

## FINANCING AND APPRAISALS

### A. INTRODUCTION AND ROLE OF COUNSEL IN FINANCING TRANSACTIONS

1. [6:1] **Scope Overview:** Buyers rarely purchase real property without concurrently procuring a loan, secured by the acquired property, to fund most of the purchase price. The structure, negotiation and documentation of a real property secured loan is therefore an integral part of the purchase and sale process.

➡ [6:2] **PRACTICE POINTER:** This Chapter discusses real property secured financing from the perspective of *counsel's role* in negotiating, reviewing and documenting various instruments evidencing loans obtained in purchase and sale transactions. The subject of secured real property financing is vast and includes a broad range of issues not covered in this Practice Guide. General practitioners new to the subject are well-advised to associate or consult with appropriate experts before launching too deeply into financing transactions.

- a. [6:3] **Financing despite “all-cash” transaction:** Many purchase and sale matters are commonly referred to as “all-cash” transactions; but this does not necessarily mean the buyer is not procuring a loan. The term “all cash” is used generically to refer to the fact the *seller* will be “cashed out.” In other words, “all cash” often simply means the total purchase price will be paid to the seller in cash at the closing (as opposed to the seller taking back a promissory note for part of the purchase price).
- b. [6:4] **Seller-related financing issues:** Buyer’s counsel typically deals with financing issues; however, seller’s counsel often has an agenda of financing issues as well. For example:
  - The seller usually must make arrangements to *pay off its existing loan* concurrent with the closing. This entails such things as arranging for reconveyance of the deed of trust, return of the original promissory note and deed of trust to the seller and, sometimes, payment to the lender of a prepayment charge (§6:250 ff.).
  - In addition, if the seller accepts a portion of the purchase price in the form of a loan to the buyer (i.e., seller financing), seller’s counsel will usually be responsible for documenting that loan.
  - Other seller-related financing issues arise if the buyer wants to take over the seller’s existing financing (see §6:310 ff.).

## 2. Counsel's Role

- a. [6:5] **Factors affecting counsel's role:** As with other aspects of a purchase and sale transaction, counsel's role in connection with financing will be determined by such things as the client's level of sophistication, the complexity and type of loan, cost considerations, timing issues, etc.

- (1) [6:6] **Type of property:** Perhaps the most important factor in determining counsel's involvement with financing is the kind of property involved. For example, in single family residence transactions financed by institutional lenders, the loan application process is fairly straightforward, and the loan documentation is standard and generally nonnegotiable. Consequently, in such transactions, counsel will at best be only minimally involved in the financing process.

By contrast, counsel's role tends to broaden in multifamily or commercial loan transactions and as the financing becomes more complex.

- (2) [6:7] **Seller financing:** The role of counsel (for both buyer and seller) is most intensive in a seller-financed transaction. Here, the parties have relatively equal bargaining strength, more issues are susceptible to negotiation, and the documentation is not precast in the lender's standard, nonnegotiable, preprinted form.

- b. [6:8] **Procuring financing:** Procuring financing—and certainly procuring the “best” financing—is a time-consuming process. It is rarely a process that should be handled by counsel.

If an attorney billing at an hourly rate handles this task, obtaining a loan becomes inordinately expensive. Equally important, however, is the fact lawyers are generally not the most qualified people to procure loans. Lawyers generally do not keep current on rapidly-changing interest rate fluctuations; they do not necessarily maintain strong, ongoing relationships with lenders; and they are usually not up to date on the latest changes in lending practices.

In most cases, the buyer either procures financing itself, uses the services of its real estate broker, or employs a professional loan broker (see ¶6:160 *ff.*).

- c. [6:9] **Overseeing loan application and processing of loan approval:** Counsel frequently needs to assist the borrower in garnering and organizing appropriate information for the loan application (appraisals, financial information, purchase agreements, title documents, leases, estoppel certificates, escrow instructions, etc.). Thereafter, counsel may need to review the loan commitment (if one is to be issued); assist the buyer in satisfying prefunding conditions of the loan; review title and negotiate title endorsements; and coordinate with

the lender and the escrow officer so that the loan is funded concurrently with the closing of the purchase and sale.

- d. [6:10] **Negotiating terms of loan and reviewing loan documents:** Once a prospective lender is designated, counsel might become involved in negotiating economic and other material terms of the loan and reviewing and negotiating the loan documents. As a practical matter, however, the role of borrower's counsel in negotiating loan documentation is often quite limited; this is chiefly because institutional lenders are extremely reluctant to modify their standard form loan documents.

➡ [6:10.1] **PRACTICE POINTER:** While there is little room to negotiate residential loan documents, lenders often will negotiate certain provisions in commercial loan documents (e.g., financial covenants).

- e. [6:11] **Resolving title insurance matters:** Because lenders invariably require a lender's policy of title insurance (*see Ch. 3*), title issues need to be addressed by the buyer.

Although the condition of title to the property might be acceptable to the buyer, it might not be acceptable to a third party lender. Institutional lenders in particular are quite conservative about title matters; buyer's counsel is therefore cautioned to consider a lender's concerns when reviewing the state of title.

(For example, a buyer might not be concerned about an easement over the property running in favor of an adjoining landowner; but the easement may be the stumbling block to a lender's willingness to finance the purchase.)

- f. [6:12] **Borrower's counsel's opinion letter:** In certain commercial property loan transactions, borrower's counsel is called upon to render a formal legal opinion concerning various matters pertaining to the borrower, the property, the loan transaction and the loan documents. This subject is covered in detail in *Ch. 9*. By way of summary, borrower's counsel's opinion letter may cover such issues as:

- the lawful existence and good standing of the borrowing entity;
- the authority of the parties signing the loan documents to bind the borrower;
- the absence of any legal proceedings involving the borrower which might adversely affect the property or the borrower's ability to pay the loan;
- the absence of any contract, law or regulation by which the borrower is bound that would preclude the borrower from entering into or satisfying the loan;
- the validity and enforceability of the loan documents;

[6:13 — 6:22.2]

- the loan not being usurious; and
  - the property’s compliance with various environmental, zoning and other pertinent land use laws.
- g. [6:13] **Mortgage broker’s fees:** In the more sophisticated and sizable loan transactions, a buyer might retain the services of a professional loan broker. The loan broker is usually paid a fee based on a percentage of the amount of the loan. The relationship between the property owner and the loan broker is—or at least should be—reflected in a written agreement. The negotiation, preparation or revision of the loan broker’s contract might therefore be one of the functions of buyer’s counsel. (See ¶6:160 ff.; and Form 6:E.)

[6:14-19] *Reserved.*

**B. SOURCES AND KINDS OF FINANCING**

1. [6:20] **General Financing Sources:** Financing may be obtained in any of the following ways:
- a. [6:21] **Third-party financing:** In a third-party financing transaction, the buyer procures its loan from a third party (typically, but not necessarily, an institutional lender).
- (1) [6:22] **“Institutional” vs. “private” lenders:** The term “institutional lender” refers to an entity such as a bank, savings and loan association, insurance company, large pension fund, real estate investment trust, or the like which *regularly engages in the business of making real property secured loans*. These lenders are distinguished from “private lenders” who are not regularly in the lending business.
- (2) [6:22.1] **Government loans and grants:** Occasionally, real property purchases are funded by government loans and grants. Given the gravity and persistence of California’s affordable housing crisis, legislation seeking to direct both federal and state aid to affordable housing providers has been and continues to be enacted. While a full treatment of all current housing support laws is beyond the scope of this Practice Guide, a few examples follow:
- (a) [6:22.2] **Cal-Vet Program:** California veterans are eligible for low-interest, long-term loans through the Department of Veterans Affairs’ “Cal-Vet” program. [See Mil. & Vet.C. §987.50 et seq.; and ¶6:337.4 ff.]

- (b) [6:22.3] **California Homebuyer’s Downpayment Assistance Program:** Low-income, first-time homebuyers are eligible for downpayment assistance in the form of deferred-payment, low-interest, junior mortgage loans. [See Health & Saf.C. §51500 et seq.]
- (c) [6:22.4] **Department of Housing and Community Development programs:** The 2012 reorganization of state government created the Department of Housing and Community Development (HCD) as part of the Business Consumer Services and Housing Agency (Health & Saf.C. §50400 (added Stats. 2012, Ch. 147)). HCD has broad powers to administer both federal and state housing programs that provide loans and grants to create rental and homeownership opportunities. [Health & Saf.C. §56406; see also the HCD website at *hcd.ca.gov* (listing active programs and available funding opportunities)]

The 2022 legislative session enhanced HCD’s powers and responsibilities in order to accelerate funding of affordable housing programs (§6:22.5 ff.).

- 1) [6:22.5] **Facilitating access to federal grants:** Among HCD’s responsibilities is the administration of federal grants for purposes of funding the acquisition of property to develop or preserve affordable housing. In order to accelerate the process, HCD has the power to publish notice of funding opportunities and application deadlines ahead of, and contingent upon, the availability of funding. [Health & Saf.C. §50406.9]
- HCD may disburse awards up-front, rather than as reimbursements, so long as the recipients meet federal standards for financial administration and HCD provides ongoing monitoring. Moreover, HCD may furnish technical assistance to applicants in meeting program requirements. [See Health & Saf.C. §50406.9]
- 2) [6:22.6] **Online tracking:** HCD’s website (*hcd.ca.gov*) is required to feature a tracking system for all programs it administers that shows the deadlines for each step of a program application. [Health & Saf.C. §50461; see also Gov.C. §§7061.1-7061.2 (1/1/33 “sunset” date)]
- 3) [6:22.7] **Encouraging “adaptive reuse” of property:** Retrofitting and repurposing existing buildings to create new residential units (so-called “adaptive reuse”) is an activity eligible for state loan programs that fund development

of affordable multi-family homes for rent or ownership. [Health & Saf.C. §50467]

- 4) [6:22.8] **CalHome Program:** First introduced in 2000, the CalHome Program supports existing programs aimed at lower and very low income households. Its purpose is to increase home ownership, encourage neighborhood revitalization and sustainable development, and maximize use of existing homes (Health & Saf.C. §50650 et seq.). Under the CalHome Program, HCD makes grants and loans to local public agencies and nonprofit corporations for specified purposes, including the construction of home ownership units. [Health & Saf.C. §50650.3]

Commencing January 1, 2024, units within home ownership development projects that are receiving CalHome funds must be initially sold to and occupied by lower income households. In addition, the units must be subjected to a recorded covenant with a term of at least 30 years' duration that includes one or more resale restrictions (e.g., recapture of the CalHome funds or equity sharing upon resale). [Health & Saf.C. §50650.3(c)(3)]

[6:22.9-22.15] *Reserved.*

- (d) [6:22.16] **Local Tenant Preferences to Prevent Displacement Act:** The Legislature has articulated a state policy of providing affordable housing opportunities to lower income individuals residing in areas facing displacement pressures and gentrification. This statutory declaration enables recipients of federal low-income housing tax credits and tax-exempt bonds to favor local tenants at risk of displacement, without jeopardizing the recipients' favorable tax treatment. [Gov.C. §7061 et seq. (2033 "sunset" date)]

The above Act requires disclosure of local tenant preference policies, coordinated through the HCD (§6:22.4). Thus, local governments adopting a tenant preference policy must, no later than 90 days after the ordinance's operational date, post the ordinance and supporting materials on its website. And every year the local government must provide HCD with a current link to that website. In turn, HCD must post a list of jurisdictions with tenant preference policies on its website. [Gov.C. §§7061.1, 7061.2 (1/1/33 "sunset" date)]

- b. [6:23] **Seller financing:** "Seller financing" occurs when the seller takes a portion (or, conceivably, all) of the purchase

price in the form of a loan to the buyer, which is secured by the property being sold. Seller financing is sometimes called “purchase money financing” (see ¶6:564).

(1) [6:24] **Secured note or land sale contract:** Seller financing typically takes the form of a promissory note secured by a deed of trust encumbering the property sold. But a “land sale contract” is also a form of seller financing (see ¶4:112 ff.).

c. [6:25] **Existing financing:** The buyer may elect to take over an existing loan encumbering the property by either (1) purchasing the property “subject to” the existing loan; or (2) specifically “assuming” the existing loan.

(1) [6:26] **“Assumption” vs. taking “subject to”:** There is a significant distinction between the concepts of taking “subject to” an existing loan and “assuming” an existing loan:

(a) [6:27] **“Assumption” of existing loan:** Assumption of an existing loan occurs when the buyer executes a specific written agreement with the lender pursuant to which the buyer “assumes” the original borrower’s obligation under the loan and becomes *directly and contractually obligated to the lender*.

(b) [6:28] **Taking “subject to” existing loan:** If the buyer does not execute such an assumption agreement but simply acquires title to the property, the buyer is said to have taken the property “subject to” the existing loan. Although the buyer continues to make payments on the loan, the buyer *is not, and does not become, legally obligated to make payments on that loan*.

(2) [6:29] **Different rights and obligations:** The rights and obligations of the lender, the original borrower and the new buyer vary greatly depending upon whether the buyer assumes or takes subject to the existing loan. Indeed, sometimes a buyer’s purchase of property without specifically assuming an existing loan constitutes a default under the loan, permitting the lender to accelerate the loan and foreclose. (See ¶6:388 ff. regarding “due-on-sale” provisions.)

*Cross-refer:* The subject of taking over existing financing is addressed in detail at ¶6:310 ff.

d. [6:30] **Combination financing:** Some financing transactions are a combination of the alternatives set forth at ¶6:20 ff.; e.g., a portion of the purchase price comes from a third party loan and another portion is supplied by seller financing.

➡ [6:31] **PRACTICE POINTER:** Given the cost of California real estate, home buyers often rely on family assistance when purchasing property. As a result, the potential tax consequences of such arrangements should be taken into account. For example, if a family lender accepts below-market interest on a loan, there may be gift or imputed interest implications. In fact, when a related-party loan is part of the transaction, prudence dictates obtaining tax advice from an expert, documenting the loan and setting an “arms-length” interest rate.

[6:32-34] *Reserved.*

2. [6:35] **Types of Real Property Secured Loans:** Buyers can choose from many kinds of secured real property loans. (Indeed, creativity in real property financing is virtually unlimited.) The structure of financing varies dramatically from lender to lender. The process is further complicated by the fact that a variety of names are used in the industry to describe similar, if not identical, loans.

The sections set forth at ¶6:36 *ff.* discuss the general features of standard real property loans, reflecting the popular terminology and salient terms.

- a. [6:36] **Short-term vs. long-term loans:** Real property secured loans generally are said to be either “short-term” or “long-term,” depending on the duration of the term. However, “short-term” and “long-term” are not legal words of art (such terminology is almost never used in loan documentation) and lenders often disagree as to whether a particular term is considered “short-term” or “long-term.”

- (1) [6:37] **Short-term loans:** Short-term loans generally mature and become due within approximately three years. They are usually for a specified purpose, such as a construction loan.

Short-term loans *made for a specific purpose* preclude the borrower from using the loan proceeds for anything other than the stated purpose. The lender usually retains control over when, and for what purpose, the loan proceeds are to be disbursed.

- (2) [6:38] **Long-term loans:** A long-term loan (sometimes called a “permanent loan”) usually involves a term of 15 years or longer. Nevertheless, some lenders refer to a seven-year term as a long-term (permanent) loan.

- (3) [6:39] **Mini-perm loans:** Loans having a term somewhere between a short term and long term are sometimes called “mini-permanent” (or “mini-perm”) loans. Mini-perm loans are often construction loans combined with fairly short-term “permanent” financing. Under this arrangement, once the construction phase of the loan

is completed, the interest rate might be adjusted and the borrower might then be required to make periodic payments of principal and interest. The loan would then mature somewhere in the range of, perhaps, five years later.

- b. [6:40] **“Take-out” financing:** “Take-out” financing is a colloquial term used to refer to a loan that pays off and, to that extent, *replaces* an existing loan. The second loan is thus said to “take-out” the prior loan. Short-term loans are therefore taken out (and replaced by) longer-term loans.

Sometimes, take-out financing is arranged concurrent with a short-term loan. This most often occurs in connection with construction loans. Under this arrangement, a lender makes a short-term construction loan and either the same or a different lender concurrently agrees to provide a longer-term take-out loan that will pay off the construction loan after completion of construction.

- (1) [6:41] **Excess amount:** Take-out financing is sometimes in an amount in excess of the prior loan, so that the owner is both able to pay off the existing loan and to pull out some of its equity in the property.

- c. [6:42] **“Gap” and “bridge” loans:** These are popular (non-legal) terms commonly used to describe certain kinds of short-term loans. The purpose of a “bridge” or “gap” loan is to provide financing in the interim period during which one loan becomes due and long-term, permanent financing becomes available. Thus, bridge or gap loans might be used to take-out a construction loan during the time the borrower seeks permanent financing.

- d. [6:43] **Development and construction loans:** Development and construction loans are typically obtained by developers at the time (or shortly after) they acquire title to property. The purpose of the loan is to finance the cost of developing the property and constructing improvements.

- (1) [6:44] **“Development” vs. “construction” loan:** Although development and construction loans are discussed at ¶6:44.1 *ff.* as if they were one loan, they are sometimes broken into two entirely different loans.

- [6:44.1] A “development loan” (or that portion of a “development and construction loan” allocated to development costs, but not construction costs) funds the cost of such things as subdivision of the property and obtaining various other zoning permits and so-called “entitlements.” A developer who does not intend to construct improvements, but merely plans to sell the property after obtaining such development permits and entitlements, would only obtain a development loan.

[6:44.2 — 6:49]

- [6:44.2] On the other hand, a developer who wants to improve the property will obtain a construction loan (sometimes called a “building loan”) to fund the actual cost of constructing improvements. Developers sometimes purchase property with permits and entitlements already in place (or which requires little in the way of permits and entitlements), in which case only a pure construction loan is necessary.
- [6:44.3] If both development and construction is intended, the loan is usually a combination development and construction loan.

**FORM:** Construction Loan Agreement, *see Form 6:A.*

- (2) [6:45] **Acquisition portion of development and construction loan:** A developer sometimes combines its development and construction loan with an “acquisition” loan at the time it purchases the property. The “acquisition” portion of the loan funds a portion of the purchase price and the balance of the loan funds development and construction costs.
- (3) [6:46] **Take-out financing:** A development and construction loan sometimes is tied to take-out financing (either from the same or a different lender). Under this arrangement, a lender agrees to provide long-term financing that pays off and “takes out” the development and construction loan (*see ¶6:40 ff.*).
- ➡ [6:47] **PRACTICE POINTER:** Many lenders require, as a condition to making a development and construction loan, that the borrower obtain a commitment for take-out financing. The reason is that the borrower will not necessarily have any income from the property upon completion of construction and the lender wants to make certain a source of financing is in place to pay off the construction loan.
- (4) [6:48] **Term:** The term of a development and construction loan is tied to the amount of time anticipated to complete the development and construction work. The loan term is thus determined by the magnitude of the project.
- (5) [6:49] **Development costs:** A development loan (or the development portion of a development and construction loan) finances the cost of subdividing the property and obtaining zoning permits and other “entitlements” for property development. It therefore funds such things as engineering and other professional fees, governmental permit application fees, and the cost of certain physical development of the property.