments of a note that had payments of $2097.64 @ 7.5% for 348 months. Assume the investor will receive a yield of 12.5%. Here is how the partial purchase would look:

N	I/YR	PV	PMT	FV
72	12.5	-105,881.81	2097.64	0

Two years have gone by and the note sellers are in immediate need of cash. They want to know if they can sell 72 more months of payments. This is a common scenario. Note investors will be happy to prolong their cash flow on a note they already own, assuming the payors have been making their payments on time, the property value will support the additional investment, and nothing else has decreased the value of the note. More often than not, the note sellers expect to receive the same $105,881.81 they received the first time. However, the note sellers are about to get "sticker shock" when they discover their prior offer has been discounted approximately 40%.

If you are a note broker and you are not aware of this principle of the Time Value of Money, you are also going to be "shocked" when the note investor gives you a quote for the additional payments due in the future, which will be much less than the original offer. Moreover, how are you going to explain the huge decrease in price to your note seller if you do not understand it?

As a professional broker, you should be preparing the note sellers from this first conversation as what to expect prior to requesting a quote from your note investor.

Before you can explain to the note seller what to expect, you are going to have to know as well as understand how to calculate buying payments in the future.

This problem can be divided into two parts. The first part is to calculate the PV of 72 payments at a 12.5% yield, the same way as above. The next part is to calculate what this PV will be in the future.

To determine what the PV will be at a future date, we must first calculate how many pay periods, in this case months, will be before the note investor will start receiving payments.

Remember, your or your investor originally purchased the right to receive 72 monthly payments. 24 payments have been paid. 24 from 72 is 48. In other words, unlike buying the first 72 payments where the payments will be received immediately, the note investor will have to wait 48 months to receive the next 72 payments. This is going to affect the price enormously, as we shall see.

BUYING THE TAIL • CONTINUED

The last step is to calculate the PV of 72 payments of $2097.64 @ 12.5% to begin 48 months in the future. But how do we calculate payments due in the future? EASY.

First we calculate the PV of 72 payments as we did originally. The answer was $105,881.81. Keep in mind, the note investor will not realize their investment until 48 months in the future.

The next step is to place $105,881.81 into FV; 48 into N; 12.5 into I/YR, and since no payments will be received for 48 months, we insert 0 into PMT. Now all we need to do is to solve for PV. Here are the calculations:

N	I/YR	PV	PMT	FV
48	12.5	-64,386.87	0	105,881.84

WOW!! This was a big drop in the original purchase price. Why the big difference? Because in the second 72 month period, NO PAYMENTS WILL BE REALIZED UNTIL 48 MONTHS IN THE FUTURE.

Remember, the note investor is purchasing cash flow. In the 48-month period where the investor is receiving no payments, there is no cash flow. Therefore, PV decreases proportionally to the time period where payments are not being made.

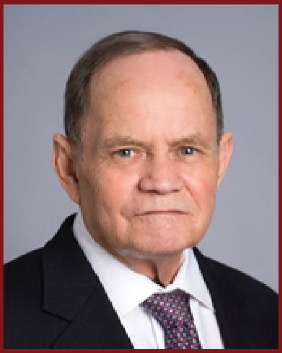
As a side note, did you notice the balance of the note never came into play when calculating the purchase price of the future payments? Although the balance of the note is not necessary to calculate the PV of payments due in the future, you should have an amortization schedule available to show your note sellers exactly what the balance of their note will be at the end of the second 72 month period, as well as the Schedule B in the event of early payoff or default.

This is where I find programs like TValue Amortization Software (www.timevalue.com) to be invaluable. By instantly being able to devise an amortization schedule, which will show balances of the note at all levels of payments for the payors, you will also be able to show the note sellers exactly what they will receive in the event of early payoff or default. Proper preparation makes educating and explaining partials much easier.

BUYING THE TAIL • CONTINUED

To summarize, buying future payments of a partial is a common scenario for note investors and brokers. However, to avoid "sticker shock" you should be preparing the note sellers that the value of payments in the future will be less than the original offer. I like to offset any negative with a positive. After preparing the note sellers for the lower offer they will receive, I point out they can get their lump sum of cash in only a couple of days after signing a contract. Remember, all the due diligence and title work have already been completed from the prior purchase. All that is left is to sign the note transfer.

Food for thought: Are you contacting your note sellers who have sold partials to ask them if they would like to sell more payments? If not, why not?



Tom Henderson earned a BBA degree in Finance and Economics. He entered real estate in 1980 and has mastered the skill of acquiring and disposing of real estate using owner financing, as well as buying and selling notes to achieve astronomical yields.

His "tell it like it is" approach has earned him the respect of his students and peers alike. He is a much sought-after speaker, author and instructor for real estate groups and publications nationwide. Tom has been called "the best kept secret" of instructors in the nation. He is president of H&P Capital Investments, LLC, which buys, sells and trades owner financed notes.

New Product

The Paper Source
The Voice of the Note Business

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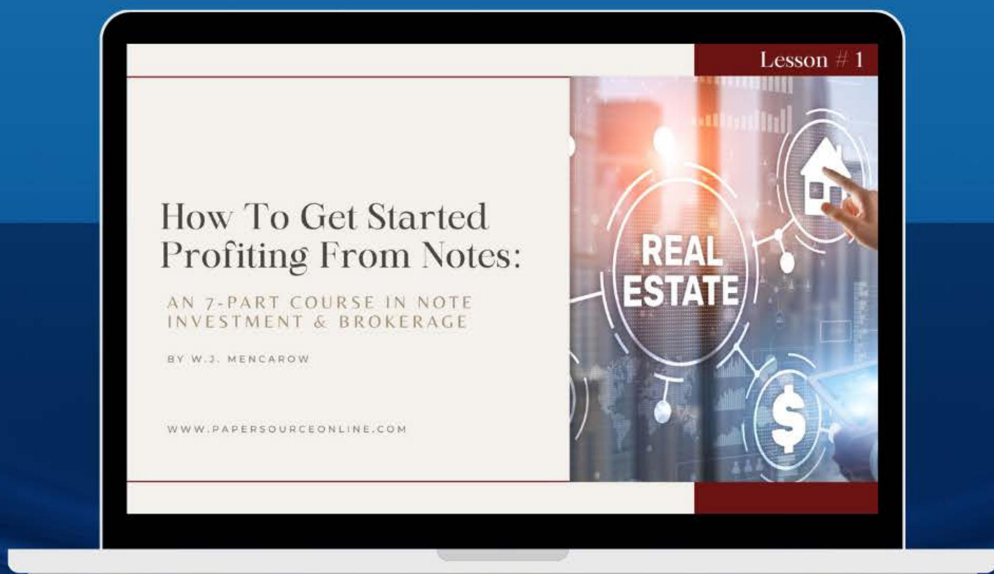

A comprehensive introductory online course in note investment and brokerage, written by **W.J. Mencarow** of **The Paper Source**

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*"This is the most **valuable** and **well-written e-course** I have yet to see."*

— Bill Peeler

Phone Tips To Move Your Note Holders To Action

JEFF ARMSTRONG

Simple phone-sales principles that build rapport, create momentum, and move note holders toward the next step.

> *"Nothing happens unless you pick up the phone."*

Here are some easy phone sales tips that will help you build rapport with your note holders and move them to the next step. These straightforward yet often overlooked phone sales techniques are back to basic principles AND work all the time.

Pick Up the Phone

A buddy of mine has sold note holder leads for over 15 years. He says that most people who buy leads never use them — most don't even open the file! Do people think if you just buy a list of note holders that somehow magically they will get a deal? And even people who are prospecting or generating their own leads online or through networking and referrals aren't calling their leads either. Just plain silly!

So, the first phone sales advice I have is simply to call your note holders. Even if they filled out your form online, call them to go over it with them to make sure it is accurate and to get the story behind the note. Nothing happens unless you pick up the phone.

1. Know who you are calling. Take that extra minute or two and do some quick intelligence gathering on your note holders. I always look up the area code and say something like this when I call: "Hey John, 213 area code, are you in LA? I was there two weeks ago." Or I'll mention a great restaurant I went to in LA, etc.

In addition, I might do a quick Facebook or Google search to look for commonalities and mutual interests. This all helps to build rapport and identify things in common.

2. How can I help you? That's what I ask. Unless they entered a specific request for information or I'm certain I know why their name is in front of me, I ask. No need to talk about a bunch of topics that he or she may have zero interest in; ask what they want. What prompted them to enter their information on your online form? What's going on? You want to know.

3. Call to action. If you are not doing this on every call, just hang up the phone now. Out of all the phone sales tips I can give you, this is #1! Towards the end of EVERY call you want the person to take action. You must take some type of actionable step to move the process forward.

It doesn't mean they accept a price from you and sell you their note at that moment, but you get their commitment to take action on something. Have them send you initial copies of the note and settlement statement and/or payment history.

Here are a couple more items to consider whether you are a note broker or investor:

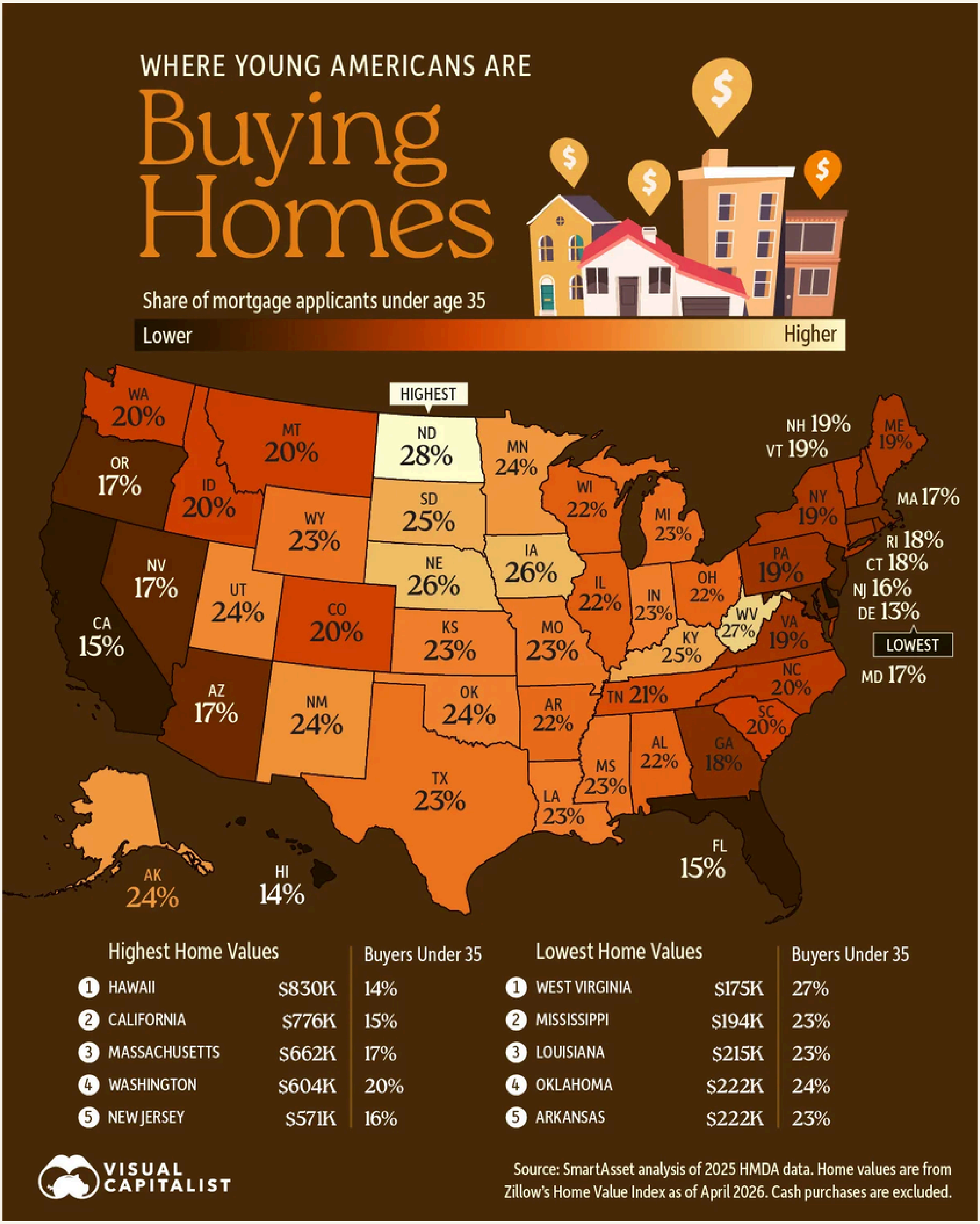
- Numbers Cure EVERYTHING (the business is a numbers game).
- The phone doesn't weigh 500 pounds.

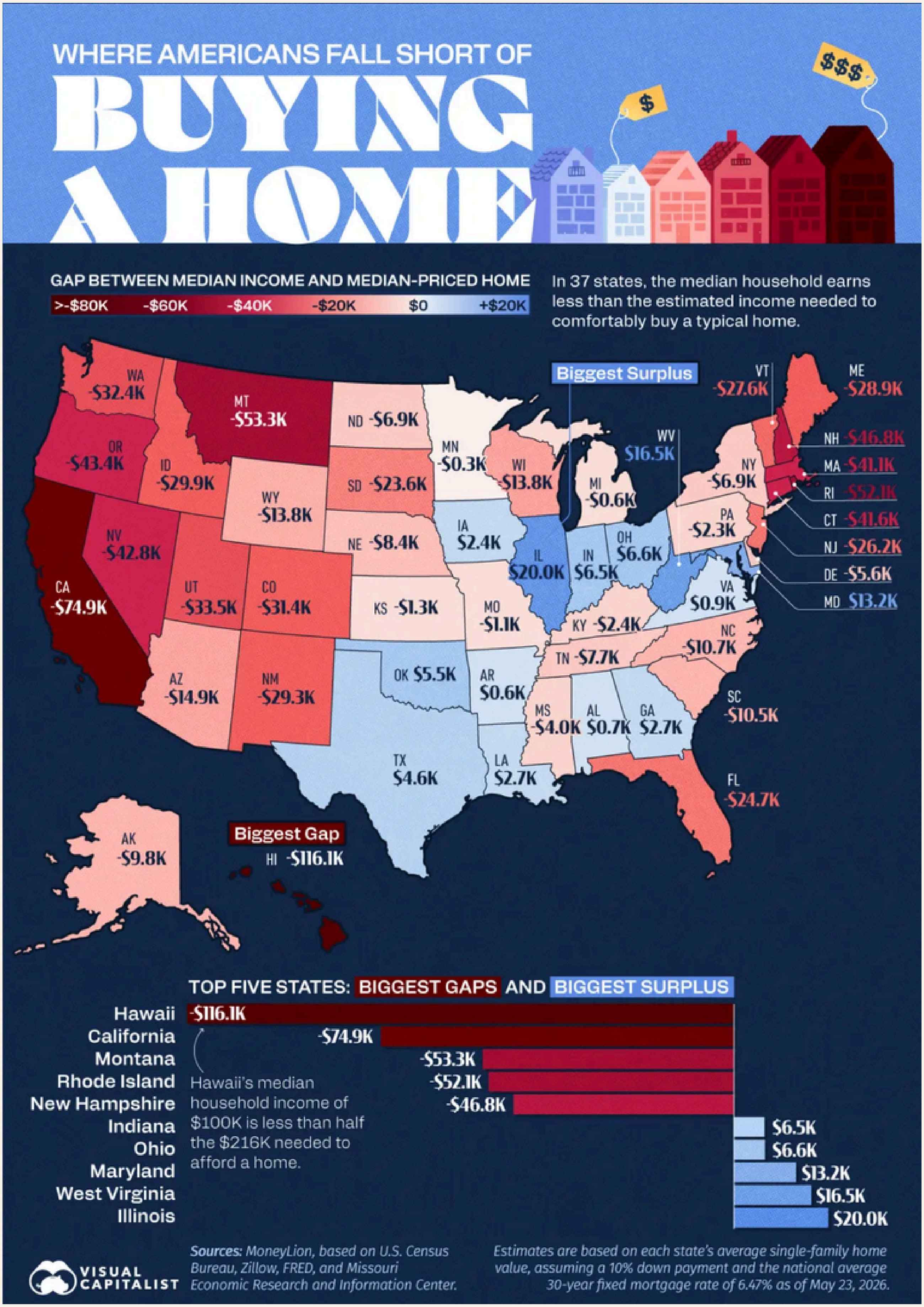
So why not pick up the phone and start making money? Call your note holders when they fill out your online form. Follow up with them on a regular basis until they need the money. And if you want more closed transactions, practice, practice, practice your phone skills. Again, numbers cure everything. Remember success demands action, keep on marketing, it's going to work! TWITA! (That's What I'm Talkin' About!)

Jeff Armstrong of Armstrong Capital has been a note broker and investor specializing in the seller-financed note industry since 1991.

He can be reached by email at jeff@armstrongcapital.com. For information on how he can help you with your note business, your note investments, or to request a quote on a note you currently have.

Visit www.armstrongcapital.com


WHERE YOUNG AMERICANS ARE
Buying Homes
Share of mortgage applicants under age 35
Lower
Higher
HIGHEST
LOWEST
WA 20%
OR 17%
CA 15%
NV 17%
ID 20%
MT 20%
WY 23%
UT 24%
AZ 17%
CO 20%
NM 24%
ND 28%
SD 25%
NE 26%
KS 23%
OK 24%
TX 23%
MN 24%
IA 26%
MO 23%
AR 22%
LA 23%
WI 22%
IL 22%
MI 23%
IN 23%
OH 22%
KY 25%
TN 21%
MS 23%
AL 22%
GA 18%
FL 15%
SC 20%
NC 20%
VA 19%
WV 27%
PA 19%
NY 19%
ME 19%
NH 19%
VT 19%
MA 17%
RI 18%
CT 18%
NJ 16%
DE 13%
MD 17%
AK 24%
HI 14%
Highest Home Values | Buyers Under 35
1 HAWAII $830K 14%
2 CALIFORNIA $776K 15%
3 MASSACHUSETTS $662K 17%
4 WASHINGTON $604K 20%
5 NEW JERSEY $571K 16%
Lowest Home Values | Buyers Under 35
1 WEST VIRGINIA $175K 27%
2 MISSISSIPPI $194K 23%
3 LOUISIANA $215K 23%
4 OKLAHOMA $222K 24%
5 ARKANSAS $222K 23%
VISUAL CAPITALIST
Source: SmartAsset analysis of 2025 HMDA data. Home values are from Zillow's Home Value Index as of April 2026. Cash purchases are excluded.


WHERE AMERICANS FALL SHORT OF
BUYING A HOME
GAP BETWEEN MEDIAN INCOME AND MEDIAN-PRICED HOME
>-$80K -$60K -$40K -$20K $0 +$20K
In 37 states, the median household earns less than the estimated income needed to comfortably buy a typical home.
Biggest Surplus
Biggest Gap
WA -$32.4K
MT -$53.3K
ND -$6.9K
MN -$0.3K
OR -$43.4K
ID -$29.9K
WY -$13.8K
SD -$23.6K
WI -$13.8K
MI -$0.6K
NV -$42.8K
UT -$33.5K
CO -$31.4K
NE -$8.4K
IA $2.4K
IL $20.0K
IN $6.5K
OH $6.6K
CA -$74.9K
KS -$1.3K
MO -$1.1K
KY -$2.4K
AZ -$14.9K
NM -$29.3K
OK $5.5K
AR $0.6K
TN -$7.7K
MS -$4.0K
AL $0.7K
GA $2.7K
TX $4.6K
LA $2.7K
AK -$9.8K
HI -$116.1K
WV $16.5K
VT -$27.6K
ME -$28.9K
NH -$46.8K
NY -$6.9K
MA -$41.1K
RI -$52.1K
PA -$2.3K
CT -$41.6K
NJ -$26.2K
DE -$5.6K
VA $0.9K
MD $13.2K
NC -$10.7K
SC -$10.5K
FL -$24.7K
TOP FIVE STATES: BIGGEST GAPS AND BIGGEST SURPLUS
Hawaii -$116.1K
California -$74.9K
Montana -$53.3K
Rhode Island -$52.1K
New Hampshire -$46.8K
Indiana $6.5K
Ohio $6.6K
Maryland $13.2K
West Virginia $16.5K
Illinois $20.0K
Hawaii's median household income of $100K is less than half the $216K needed to afford a home.
Sources: MoneyLion, based on U.S. Census Bureau, Zillow, FRED, and Missouri Economic Research and Information Center.
Estimates are based on each state's average single-family home value, assuming a 10% down payment and the national average 30-year fixed mortgage rate of 6.47% as of May 23, 2026.
VISUAL CAPITALIST

PRIVATE LENDING

Private Money Real Estate Loans:
An Overview of Good Reasons

DAN HARKEY

Private money is in great demand, and that demand will increase as interest rates rise.

Borrowers who expect low rates with banks must be ready for a seemingly endless maze of paperwork demands and the frustration that they will experience in the unclear, drawn-out processes.

A subset of the real estate lending business exists where the loans are funded by private party investors rather than banks or other institutional lenders. This is referred to as bridge lending, private party lending, or hard money lending. The purpose of these privately funded loans is to serve as a short-term or intermediate term borrowing solution for problematic borrowers and/or property related deficiencies. Borrowers who experience problems such as unexpected bank declines, not having the time for long and drawn-out complex banking processing and underwriting requirements, poor or marginal credit qualifications, needed property upgrades, paying off judgments and liens, curing defaulted payments arrearages may now have an excellent alternative lending solution.

This solution will solve their immediate problem and allow them time for future planning such as property refinancing into a longer-term lower interest rate loan or sale of the property. The term of these loans is usually for a period of 1 to 10 years. Most privately funded loans are made and/or arranged by real estate and mortgage brokers who represent private party investors and act as their agent and fiduciary.

Private party investors are also called lender/beneficiaries because their names are placed on the promissory note and recorded deed of trust as the lender/beneficiary. The borrower will sign a promissory note which is a promise to pay and sign a deed of trust which is recorded with the closing of the loan transaction.

Possessing a signed and recorded deed of trust by an investor proves that he/she has a security interest as a matter of public record in the subject collateral property. Purpose of this article: This article is meant to be a general educational overview of the private party lending industry and to list circumstances why real estate borrowers may benefit from these loans. This overview is not intended as a solicitation for loans. Licensing: Most states require both state and federal lender licenses for single-family consumer lending of 1-to-4 residential units, both owner and non-owner occupied. Many states do not require a license for 1-to-4-unit business purpose lending. A few states require a license for all lending activity. Licensing fees make an excellent money grab for state governments as an alternative to forced taxation.

Many states do not require a license to make loans on 5 or more residential income units, commercial, industrial, and land loans. For all types of properties other than single family 1-to-4 units licensing and regulations to engage in the business of procuring loans with the expectation of compensation will differ in each state. Also, this will depend on the type of real estate, purpose of loan, use of loan proceeds, use of the property, location, and conformity to zoning and building regulations. Generally, the real property lending industry is governed by both federal and state real estate laws, contract laws, agency laws, securities laws, and in some cases Department of Labor laws. Department of Labor laws are involved for pension plan related trust deed investors who are governed under The Employee Retirement Income Security Act of 1974 (ERISA).

Individual Retirement Account (IRA) investments are regulated by the Internal Revenue Service. Most of the laws governing what a plan trustee or plan fiduciary may or may not do mirror each other. California regulatory oversight for the private money lending industry: California has a long history of real property transactional regulations affecting private money lending, including a required real estate license by the state for all individuals who engage in the business of making or arranging loan transactions with the expectation of compensation. Additional state regulations apply for contract laws, real estate laws, trust accounting, and agency relationships. For personal property that is attached to the real property and noticing of the lien the Uniform Commercial Code (UCC) applies.

There are also state required disclosures for both the borrower(s) and trust deed investor(s) which is the responsibility of the procuring mortgage broker to complete and get signed by the respective parties. The reason for pointing out all the regulations is to remind you that the business of making and arranging privately funded real estate loans is highly regulated. Many states outside California have fewer regulations, and some states have little or no regulations. The private party lending industry has separate underwriting guidelines in almost all cases and a less rigid process than institutional or bank lenders. Standards for analyzing the borrower(s), credit, income, and value of the collateral property are more flexible.

Whether considering government regulations, stricter bank underwriting, borrowers' special circumstances, or COVID-19 related business interruptions and personal life disruptions the private money lending industry provides a substantially more flexible option that is currently in high demand. This demand will only rise in the future as interest rates start to creep up because of inflationary pressures and/or institutional lenders underwriting tightens up or they decide to delay all lending altogether.

Borrowers: Real estate borrowers will always choose the lowest interest rates and most favorable terms for their own circumstance.

And they should! But banks, institutional lenders, and government sponsored entity lenders (GSEs) who have the lowest interest rates and best terms will also have much more rigid underwriting and approval processes that limit, delay, or possibly kill many loan approvals. Borrowers who expect low rates with banks must be ready for a seemingly endless maze of paperwork demands and the frustration that they will experience in the unclear, drawn-out processes.

A mortgage broker who offers trust deed(s) or mortgage investments to the public must be aware of the federal and state securities exemptions and safe harbor rules. Various federal securities exemptions from registration are commonly used to comply with federal securities laws.

Federal exemptions for privately funded real estate loan transactions and real estate loan related pooled investors are usually found in Regulation D, Regulation A, Rule 147 and 147A of the Securities and Exchange Commission Rules. Exemptions and definitions can be found on www.sec.gov.

In California, the Corporations Commissioner's rules cover the offer and sale of trust deed investments. There are several exemptions from registration. These include the private offering exemption 25102, specifically safe harbor rules contained in 25102(e) (f) (n), 25113, and 25102.5.

The fractional note exemption 25102.5 covers multiple investors up to 10 investors (lenders / beneficiaries). Under the 25102.5 exemption a maximum of 10 private investors can co-invest into a single trust deed as tenants-in-common.

The fractional note exemption rules are defined in the Business & Professions Code 10237-10238, 10232, and Civil Code 2941.9. Interested parties should consult a real estate or securities lawyer specialist. The investor's individual beneficial interest portion of ownership would be represented by the percentage of the entire trust deed that they own. For example, if the trust deed investment was for $1,000,000 and the investor purchased $200,000 then they would own a 20% undivided interest as tenants-in-common. He/she would rely upon the loan servicing company to collect the payments from the borrower, then forward a percentage of the total to each individual investor. This process is subject to a well drafted servicing agreement between the loan servicer or collection agent and the investor.

The investor will give or convey a certain number of delegated responsibilities/rights to carry out the payment collection function as an agent/fiduciary until the loan is paid off and a reconveyance is issued. Private party investors may invest individually or into pooled type of entities with other investors. Private party investors include individuals, family trusts, corporations, IRAs, and pension plans and family offices. Here is a partial list of reasons that private lending industry participants have suggested as to why private loan transactions could benefit borrowers.

PRIVATE MONEY • CONTINUED

1. Fast loan approval with possible 2-to-4-day funding for bank declines and fallouts. Maybe the bank has already done significant underwriting including opening escrow & title, obtained an independent appraisal, and completed application and financials. Some private lenders may be able to use bank's information to fund faster, particularly when they have a mortgage pool or immediate capital available to fund.

2. Debt consolidations of businesses, consumers, or a combination of both. In most cases, the loan may be used for debt consolidation that will lower the borrower's total monthly payment obligations. Also, when the loan is a second deed of trust the averaging of the interest rate on the first and the second may be calculated to show net-effective rate. This is the averaging of the two rates. This should give the borrower some breathing room to improve his/her credit to then obtain a long-term bank loan.

3. Payoff loans coming due or past due. Refinance and payoff existing first, second, and third lien position loans which may be coming due. This is available for both owner and non-owner occupied residential and commercial properties.

4. Borrow money secured by the real estate with the intention to get cash out. The primary security is the based upon the protective equity of existing real estate. The cash out may be used for most business and consumer purposes. The Federal Government and some states such as California require a special license to engage in consumer purpose lending.

5. Second lien position or junior lien loans on both owner and non-owner-occupied dwellings for business purpose.

First National
Acceptance Company

Real Note - *Real Purchase*

This single-family rental in Temple, TX came to us with 44% equity, over 4 years of seasoning, and no credit score on file - proof that a strong asset can speak louder than a credit file.

Balance: $92,309
Equity: 44%
Credit: No Score
Seasoning: 50 Months

Photo is only illustrative and does not represent the actual property purchased.

6. Construction completion, rebuild or upgrade a property that is in poor or marginal condition. The loan is usually necessary because the collateral property and/or the borrower does not meet bank underwriting guidelines in its distressed or partially completed condition. Consideration by the lender will be given for the as-is-value and the as-completed-value.

7. Marginal credit worthiness where a borrower is not bankable, and approval of a loan request is primarily property equity driven.

8. Payment consolidation is possible. Borrower may need to catch up and give themselves breathing room for accrued payments. One may refer to this as a "fresh start loan."

9. Borrower may own and operate a cash-based small business that shows limited financial strength on paper. The borrower will still be required to prove that they or he/she can make required payments.

10. Leverage equity of existing real estate developed over time to borrow additional funds to purchase additional investment properties or invest in a business enterprise.

11. Purchase a property with a combination of cash down payment, sweat equity, and/or seller's agreement to carry back a subordinated junior lien. The seller of the property would have the borrower sign a promissory note and a deed of trust with a set interest rate, payment schedule, and due date. The subordinated second would be recorded at the same time of the first trust deed but with a recording number that is after the first.

12. Inherited property where successor trustees or beneficiaries need funds for distribution to the beneficiaries, pay legal costs of the estate, or to fix up the property for future rental. Another option is to fix up and be sold on the open market.

13. Loan on unimproved raw land. Loaning on land can be a complex process. Is the land part of an existing subdivision referred to as an infill lot, a commercially or industrially zoned parcel within a subdivision, or a larger parcel held for future development? Borrower may need to use the property as collateral to raise funds to pay for future entitlements including engineering, architecture, various reports, and fees to come up with a fully entitled parcel ready to build. The borrower would pay the loan off as part of the construction loan.

14. Retail strip and community centers, industrial or other properties which need upgrades or repositioning. Many centers are in distress where tenants have not had the ability to make their rent payments.

15. Fix and flips loans for high frequency purchasers to purchase distressed property, rehabilitate with the expectation to resell and turn a quick profit. Borrowers need both experience and some of their own capital at risk.

16. Litigation settlements (e.g., a partition suit), buy a partner out or pay off a pesky family member such as an ex-spouse.

17. Pay off civil judgments and liens, including arrearage in property taxes, association dues, and federal and state tax liens.

18. Sale of existing promissory notes and deeds of trust to 3rd-party investors, usually at a discount, whether performing or non-performing. This is a way to free up cash.

19. Hypothecation or pledge of a promissory note and deed of trust owned by a borrower (assigning note and deed of trust to an investor) as collateral for a new loan.

20. Cross collateralization of more than one property to meet the equity requirements of the lender. Borrower would sign one promissory note but may have recorded liens that encumber 2 or more properties.

21. Small mobile home or trailer parks where the property does not meet the underwriting standards of institutional lenders.

22. Airbnb-type rental income properties. Financials will be necessary to prove up the ability to make payments.

23. Churches, synagogues, restaurants, bars, automotive repair shops, body repair shops, gas stations, and other single-purpose security properties.

24. New ground up construction or construction completion for a partially completed project. Most requests are a result of borrowers needing to fund more money into the project to complete the project when their own personal capital or existing construction loan proceeds have been depleted.

25. Collateral is a combination of real and personal property such as a motel, restaurant, carwash, or gas stations with mini markets. Valuation and decision to make the loan must be on the real property only. A trust deed will be recorded to encumber the real property and a UCC-1 financing statement to be filed with the Secretary of State to encumber personal property.

26. Long-term lease on commercial property has or is expected to expire soon. This will cause a vacancy and a disruption in rental income. If the master tenant is leaving this will also cause disruption with other smaller in-line tenants because the master tenant is responsible for the primary draw of foot traffic to the center. Banks will usually not make this loan. This loan is usually made as a bridge loan until the owner obtains a long-term lease with a credit worthy tenant and manages the center back into stabilization.

27. Credit approval is subject to highly sophisticated lease analysis with multiple tenants having different terms of leases including length, lease rate, and lease provisions. Maybe some tenants are on long term leases, and some are on month-to-month tenancy. Lease documents may include go dark provisions for the anchor tenant or provide for lease cancellation in the event of excess vacancy or loss of an anchor tenant.

28. Mutual property access easements for ingress/egress, or complex rights of usage such as reciprocal parking agreements. Many properties such as churches and retail shopping centers sign agreements with multiple property owners to use the entry/exit of the property or the parking in certain ways or at certain times.

29. Foreign nationals with and without a social security number. The borrower must have a US bank account(s). The borrower must have a service of process agent which can be arranged.

30. “Notice of a substandard condition” or “notice of property noncompliance,” is recorded on public records by a building department notifying the public that the property is out of conformance, or in disrepair for building and zoning codes. Institutional lenders will not make these loans. The bridge loan funded by private lenders will provide funds to make substantial improvements and modifications to bring the property up to the acceptable building, safety, and zoning standards.

31. Non-conforming property that does not comply with current zoning and building standards. As a result, there are strict limitations on the ability to repair or replacement of the structures in case of destructive acts such as fire, flood, windstorm, vandalism, earthquake. The property may not be able to be rebuilt to an acceptable level after the destructive event occurs.

32. Earthquake seismic retrofit. Many older properties need to be upgraded with engineered reinforced steel frames bolted into the existing structure, and walls shored up with steel support fasteners to withstand earthquakes.

33. Tenant improvements. Owners of commercial buildings need to provide funds to install interior and/or exterior improvements to satisfy the owner’s and the prospective tenants’ leasehold improvements.

34. Cannabis related properties, both manufacturing and retail facilities. Some states have legalized lending in cannabis related operations and some states have not.

When borrowers discover that they were declined for a bank loan, or unsuccessful at closing for any reason they may discover that there is an excellent alternative funding source that provides much greater flexibility in the processing, underwriting, approval, and speed of funding. Interested parties should consult a highly qualified lending specialist to help in their circumstance.

Trust deed investor expectations: Individual private parties, private pension fund trustees such as owners of 401-Ks and IRAs, and family offices invest in trust deeds. Reasons for investing include perceived lesser risk, consistent monthly cash flow expectations and a comparatively higher annualized yield. Also, the time outstanding for the investment from the initial date of investment until the investor regains their capital is shorter to intermediate in time, usually 1 to 5 years.

Investors will expect to receive a written disclosure package from their mortgage broker source that outlines the terms and conditions of the proposed investment. This will include a summary explanation of the loan transaction, borrower’s application, credit report, and independent appraisal of the collateral property.

PRIVATE MONEY • CONTINUED

It is necessary for an investor to spend adequate time in reviewing the disclosure package to understand material facts and risk for the purpose of making an informed and prudent investment decision.

Interested borrower and investor parties should seek out loan broker professionals who understand the required regulatory compliance, transactional processing and loan underwriting, and correct documentation. Lastly, interested parties should seek out someone with an experienced track record to act as their agent and source of new trust deed investment opportunities. Having the loan broker act as a servicing agent, collecting the borrower's monthly payments, and handling all communications all the way through the loan payoff will be very helpful.

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This article is not intended as legal advice. Consult an attorney qualified in the subject matter before you act on anything in this article.

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DUE DILIGENCE

Due Diligence Makes Seconds Come First

Sándor Lau

"You should know more about the note than the seller does."

I specialize in buying nonperforming junior liens on residential properties -- but not just any properties. I'm looking for cases where the homeowner is paying the first mortgage, one of the strongest indicators they are willing and able to resume paying the second mortgage after years of default.

These defaulted loans sell for a discount, but the holder has the legal right to collect in full. It doesn't often happen that way, but if you buy for a great deal, and give the homeowner a good deal, everybody wins.

The loans that meet my criteria are primarily second mortgages and home equity lines of credit (HELOCs) originated in the real estate boom of the mid-2000s. I'm always looking for evidence that borrowers will voluntarily cooperate, and am happy to say that I haven't yet had to complete foreclosure.

In the second lien mortgage investing business, you have a limited window of time to make the right decisions on properties you have never seen, occupied by people you cannot contact until after you have made your decision.

Buying loans, you get a spreadsheet of borrowers and properties (known as a tape), and a very limited time period to decide how to invest tens or hundreds of thousands of dollars or more. You don't have to be right all the time, just most of the time. If I have the choice between taking longer to do perfect research, or completing good research quickly, I'll do it quickly. You're buying these loans for the price of a used car, not betting the farm on any single one.

No one can accurately predict the resolution of defaulted loans 100% of the time. There will be loans that look gold-plated from a distance, full equity, high-earning borrowers who pay their first mortgage like clockwork, beautiful houses.

Some of these loans will not work out as you hoped. There will be loans on broken down houses that you didn't want and didn't pay much for that will produce extraordinary returns.

To predict the future as accurately as possible, I'm looking for three things: security, will, and capacity.

- **Security:** Is the second lien on the property still valid? If the lien was voided in chapter 13 or chapter 11 bankruptcy, it's uncollectible and worthless. If the house was foreclosed on and is now owned by someone else, the former homeowners no longer have emotional equity and you own an unsecured debt more like a credit card or medical bill.

- **Will:** How badly do the owners want to keep their home? The number one indicator of their will is their payment history with their first mortgage. If they are not able to pay their first mortgage, they most certainly can't afford to pay their second.

- **Capacity:** You can't get blood from a stone. I try to find all indicators I can regarding the homeowner's income and assets. In the universe of defaulted or bad loan investing, I'm looking for the good bad loans, the ones where otherwise responsible people were caught by the recession and made this one financial mistake, but are now on their feet again and want to make it right.

If you invest in first mortgages, it is hard to tell whether the house is vacant or occupied or by whom, how far behind the taxes are, and whether or not it is a meth house. For seconds buyers, the status of the first mortgage is the canary in the coal mine.

DUE DILIGENCE • CONTINUED

Tools: There are five main tools I use to check on a borrower's security, will, and capacity. These tools are: Zillow, credit, TLO, bankruptcy, and title.

I'm always looking for reasons NOT to buy a loan. If there's one deal killer on a loan, I can stop wasting my time and move on to another. The note seller's tape of information represents the best data they have available. In my many years in this business, I have yet to see one instance of a seller deliberately misrepresenting information. Yet I also assume everything on the tape is wrong until I independently verify it, because I have yet to see a tape where all the information is correct. The banks that are the sources of this data have a lot on their hands. When they're unloading notes, they're doing it in bulk, and may not even know the details themselves. If you scrub right, you should know more about the note than the seller does before you finish.

Zillow: While data on Zillow is estimated, it is a convenient place to get a lot of data from one website. Zillow will probably tell you property characteristics like square feet, bedrooms, bathrooms, lot size, and when the property was last sold. It may also tell you whether there has been any foreclosure action on the property or indeed whether the property has already been foreclosed.

Zillow also gives you a link to the county tax assessor that will often give the current owner of the property. If current owner is someone other than the person obligated to the debt on the note, your lien may be unsecured, and therefore much more difficult to collect. If you can't get to the county assessor from Zillow, use Netronline.com to get to the assessor, or even better, the county recorder to check what public ownership and lien records are available.

While Zillow is a great starting place, it is not a good ending point. Zillow rarely provides false positives, but watch out for false negatives. If Zillow provides data that a property was in foreclosure at a certain date, it's unlikely they're making it up. But absence of foreclosure data on Zillow is no guarantee the property is not currently in some stage of foreclosure. Dig deeper. Before you buy a loan, check multiple valuation websites and use your own judgement to estimate the worth of the home.

TLO: Transunion's TLO product gives note investors incredible amounts of information on homeowners instantly at reasonable costs. In a few keystrokes, TLO can provide fairly reliable information on someone's SSN, address of residence, phone number, and property ownership. On the property, it will give a good guess as to who the current owner is, and what liens are recorded against it.

Like with Zillow, there are very few false positives, but absence of information does not indicate absence of facts. Dig deeper.

Credit: Many sellers will provide you with borrower credit reports that will indicate among other things who services the first mortgage, what the monthly payment amount is, what the current unpaid principal balance is, and when the last payment was. The credit report was already a month old the day it was pulled, and the report provided to you may be months older than that.

I like having my own account to pull fresh credit if I'm going to spend thousands of dollars on a note. I use soft pulls which are allowed without the borrower's written permission for purposes such as evaluating them for potential future business, or checking on borrowers in your portfolio. Soft pulls do not affect the borrower's credit score and if you look at your own credit report, you will probably find that credit card companies may already be doing soft pulls on you.

In addition to information on the first mortgage, the credit report will usually provide the borrower's credit score, birthdate, employer, history of bankruptcies and judgments, and how they are performing on their other debt obligations. These are unlikely to be false positives, but keep digging in public records to verify.

A final note on credit: the single most important thing you're checking for is the first mortgage. Sometimes the credit report will explicitly state that the first mortgage was modified and other times it may be modified without the report saying so. If the loan period is anything other than 30 years or 15 years, it is likely to be modified. If it's longer than 30 years, it's almost guaranteed to be modified.

The credit report will usually say the current unpaid principal balance (UPB) of the loan. If the borrower got behind on the loan, they may have a balloon payment due at loan maturity that is not reflected in the UPB. Look for a dramatic difference in the origination amount of the loan and current UPB.

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DUE DILIGENCE • CONTINUED

If the original UPB was $100,000 in 2005 and the current UPB is only $50,000, and the loan shows a modification to 40 years after the borrowers were behind for nine months or more, you may have an unpleasant surprise.

If the house is worth $100,000 and the first loan payoff amount is $50,000, you have $50,000 of equity to protect your second position lien. But if the second UPB is $50,000, and there is a $50,001 balloon representing the back interest and fees the borrower accrued while they were delinquent, the credit report may not show the balloon. Your equity position could be at risk in bankruptcy as the borrowers are underwater on the first mortgage. The credit report may give you hints on this subject, but the title report could be more definitive.

Title: The title report or ownership and encumbrance report (O&E) shows who the county recorder's office lists as the owner of the property and recorded liens against it. If the first mortgage has been modified, and if you are lucky, that first loan's modification may be recorded, though more likely it is not.

Title reports will typically cost you around $100 and take a day or two to get back to you. I usually pull title late in the game once I have enough confidence that a loan is very likely to meet my criteria. But if I'm going to spend the price of a used car on a loan, I will always pull title.

The sellers of second liens will bundle their inventory together for sale and represent that the liens are in second position. Checking title will verify whether they are correct. Title may tell you the lien you were ready to buy is not in second position, but in third or fourth position. It doesn't happen often, but I recently passed on what I thought was an exciting loan on a luxury $500,000 condo that had a $200,000 first mortgage and a million dollar second. The loan I was going to buy was in third position.

You may find that there are utility or HOA liens or contractor's liens on the property, all further evidence that the homeowners are just scraping by, and have nothing else to pay their second mortgage.

DUE DILIGENCE • CONTINUED

But if you're lucky, you may also find the unusual surprise that you are in first position. During the mid-2000s boom when HELOCs were flowing freely, occasionally people with free and clear houses took out home equity lines of credit on their unencumbered homes. And in the past decade, some people have also paid off their first mortgages moving their second mortgages into first position. I've been lucky enough to buy exactly one of these.

Bankruptcy: I always check bankruptcy on every loan through PACER.gov. Bankruptcy makes many other people afraid, and gives you far more information than you would otherwise have about a borrower's income and assets. Borrowers usually file chapter 13 bankruptcy in order to strip their second mortgages. Only the 1/3 of chapter 13 filers who complete their 3-5 year bankruptcy plans with perfect payment histories actually get their second mortgages stripped, though.

Chapter 7 bankruptcy allows borrowers to shed their unsecured debts like credit cards and medical bills, but except in very rare circumstances, keeps second liens intact. Borrowers no longer bear personal liability to pay their liens, but second lienholders have the right to foreclose once the bankruptcy is complete. People don't pay their loans because a piece of paper says they have to. They pay because they want to keep their homes and I have found post-chapter 7 homeowners as willing to pay as others.

Due diligence is always a balance of measuring the value of time versus accuracy. Part of maximizing efficiency of time is being fully prepared when an opportunity arrives by having your systems in place. The time to prepare for your next buying opportunity is right now.

Sándor's book "*Intoxicating Assets: Notes on How to Be the Bank, Invest in Real Estate Without Tenants, and Why Second Mortgages Come First*" is available at www.notedfinancial.com

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NPNS

Key Questions About NPNs

APRIL SMITH

Thinking about purchasing delinquent or non-performing notes (NPNs)? Here are key questions you must ask when considering "bad" mortgages.

PRE-PURCHASE DUE DILIGENCE QUESTIONS

What does the data tell you about a particular pool? When you scan the data, does anything in particular jump out at you? What could it mean? Is there any way to further investigate possible anomalies? Is there anything unusual (good or bad) that could affect the bid price, representations and warranties or other considerations? How many servicers are involved? How many lenders? Where are the properties? How homogeneous is the pool?

PROPERTY QUESTIONS

Current BPOs (Broker's Price Opinions) are the beginning of your research. Sale prices are what you need. Ignore online estimates of market value.

Did the property exist when the mortgage was made? Is the appraisal on the correct property?

The use of a trusted BPO company is paramount. Not all BPOs are created equal. This is one area where you don't want to scrimp.

Equally important is turnaround time, ability and willingness to answer questions and provide feedback, and additional services such as occupancy checks. Occupancy is an important factor in determining the likelihood of a workout.

There are a number of ways to determine whether the borrower is occupying the property as his primary home. This information is invaluable in determining how to proceed once you own the mortgage.

BANKRUPTCY QUESTIONS

Has the payor filed for bankruptcy? When? What type? What is the current status? Perform your own bankruptcy search; the payor may have filed yesterday. What if every payor in the pool has filed bankruptcy? Not likely, but worth thinking about.

LEGAL QUESTIONS

Does the chain of title run to the entity who is selling the mortgages? Are the mortgages recorded and valid? Courts have invalidated foreclosures when note holders cannot prove ownership of the mortgages. Imagine that you purchase a pool of distressed mortgages. You foreclose on some of them only to find at the last minute that your interest is not perfected and that the chain of title is invalid. Chances are you won't be able to move forward, and you will have to spend time and money to correct the problem.

SERVICING QUESTIONS

Has the collection, default and foreclosure process to date been in statutory compliance? Be sure to review servicing and collection records to determine whether state, federal and even city and county mandates have been complied with. What is the status of each mortgage? How far into the process is the mortgage, and what are the remedies? Is a mortgage that's represented as 90 days delinquent really 90 days delinquent? These issues can be expensive; a servicing review alleviates the possibility of a costly surprise down the line.

It is your responsibility to make sure that the status of each of your mortgages is what you think it is.

WORKOUTS

This is the biggest challenge facing investors and servicers today.

Each investor has a different philosophy about how the communication issue should be approached. It is up to you to determine which mortgagors are worth approaching after the purchase and which are not. It is illegal to have any contact with the defaulted mortgagor before you own the mortgage.

NPNS • CONTINUED

COMPLIANCE

Suppose you buy a pool of mortgages and begin to work with the payors to modify the notes that warrant it, at the same time proceeding with foreclosure on those where modification is not possible. One of the mortgagors decides to have a "forensic audit" performed on his mortgage.

During the audit, it's discovered that at the time of origination a violation of the Truth in Lending Act occurred. The mortgagor obtained a cash-out refinance of his primary home, and the right to cancel (commonly known as the right of rescission) was not executed correctly. The validity of the mortgage from the time of origination is in jeopardy; the right to rescind may be deemed still open, even years after the mortgage was closed.

Now go one step further and imagine that the attorney who ordered the forensic audit assembles a class. He then initiates a class action lawsuit against the originators, servicers and owners of this pool of mortgages. While this is unlikely, today's news is full of situations nobody thought would ever occur.

They say knowledge is power. In this case, knowledge is money. A compliance check to substantiate conformity with RESPA (settlement procedures), TILA (disclosure of APR, right of rescission) and a review of the title to determine the status of the lien and exceptions to the title may be money well spent.

REPS AND WARRANTIES

Right now you may be saying to yourself, "But I'll have representations and warranties for some or all of this." Now may be a good time to remind yourself that reps and warranties are only as strong as the seller who makes them. In the recent past we've seen that no institution is safe from takeover, bankruptcy or oblivion. A prudent investor will proceed as if his reps and warranties may be limited or non-existent in the future.

ABOUT THE AUTHOR:

April Smith is the owner of April Smith & Associates, Inc. She has over three decades of multi-layered experience in the field of mortgage finance.

She continues to provide hands-on strategy and planning for both new and established clients. She is an active speaker and educator to the industry. April is a recognized authority on mortgage due diligence.

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