Cross Collateralization and Cross-Default Provisions

The term collateralize in real estate lending is the act of using an asset as collateral for a loan. The owner of the real property agrees to convey an equitable title or a security interest in his property to be held by the lender as security for the loan. This is accomplished by executing a promissory note, which is a promise to pay and a deed of trust or mortgage. The deed of trust or mortgage will be recorded in public records which encumber or clouds the title of the property. This process is called placing a lien against a property.

If the borrower performs in making loan payments in a timely manner and pays off the entire loan, then the lien will be removed from public record. If the borrower fails, then he will lose the property in a foreclosure proceeding or liquidate the asset in a sale to a third party to pay the lender.

Usually, a borrower will encumber a property with a lien referred to as the first lien position, because it is recorded first in public records. Lien priority is a matter "first-in, first out." If three liens are recorded against the property, the one with the earliest recording date and the number will be a first, the next will be a second, and the last will be a third.

Let’s assume that a borrower approaches a lender with a request for an equity second. Proceeds will be clearly used as a business purpose to purchase an Easter egg farm and grow Easter eggs. The lender will encumber the borrower’s home and place a second trust deed on the property with cash out to provide start-up and working capital for the new business enterprise.

The borrower provided a business purpose loan application with all the relevant information. With a desk review by the loan officer, it was determined the borrower’s home has a probable market value of $900,000 even though the application represented that this value was $1,200,000. Sound familiar? The first lien balance was $600,000. The borrower thought the combinations of the first trust deed and new equity second of $200,000 would reflect a loan value of 67% but the lender’s estimate was 89%. Here was the problem, the lender guidelines provide for second lien loans up to a combined 70% loan-to-value whether a single property or multiple properties. In this case, there was insufficient equity to provide for the $200,000 cash out.

A good loan officer would then review the loan application to determine if the borrower had additional real estate assets to encumber. The borrower owned a 4 unit building with a probable value of $900,000 with a first lien of 350,000 and a second lien of $100,000.

If the borrower would allow the lender to encumber both properties and record in the second lien position of both these properties, the loan request may be possible. The lender would “cross-collateralize”, meaning encumber both properties as security for the loan. The borrower would sign one promissory note, a promise to pay, and one deed-of-trust as a security instrument and cross-record on both properties. The documents would contain identification and legal descriptions of both properties. The escrow and title would contain both properties. Any title search would reflect evidence of the cross-recorded instruments on both properties.

As far as the underwriting guidelines, the total value of both properties is $1,800,000. With a first on the home of $600,000, first on the four-plex of $350,000, and a cross-collateralized encumbrance of $300,000 reflecting a second lien position on both properties, the combined loan-to-value would be 69.44%, within acceptable guidelines of the lender. The new cash out of $300,000 included paying off the second on the four-plex of 100,000 and providing a cash-out of $200,000. Costs of loans have not been included in the example.

I have been involved where a cross-collateralized encumbrance was recorded on 5 different properties to ensure adequate protective equity and protective equity to satisfy the lender

requirements.

Both the underwriting and the documentation can be complex. A borrower, mortgage broker or lender who contemplates placing a junior lien on a property needs to review the existing first lien deed of trust. Some lenders will place a clause in the trust deed called "due-upon further-encumbrance." What that means is that if the borrower records a junior encumbrance, the lender can call the loan due and payable or immediately place the loan into default status. There are federal regulations that prohibit lenders from enforcing the due-on-further- encumbrance for single family 1 to 4 dwellings and principle dwellings. There are no protections for any other types of properties.

There are other issues that need attention. One is providing for a partial release provision and the other is a cross-default clause.

A partial release clause is usually a written addendum to the loan documents that provide an agreement wherein a lender will release or re-convey the recorded documents upon a sale of one property with provisions that the lender receive a certain percentage of the net proceeds from the sale, which will reduce the outstanding balance of the loan. I have seen negotiated release provisions where the lender gets all the net proceeds or various percentages of the net proceeds.

A lender who makes a construction loan for acquisition, entitlement, and development loan on a 10-home subdivision and encumbers all 10 properties will usually provide for a partial release to pay down the loan with each sale but allow the builder/developer to keep a certain portion of the proceeds for operating capital. A 50/50 split or 80/20 of net proceeds upon each sale is possible.

A cross-default provision is usually a written addendum to the loan documents which allows the lender to place the borrower into default status if the borrower does not make payments on any of the related loans, including the subject loan, senior, or junior loans. The cross-default provisions exist to protect the interest of the lender who will want to be notified if the borrower does not make payments or violates any of the negative or affirmative covenants to the loan documents. A negative covenant requires a borrower to refrain from certain activities such as using the property for illegal purposes. Affirmative covenants obligate the borrower to perform certain actions such as maintaining insurance coverage or maintaining the property in good condition.

This is a complex subject, which includes best practices, federal & state regulations, and

property documentation. Work with competent counsel to properly draft correct and thorough due-on-sale and due-on-further encumbrance clauses that will protect the interest of the lender and preserve the agreed rights of the borrower.

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