INTERIM FINANCING ON HOUSING PROJECTS

EDWARD C. LEBEAU*

Commercial banking forms of doing business are not devised from pure whim. They are born in the minds of pragmatic men to deal with the commercial needs that a dynamic economy is constantly creating. As expansion begets a need, the need begets a form. "Interim financing" is such a form.

An attempt at more precision will be found in a later part of this paper, but it is well to understand at the outset what kind of form interim financing is, in general, and what need it purports to serve within the housing industry. Certainly the bedrock element is the residential real estate mortgage.[1] This is given by an owner to a mortgage banking company in return for the latter's loan. Typically, the mortgage company has a very limited capital and neither wishes nor is able to carry long term mortgage investments on a permanent basis. The mortgage company, then, endeavors to sell its interest in the mortgage[2] to, let us say, a life insurance company. The insurance company may be anxious to add this item to its real estate investments portfolio. For reasons of company policy and state insurance laws, however, it will insist on a completed structure ready for occupancy plus full documentation before any disbursement of funds is actually made.

At this point two alternatives are open to the mortgage company. First, it can hold on to the mortgage until the permanent investor's conditions are met. The waiting period, though, may be up to a year and a few such holdings would freeze the entire lending power of the mortgage company. This cuts squarely against the grain because a mortgage company depends on mortgage servicing charges for a large share of its income. When the number of mortgage accounts it has to service goes up, so does the mortgage company's gross income. Therefore, the velocity at which it engages in mortgage lending can well be more important than the rate of interest it may happen to charge. Thus is the mortgage company brought to its second alternative: the commercial banker.

Under this alternative, the mortgage company can offer to pledge the owner's mortgage to the commercial banker, as security for a short

---

* See Contributors' Section, p. 269, for biographical data.

[1] Where used without amplification, "mortgage" includes both the debt and the security.

[2] These mortgages very frequently have FHA or VA backing.

term loan. This is sought to cover the "interim" period ending with the permanent investor's disbursement of funds in payment for its purchase of the mortgage. If the commercial banker agrees to make the loan, he is engaged in interim financing.[3]

While the elements which go to make up interim financing—*e.g.*, residential construction, mortgages, assignments, pledges, negotiable instruments, statutory liens, federal mortgage insurance and guaranty, risk of loss insurance and title insurance—are individually the subjects of a great body of legal and business writing, the activity itself as a recognized form of commercial banking is still in process of development. Due to unsettled definitions and a lack of appreciation of the special risks, considerable distrust and discussion at cross-purposes have been evidenced.[4] The lack of integrating literature draws comment.[5] Given the circumstances it seems appropriate to conduct an examination into the topic sounding more in breadth than in depth. Where particularization is thought necessary the laws and conditions of Arizona will be looked to.

I. FEDERAL INTERVENTIONS

Dating back to the first New Deal administration the federal government has exerted a powerful, in some respects incalculable, influence on the housing and mortgage industries. Even if we limit our inquiry to those branches created to play a large and direct role in the mortgage economy, four organizations come to mind: Home Owners' Loan Corporation; Federal Housing Administration; Federal National Mortgage Association; Veterans Administration. A brief view of each—touching on its birth and growth, its purpose and the way it operates, and its particular impact on the national and state real estate economy—seems advisable to help serve as context in which mortgage lending decisions, both legal and business, should be made.

(1) *HOLC*

Constituted in 1933[6] the Home Owners' Loan Corporation was liquidated by June 30, 1951, and officially laid to rest June 30, 1953.[7] Nevertheless, it has a place in this study as an example of emergency federal mortgage operations which are apt to be adopted again if 1933 real estate market conditions should reoccur.

---

[3] Often the mortgage company step is omitted, for instance where the "owner" is a builder-developer with substantial credit standing. Often, too, the project is a shopping center, office building, or other commercial undertaking rather than residential construction, but most of the material and observations contained in this study of housing projects are applicable to the activity in general.

[4] Address by King Upton, Vice President of First National Bank of Boston, and specialist in interim financing work, at Midwestern Mortgage Conference on February 23, 1956.

[5] Goodwin, *Mortgage Warehousing—A Misnomer*, 104 U. PA. L. REV. 494 (1956).

[6] Home Owners' Loan Act, 48 Stat. 128 (1933), 12 U.S.C.A. § 1461 (1957).

[7] 67 Stat. 126 (1953).

HOLC was designedly a stopgap, to supply home mortgage lending activity to a depressed economy. The mission was pursued with a vengeance. By encouraging liberal appraisals, deliberately high loans were made on the mortgagor applications that came pouring in until the close of lending operations June 12, 1936.[8] At this point HOLC found itself a $3 billion mortgagee[9] and the mortgagors found themselves saddled with heavier debts than before. But the mission had been accomplished. Private mortgagees converted much of their frozen securities into liquid assets with which to resume lending activity. HOLC was an indulgent creditor and though defaults grew enormous[10] the Corporation was properly loath to foreclose and turn the occupants out.

It is not surprising that the cumulative total capital loss of the Corporation on complete liquidation amounted to some $337,000,000, ranging from 22.8% on its New York operations to 0.0005% on its Hawaiian holdings.[11]

(2) *FHA*

This organization was given birth by the enactment of the original National Housing Act.[12] Its operations extend to many phases of the housing and mortgage industries, but our purposes will be served by an inspection of the activities devoted to insurance of mortgage loans for proposed or existing residential property.

The FHA is empowered to insure, or to issue a commitment to insure, a mortgage on application of the mortgagee provided the mortgage meets all statutory requirements. A list of these requirements would include:

(a) Responsible mortgagee approved by Federal Housing Commissioner.

(b) Mortgage must be a first lien.

(c) Family dwelling, not over four-unit size.

(d) Maximum principal obligation as Commissioner may direct, not to exceed stated amounts.[13]

---

[8] Skilton, *Government and the Mortgage Debtor, 1929-1939*, 18 TEMP. L .Q. 61, 100, (1943).

[9] U. S. HOME LOAN BANK BD., *Final Report to the Congress Relating to the HOLC* (1952). This represented one-sixth of all urban home mortgages. The average loan was $3,039.

[10] Skilton, *supra* note 8, at 103.

[11] U. S. HOME LOAN BANK BD., *supra* note 9, in Schedule No. 6.

[12] 48 Stat. 1246 (1934), 12 U.S.C.A. § 1701 (1957). Amendments have been voted by many of the succeeding sessions of Congress.

[13] As of December 31, 1959, maxima were set at $22,500 for single-family residences, $25,000 for 2-family residences, $27,500 for 3-family residences and $35,000 for 4-family residences. As a further qualification the principal cannot exceed the *sum* of 97% of first $13,500 of appraised value and 73% of excess over $13,500 up to $18,000 and 70% of all over $18,000. If the mortgagor is not the owner-occupant, 85% of the total as computed above becomes the maximum.

(e) Maximum interest rate as prescribed by Commissioner, not to exceed 6 per cent per annum.[14]

(f) Maturity as Commissioner may set, not to exceed 30 years.[15]

If the Commissioner is satisfied that a particular mortgage and the project to which it is connected meet all requirements, he will execute a contract of mortgage insurance.[16] This contract is conclusive evidence of the eligibility of the mortgage for insurance and is incontestable in the hands of an approved mortgagee. Added to this incontestability feature the fact that the Commissioner does not, in practice, raise technical objections to titles proffered to him after default and foreclosure,[17] an insured mortgagee can rightly conclude that his investment is safe to the extent of the coverage.

FHA mortgage activity has been enormous. Through May, 1953, FHA had insured 3,275,689 individual home mortgages, totaling almost $20 billion.[18] The period 1948-1950 saw the peak nationwide activity, with a tapering off since then.[19] The decline is generally attributed to the pegged interest rates which consistently lag behind the free market mortgage rate, and there is agitation for adoption of flexible rates.[20] The argument is made that artificial maximum rates drive mortgage lenders away from low and middle income prospective home owners and thereby defeat the purpose of the National Housing Act, said to be the encouragement of a high level of housing construction under supervised standards.

Contrary to the national trend, recent FHA activity continues high in Arizona, based on figures made available to the writer by the Director for the Arizona Insuring Office. The year 1959 saw a total of 20,169 Arizona cases processed, out of which 11,459 loans became insured in the total amount of $132,909,700. Statistics for the first six months of 1960 illustrate about the same level of activity, with perhaps a small upward trend in the percentage of processed cases that ultimately are accorded the benefit of FHA insurance.

(3) *FNMA*

"Fanny Mae" as such was chartered in 1948[21] to serve as a secondary mortgage market, buying mortgages in areas where mortgage funds

---

14 As of December 31, 1959, put at 5¾% by Commissioner.

15 Commissioner allows statutory maximum.

16 Mortgagee must, however, tender the initial mutual mortgage insurance premium charge with his application. Premium rate is presently ½% per annum on declining balances. This charge is invariably passed along to the mortgagor.

17 Neel, *How Good Is a Government Guarantee?*, Banking, Dec. 1953, p. 47.

18 *Ibid.*

19 Colean, *Plan for a Secondary Home Mortgage Market*, Harv. Bus. Rev., Nov.-Dec. 1953, p. 79 at p. 84.

20 *E.g.*, Colean, *supra* note 19.

21 62 Stat. 1208 (1948), 12 U.S.C.A. § 1717 (1957). The legislative principle, however, dates back to the original National Housing Act of 1934.

are scarce and selling elswhere to private institutions as market conditions permit.[22] It deals in FHA or VA insured or guaranteed mortgages only.

With the Housing Act of 1954[23] FNMA underwent quite an alteration. It is now composed of three largely autonomous units: Management and Liquidating Functions, Special Assistance Functions, and Secondary Market Operations.

Management and Liquidating Functions is engaged exclusively in liquidating mortgages acquired prior to November 1, 1954.

Special Assistance Functions is presently limited to financing in special housing areas, *e.g.*, Guam, Alaska, and military posts.

Secondary Market Operations carries on the traditional FNMA function, except that financing for Operations is being sought by the sale of debentures and stock to private investors.[24]

FNMA's secondary mortgage market operations do not purport to supply anywhere near full liquidity for every FHA and VA mortgage. Even so, FNMA's impact is significant enough to draw widespread criticism, ranging from mild[25] to outright advocacy of its abolition.[26]

(4) *VA*

As World War II progressed, sentiment mounted for federal legislation designed, however artificially, to help repay returning servicemen for their years spent away from civilian endeavors. This resulted in passage of the Servicemen's Readjustment Act of 1944,[27] one feature of which is mortgage guaranty.[28]

A certificate of discharge, other than dishonorable, showing ninety days active duty between September 16, 1940 and July 25, 1947, or between June 27, 1950 and February 1, 1955, is the key to admission

---

[22] According to information recently promulgated by the Los Angeles regional offices, as of March 31, 1960, FNMA was holding approximately 4,100 Arizona home mortgages aggregating $43,500,000. Nationwide, FNMA's balance sheet showed FHA and VA home mortgage holdings which totalled $2,274,064,552, carried at cost of acquisition.

[23] 68 Stat. 613 (1954), 12 U.S.C.A. § 1717 (1957).

[24] Mr. Paul Akin, Los Angeles manager for FNMA, in an address delivered before the Arizona Mortgage Bankers' Association on June 12, 1956, said that mortgage bankers themselves must assume much of the responsibility for the success or failure of this facility, and suggested that they be leading subscribers to the stock offerings.

[25] *E.g.*, Colean, *supra* note 19. He states that arbitrary administrative control of rates and politically oriented decisions distort its laudable mission and can have dangerous inflationary effects.

[26] Andrus, *For Flexible Mortgage Rates*, Banking, Jan. 1957, p. 48.

[27] 58 Stat. 284 (1944).

[28] 58 Stat. 291, 38 U.S.C.A. § 1801 (1959). Numerous amendments have been enacted since 1944. No further citations to this act or to VA regulations will be given in the following discussion, which is grounded on the act and the regulations in effect on December 31, 1959.

under these provisions. A loan made to a qualified veteran is automatically guaranteed.

As with FHA insurance, technical prerequisites surround the eligibility for loan guaranty and there are other specifications concerning the maximum amounts guaranteed. The major points:

(a) Application for guaranty must be made not later than July 25, 1962, for World War II veterans; January 31, 1965, for Korean veterans.

(b) Where loan is to finance the purchase or construction of residential dwelling, must be owner-occupied.

(c) Loan can at the present time be for up to 100 per cent of purchase price.

(d) Lender must be approved by Administrator, or else be an institution subject to supervision by the United States or by any state.[29]

(e) Maximum maturity of 30 years.

(f) Maximum interest rate of 5¼%.

(g) Maximum guaranty of residential mortgage loan is the lesser amount of $7500 or 60 per cent of the loan.

The amount of residential mortgage loan guaranty has been about equal to FHA's mortgage insurance activity. Through May, 1953, some 3,000,000 individual home loans aggregating almost $20 billion have received VA blessings.[30] A steady decline in VA nationwide loan activity since 1951[31] is due in part to the fixed-class nature of eligible mortgagors and undoubtedly in part to the fixed maximum interest rate in a tight market period.[32] As in the FHA market, though, Arizona VA activity continues to run unexpectedly high. The Phoenix office reports that its current monthly applications volume for the state is above its overall monthly average and that better than half of the applications still come from World War II veterans. Since the inception of the VA mortgage guaranty program down through July 31, 1960, a total of 31,375 Arizona loans representing $254,727,434 in face amount have been guaranteed. Of eligible veterans now living in Arizona there are still an estimated 73% from World War II and 81% from the Korean conflict who have not utilized any VA loan guaranty.

II. INTERIM FINANCING: DEFINITION AND EXPOSITION

A trace of the ancestry of the term interim financing leads to "mortgage warehousing," a very broad phrase that bankers have long used

[29] Any loan at least 20% of which is VA guaranteed may be made by a national banking institution without regard to limitations laid down in other statutes.

[30] Neel, *supra* note 17.

[31] Colean, *supra* note 19.

[32] The present rate of 5¼% is set by Congress. *Cf.* National Housing Act, under which the Commissioner has flexibility up to 6%.

to refer to all types of lending or purchase commitments in the real estate mortgage market. Even to those accustomed to a more precise use of language, mortgage warehousing signifies any loan by a commercial bank to the owner of a mortgage, when the mortgage is taken as collateral security for the loan. The extreme credit stringencies of late in commercial banking have motivated an awareness that mortgage warehousing covers a multitude of sins.[33] The result seems to be that the new epithet, "interim financing," is rapidly taking over semantic duties from the old "mortgage warehousing."

A substitution of words, without more, contributes little toward clarity, of course. But this changeover is being accompanied by a realization throughout commercial banking that the old scheme ". . . led to some confusion and discussion at cross-purposes."[34]

In order to avoid back-sliding, then, "interim financing" must be particularized. It is submitted that a rational dichotomy can be drawn: financing which involves existing structures, and construction loan financing.

A. *Financing on Existing Units*

Within interim financing of mortgage companies by commercial banks where the mortgages[35] pledged are on residences already built, perhaps four categories[36] suggest themselves.

(a) Collateral loan, 90-180 days, secured by mortgages committed for immediate purchase by a permanent investor. This is the ordinary clearing loan[37] necessitated by the time required to assemble all documentation—the "old timer" of interim financing.

(b) Collateral loan, 1-2 years, secured by committed mortgages. This arises when a permanent investor enters into "long term forward commitments," *i.e.*, deferred purchases, in an effort to synchronize available mortgages and available investment funds. The length of the period indicates that normally short term commercial bank credit is frozen for an unusually long term, and an unconditional commitment is normally required. Inflationary pressures are particularly apt to be lurking in this category, since the de-

---

[33] Upton, *supra* note 4.
[34] Upton, *supra* note 4.
[35] Insured or guaranteed by FHA or VA. See note 2, *supra*.
[36] Since it is my intention to accentuate construction loan problems, what follows is an oversimplification of this very important half of interim finance activity. For affirmative defense I plead that lawyers and bankers are comparatively more familiar with this older branch of the family.
[37] Sometimes called "closing loan."

ferred purchase is being superimposed on the usual investor commitments.[38]

(c) Collateral loan, 6-9 months, secured by uncommitted mortgages. This is essentially the same as financing a shoe retailer on his unsold inventory.

(d) Collateral loan, one year or less, non-recourse note, secured by uncommitted mortgages. Since the "borrower" is not liable for anything beyond the value of the collateral, this amounts to a purchase of the mortgages by the bank, with an option in the pledgor to repurchase within the stated time and at the pledged price. This could be called a "stand-by purchase commitment."

The above survey should demonstrate the unwisdom of characterizing all collateral loans to mortgage companies with a single unmodified phrase. Use of the term "interim financing" is commendable, because it is more descriptive of these lines of credit than is the venerable "mortgage warehousing," but is should be recognized as a generalization which covers up a spectrum of significant distinctions.

B. *Construction Loan Financing*

This is interim financing's new but bustling baby. It is a legitimate offspring because all the family markings are there; just envision a housing project builder as the "owner." Still, it has so many traits not found in the rest of the family that it demands independent treatment.

A builder may not be in a secure enough financial position to obtain funds for his project directly from a commercial bank. He is then likely to petition a mortgage banking company, which may see fit to take the project on.[39] The mortgage company will arm itself with an FHA preliminary commitment on the as-yet empty lots, enter into a conditional construction mortgage agreement with the builder, and present itself at a commercial bank to seek out funds for the period of construction.[40]

The same bank whose doors were closed to the builder may be very receptive to this applicant and the reason is plain: bank would have the full worth and management abilities of mortgage company to look to as primary obligor, and could hold the builder as well on his initial obligation.

---

[38] See N. Y. Times Magazine, January 20, 1957, p. 15, for a seldom expressed but disturbing thesis by Professor Henry Wallich of Yale. Briefly, he asserts that the "acceptance" of a 2% annual inflation induces people to plan for it via escalator clauses, short term speculation, etc. Such "planning" is generative of further pressures so that ultimately a runaway inflation results.

[39] The mortgage company may enjoy a very favorable rate differential, *i.e.*, the difference between what it receives from the builder and what it must pay as a borrower. Or, even if the differential is unfavorable, mortgage companies in some locales must underwrite the builders in order to control mortgage production.

[40] In Arizona seldom over six months.

If the bank agrees to grant the loan, mortgage company will pledge as collateral the mortgages executed by builder. This collateral should not mislead anyone because construction loans to a mortgage company are to be treated as commercial loans and not as real estate loans.

Let us assume[41] bank determines to interim finance this construction project. Note that mortgage company is little more than a conduit for bank's funds. This means that bank will in effect dictate all terms and conditions, including those of the mortgage loan between builder and mortgage company. To begin with, bank and mortgage company will execute a master agreement which, among many other provisions, identifies the line of credit, and mortgage company executes a construction loan note for the expected upper limit. As the project, house by house, goes up, the bank will likely be making periodic disbursements of loan funds, keyed into such factors as state of construction and FHA progress inspections. By the time the project is completed it is to be hoped that builder has excellent prospects of selling each house, with each purchaser-occupant assuming builder's mortgage obligation to mortgage company or, possibly, executing new paper naming the bank as mortgagee. Mortgage company pledges each such purchaser's mortgage to bank as collateral for its closing loan note, made payable to the order of the issuer of the closing loan credit.[42] Observe that mortgage company does not receive additional loan funds on this note over and above its construction loan note and receipts. All it wants, and all it gets, is more time.

Meanwhile, all relevant documents are being collected.[43] When a mortgage with its respective documentation is gathered together, the mortgage package is mailed by bank to permanent investor on the latter's purchase commitment. Proceeds of this sale will be forwarded to bank and credited on mortgage company's note. After the project is completed *and* a mortgage package on every house is received and paid for by permanent investor, mortgage company's obligation on its clearing loan is satisfied and a small surplus will be available, provided mortgage company was operating under a favorable rate differential. When the interim financing is completed mortgage company will get back its construction note and all of its closing loan notes.

By no means every mortgage company throughout the country engages in construction lending to builders, but in expansion-minded Arizona the practice is very general. It is especially true of this type of in-

---

[41] Factors which should be studied to arrive at this determination are discussed in Part III, *infra*.

[42] This may not be solely the same bank that we started with, since frequently a participation by another commercial bank has been obtained.

[43] An escrow agent, ordinarily the title company, can be appointed to serve as depository for the documents.

terim financing that an increase in construction lending activity by mortgage companies calls for an almost corresponding increase in interim financing activity by commercial banks.[44] The banks in the Southwest have not had to turn good customers away, though. Eastern commercial banks are able and eager to participate on the Southwest bank's say-so. Though the risks may be many[45] the basic ones have not yet been felt in Arizona. What happens if housing supply ever clearly surpasses demand is still a chapter set in the future.

III. MATERIALS FOR THE FORMULATION OF LEGAL AND BUSINESS DECISIONS IN ARIZONA INTERIM FINANCING

To split up an interim financing transaction into "legal" and "business" elements is to lay one's self open to the charge of creating artificial categories. This criticism is in a large measure true, but the fact is that we have bankers and we have lawyers. So let us be content with simple definitions: those elements are "legal" which a lawyer can be expected to take into consideration; those elements on which a banker is most apt to concentrate his thinking are classified as "business."

A. *LAW*

It would serve no purpose to outline in detail the several fields of law, already abundantly familiar to most lawyers, onto which interim financing touches. As stated before, the central item is the residential mortgage, meaning a negotiable promissory note and a duly acknowledged and recorded[46] mortgage deed. Each will be transferred to the interim lender, the note by negotiation and the mortgage deed by formal written assignment.

The mortgage transaction, often being for construction purposes, will contemplate future advances. In Arizona, section 33-773 of the Arizona Revised Statutes is the only statute which expressly permits a present mortgage to secure advances to be made at some future date, and the section by its own terms is limited to ". . . a mortgage of livestock or other animate chattels, or of crops. . . ." Nonetheless, the Arizona Supreme Court has clearly applied the doctrine to a realty mort-

---

[44] A minute fraction is taken up by increases in capital structure of some mortgage companies.

[45] See Part III, *infra.*

[46] Who bears the burden of mistakes in indexing and recording made by the county recorder—the grantee who offers an instrument for recording, or the subsequent purchaser or encumbrancer who has inspected the record? This minor point has not been decided by the Arizona Supreme Court but it is submitted that the grantee suffers this burden. ARIZ. REV. STAT. § 33-416 (1956) indicates this when it says: "The *record* of a . . . deed . . . shall be notice. . . ." (Emphasis added.) But the best evidence is a change in language from the old Arizona Code, 1939 § 71-423, effected in its 1956 counterpart, ARIZ. REV. STAT. § 33-412(A). The old section read: "All . . . conveyances . . . shall be void . . . unless they are . . . *filed* with the recorder *to be recorded* . . ." (Emphasis added.) This now reads: ". . . . unless they are . . . *recorded* in the office of the county recorder. . . ." (Emphasis added.)

gage and held that such mortgagee is entitled to the priority of his lien from the date of recording, at least as against the mortgagor and all others who acquired their interests only after the mortgagee actually made his advances.[47] One is left to speculate what the outcome might be in a contest of priorities between the mortgagee and an encumbrancer or purchaser who becomes such prior to the "future advance" by the record mortgagee, but Arizona title companies do not seem too concerned since most, if not all, will issue their policies of mortgagee insurance from the date of mortgage recording provided the mortgagee is on that date under a fairly firm obligation to make the future advances.

Because of Arizona's status as a community property state the mortgage must bear the signatures of both the husband and the wife. The husband alone might be sufficient on the note, having in mind that he is the manager for all community personalty[48] and also the presumption that debts incurred during coverture are community debts.[49] Potential liens in favor of judgment creditors[50] and mechanics and materialmen[51] must be reckoned with. The law of pledges frequently enters the picture, with the lender taking a detailed general pledge agreement from the mortgage company along with the note and mortgage.

Trust Receipting. Sometimes the commercial bankers in the interim field also demand a system of trust receipting. The Uniform Trust Receipts Act[52] has been law in Arizona since 1947. Trust receipt financing was devised to bridge the hiatus in personal property security between the possessory lien and no lien at all. When a lender takes actual possession the law of pledges accords him a lien on the property so possessed. Given the right set of circumstances a lender may be able to qualify for security interests rendered under UTRA and he will enjoy the best of both worlds, since he need not bother with the cumbersome and inelastic matter of taking possession.

Arizona case law is non-existent on the point, but this writer submits that by the clear implication of the statutory words commercial bankers are wasting their time[53] when they provide for trust receipting vis-a-vis mortgage company borrowers.[54] The indispensable documents are: (a) negotiable promissory note (b) realty mortgage deed. Both of

---

[47] Griffith v. State Mut. Bldg. & Loan Ass'n, 46 Ariz. 359, 51 P.2d 246 (1935).
[48] ARIZ. REV. STAT. § 25-211(B) (1956).
[49] Fox v. Weissbach, 76 Ariz. 91, 259 P.2d 258 (1953).
[50] ARIZ. REV. STAT. § 33-961 (1956).
[51] ARIZ. REV. STAT. §§ 33-981 to -1001 (1956).
[52] ARIZ. REV. STAT. §§ 44-821 to -839 (1956).
[53] Plus one dollar per year filing fee for the "Statement of Trust Receipt Financing." ARIZ. REV. STAT. § 44-833(A) (1956).
[54] This assertion cannot be made unless the mortgage debt is represented by a negotiable note, which is almost always the case.

these fall outside the penumbra of UTRA. Regarding the note, Arizona Revised Statutes section 44-829(A) provides that nothing in the act shall limit the rights of a good faith purchaser of negotiable instruments from the trustee (which would be the mortgage company) and that ". . . filing under this [act] shall not be deemed to constitute notice of the entruster's [the lending bank] interest. . . ."[55]

Turning to the mortgage security deed, the definitions section[56] makes it clear that such a document is not contemplated by the act. It is not an "instrument." Nor is it a "document," which is limited to mean "document of title to goods."[57]

Granted there are many items that go to constitute a complete mortgage package, it seems that if trust receipt financing offers no pro-protection to the entruster for the indispensable documents it is but hollow form to insist on it for the other documentary items.

Bankruptcy. Consideration of the potential bankruptcy of an obligor in mortgage and pledge financing opens up an immense study, far outside the limits of this paper. However, a reference to several of its fundamental features will be attempted because no attorney presuming to advise an institution engaging in any lending activity can afford to disregard its possible impact.

Bankruptcy law is within the exclusive province of the federal government, and Congress enacted the structure of the present act in 1898. Amendments have come with almost every session and the trend has been toward ever increasing powers of the trustee in bankruptcy to "upset the applecart." Small wonder that bankruptcy has long been called the acid test of a security transaction.

The trustee's powers to invalidate a lien and sweep the subject property into the estate for general creditors are grounded in a number of sections:[58] 60b - 96(b); 67a - 107(a); 67(d) - 107(d); 70a - 110(a); 70c - 110(c); 70e - 110(e). To withstand attack a lien must successfully run the whole gantlet.

By section 60b a preferential transfer, which includes a transfer for security purposes, can be avoided if the transferee had "reasonable cause to believe" the transferor was insolvent[59] at the time of the

[55] There is an exception as against "transferees in bulk" but the term is defined as including ". . . a mortgagee or a pledgee or a buyer of the trustee's business substantially as a whole." ARIZ. REV. STAT. § 44-821(13) (1956). This is a most unlikely eventuality.

[56] ARIZ. REV. STAT. § 44-821 (1956).

[57] Thus, even were Arizona a "title theory" of mortgage state, the same conclusion would be reached because the mortgage security deed would be title to *realty*, not title to *goods*.

[58] Citations to the Bankruptcy Act are made as follows: the first figure is the section number within the act itself; the figure after the dash is the corresponding section of Title 11, U.S.C.A.

[59] Insolvency in the Bankruptcy Act means balance sheet insolvency.

transfer. If bankruptcy[60] is staved off for longer than four months after the transfer is perfected the transferee is immune under this section. Bear in mind that equitable liens are expressly frowned on.

Section 67a deals only with liens by legal or equity proceedings, *e.g.*, attachment, garnishment, judgment, and levy of execution. Basically, if such lien is acquired while the debtor is insolvent and within four months before his bankruptcy it will be summarily dissolved. Note that this will hold even though a lienor be totally ignorant of the fact of insolvency.

Section 67d is the equivalent of the Uniform Fraudulent Conveyance Act, enacted in Arizona[61] and some nineteen other states. Transfers completed more than one year before bankruptcy fall outside the impact of this section.

The trustee is vested by section 70a with all the title of the bankrupt. This includes the bankrupt's title to property which he has transferred in fraud of his creditors.

Section 70c, the "strong-arm clause," endows the trustee with a hypothetical lien by legal proceedings procured as of the date of bankruptcy. Section 70a does most of the work but there are situations when section 70c alone can carry the day for the voracious trustee. An obvious example is when the bankrupt was permitted to have possession, *i.e.*, "ostensible ownership," but title was reserved in the creditor.

Section 70e gives the trustee authority to step into the shoes of any *existing* creditor of the bankrupt and utilize any law, federal or state, that said creditor could have invoked to set aside a transfer. Assets recovered then go for the benefit of the estate. The section is customarily used to take advantage of longer state statutes of limitations or other procedural benefits. The Supreme Court, however, in *Moore v. Bay*[62] propounded the far-reaching doctrine under this section that a transfer vulnerable in minor part only in the absence of bankruptcy can be totally avoided if bankruptcy occurs. In other words, the lien of a million-dollar mortgage can be totally upset if, between the times of its execution and recording, the mortgagor goes in debt another $100 to a different creditor and then is thrown into bankruptcy. The case is scathingly criticized by at least one very prominent bankruptcy authority.[63]

The reader is cautioned that this hasty sketch of bankruptcy is only that. Exhaustive tomes[64] have been written on the subject, but for a pithy, up-to-date, one-volume summary of strict bankruptcy, Professor MacLachlan's hornbook[65] is highly recommended.

---

[60] *I.e.*, the time when a bankruptcy petition is filed by or against the debtor.
[61] ARIZ. REV. STAT. §§ 44-1001 to -1013 (1956).
[62] 284 U.S. 4 (1931).
[63] MACLACHLAN, BANKRUPTCY § 284 (1956).
[64] *E.g.*, Collier—9 vols.; Remington—10 vols.
[65] *Supra* note 63.

B. *THE BUSINESS CRITERIA*[66]

Interim finance lending to a mortgage company is primarily commercial lending and the bank should not delude itself that the real estate security will carry it through in any case. This is to be particularly emphasized in construction lending. Like any commercial loan the bank will look in the first instance to the applicant's net worth, integrity, and ability.

The gradient of risk exposure runs from the ninety-day clearing loan secured by committed mortgages at the "safe" end, through the six-month collateral loan secured by uncommitted mortgages, and finally to the collateral loan for construction purposes at the volatile end. Since the construction loan includes the elements of risk common to other branches of interim financing plus some of its own, attention will be directed to it.

Two factors are found only within interim construction lending, and each contributes to making such lending a unique risk. These are cost exposure and sales market exposure. The mortgage company suffers the initial blows under both, but whenever the mortgage company's position is weaked the interim financing bank's position is weakened *pro tanto.*

Cost exposure is the greatest risk in construction lending. Causal elements can be such things as mis-estimates and costs unforeseen by builder, rapidly rising building costs, and diversion of ear-marked funds by builder to other projects. Once the first construction advance is made the lender is *in* and if, due to any of these elements, the builder is unable to complete with the loan funds assigned, the burden to complete falls back onto the lender. There is no alternative but to finish up the project if the loan funds are ever to be unlocked. It is difficult to imagine a whiter elephant than a row of half-built houses.

Up till now, the construction loan exposure implicit in a builder's inventory of unsold houses has been minimal, the reason being that market demand has been far greater than supply. The post World War II days of the automatic market, though, are over, although the Arizona market continues to enjoy a better position than the nationwide average. Today a construction lender can find himself in a locked funds predicament if the project has been badly designed or poorly located or priced too high.

The cumulative possibilities of cost exposure and sales market exposure scare many a commercial banker away from direct loans to

---

66 For much of this material the writer has drawn from a lecture given by King Upton, Vice President, First National Bank of Boston, before the School of Mortgage Banking on July 5, 1956; and from interviews with Mr. Upton and other bankers intimately engaged in interim financing.

builders. The same project need not frighten the banker when the mortgage company interposes itself and petitions the banker for interim financing. What particulars should the bank consider?

First, and of vital importance, the net worth, management abilities and integrity of the mortgage company. The lender will realize, also, that the mortgage company's construction loan business shows in a much better light if three builders have borrowed a total of $1,000,000 for three projects, than if the $1,000,000 is marked for one builder on one project.

Second, the builder's net worth, reputation and past record. Since a small builder's net worth can change profoundly with every project, a financial statement is of little use unless very new.

Third, project cost information. To be of any utility an estimate must be detailed and complete, and the builder should be able to defend each item.

Fourth, market conditions for housing and whether, in view of design, location, and price, the units are likely to move easily. If a firm market does not seem likely then the loan should not be given unless the lender has the benefit of FHA dual commitments.[67] If the market looks good and it is decided to go in without FHA dual commitments, Mr. Upton[68] suggests 66 per cent of the Certificate of Reasonable Value as the maximum loan, in order to keep builder tied into the project.

Fifth, guaranties. If the builder is incorporated, personal liability of the principal stockholders should be assured by their individual indorsements of the note to mortgage company. Another vehicle to help guard against the spectre of a hollow corporate debtor is to take a pledge of the stock. Individual continuing guaranties form the mortgage company's principal owners are also items for consideration in light of the bank's leverage position.

Sixth, the form of mortgage commitments on the completed units—whether firm, standby, uncommitted. This looks beyond the construction stage but generally the interim construction loan will refund into the interim clearing loan to be given by the same bank, from which the bank must expect to be taken out by the permanent investor.

IV. *SYNTHESIS*

A collation of some of the materials covered to see how interim financing risks can be minimized seems the logical way to bring a broad examination of the topic toward a close. Because construction loan fi-

---

[67] Commitments to insure loans in names of individual owner-occupants plus commitment on loan in builder's name on unsold houses.
[68] *Supra* note 66.

nancing presents a maximum of exposures, legal as well as business, it will be made to serve as the prototype. Legal criteria will be emphasized since it is obvious that, given the relevant raw materials, responsibility should fall on bankers' shoulders to determine business exposures connected with a particular transaction and in general to divine the future of interim financing. At the same time it should come as no surprise to the lawyers to be told that their job of counselling in this broad field can be carried out more accurately and more realistically if they possess a background of business understanding. It is just such belief that has led to the inclusion of so much "non-legal" discussion and analysis in this paper.

The point was made earlier that the bank is in a position to dictate terms all the way down the line. Most especially is this true in a period of tight credit. Therefore, it should take care that the dealings between builder and mortgage company are rigorous.

The *sine qua non* is, of course, the mortgage. Builder's note and mortgage deed to mortgage company should be on an FHA or VA approved form. The deed must include a covenant by the mortgagor to insure against risk of loss from fire or other causes. By reason of a statute enacted in 1957 the mortgagor should be permitted the right to select his own insurance carriers.[69] Policies tendered by mortgagor in compliance with his covenant may be rejected as inadequate, but only if rejected in good faith.[70]

In the construction agreement between builder and mortgage company, executed contemporaneously with the mortgage, bank should insist on builder's covenant that no work will be commenced prior to recording of the mortgage[71] and written notification of same from mortgage company. Also, builder will covenant to carry the construction to completion in accordance wth FHA or VA regulations and state and local laws, and that on completion the premises will be free and clear of all liens save for the mortgage.[72]

Minimum provisions of the master agreement between mortgage company and bank would include some reference to title insurance. Since time in the construction lending field is at a premum a title binder or preliminary letter of opinion usually suffices to justify initial disburse-

---

[69] ARIZ. REV. STAT. § 20-452(1) (1956).
[70] Smith, *Mortgagor or Mortgagee—Whose Right to Insure?*, 1946 INS. L.J. 520.
[71] The title company will check carefully for compliance with this condition.
[72] The best check, upon completion, as to builder's compliance with his covenant to keep free of mechanics' liens is to direct that a waiver of lien be obtained from each laborer and materialman, although this is an understandably cumbersome task.

ments. It must show the mortgage to be a first lien on the property.[73]

Taking possession of a builder's note is a prerequisite to perfecting bank's lien on it. Additionally, a general pledge agreement should be taken from the mortgage company. It can serve indefinitely to spell out special terms of pledgings now and for the future. In it the mortgage company can warrant unencumbered ownership of the pledged paper. Bank can reserve the power to indorse instruments in the name of the pledgor. Bank should declare its power of sale without notice, by public or private means, in the event of stated defaults by pledgor, and that bank may buy in at such sale if it wishes.

Bank could request that an up-to-date "estoppel certificate"[74] be attached to the mortgage as a check on the representations of mortgage company. However, in the context of construction loan financing it is of limited value because at this stage little or no money has changed hands.

The assignment of the mortgage security must have the stature of a conveyance. The bank may decide not to record the assignment but it should realize that two legal risks are being run:

(a) Mortgage company could fraudulently discharge the mortgage as of record.

(b) Mortgage company could be declared bankrupt.

By the first eventuality liens subsequent to the mortgage will gain priority. Indeed, the mortgage may be totally divested if the mortgagor procured his discharge by giving consideration and in ignorance of bank's interest. By the second eventuality a rough-riding trustee in bankruptcy may be able to take the mortgage lien away from bank[75] and preserve it for the bankrupt's general estate.

This paper opened with the stated purpose to explore in breadth a new commercial banking form. In following the route of such ex-

---

[73] Title companies will frequently issue a final policy without listing exceptions for mechanics' and materialmen's liens even where construction commenced before the mortgage was recorded and the statutory period after completion of construction for filing notices of liens has not expired, and even though lien waivers have not been collected. This is done under indemnity agreements which are executed by the property owner and the general contractor in favor of the title company. For a sobering thought from a title insurance company president, see Henley, *What Investors in Mortgage Loans Are Demanding in Title Insurance*, Title News, May 1956, p. 9. He warns that if title insurance companies bow to pressures by construction lenders to issue policies "free and clear of statutory liens" they are leaving the realm of title insurance and in effect insuring against losses from future occurrences. And, he says, this may backfire against the lenders ultimately, considering how small many title insurance companies are.

[74] A statement signed by the mortgagor setting forth the interest rate and the state of accounts between him and the mortgagee as of given date. See 2 GLENN, MORTGAGES § 322 (1943).

[75] *E.g.*, as voidable preferential transfer.

ploration one discovers that it winds through the entire landscape of residential mortgage finance. Incomplete would be the effort to describe this scene in legal or banking or economic terms alone. All are needed and all have been utilized.

Economics tells us that interim financing activity is inextricably keyed to the housing and mortgage money markets. The law tells us that it is flexible enough in its existing state to provide for rigorous interim financing but it also warns of pitfalls not common to other forms of security transactions. And lastly, banking tells us that interim financing is fraught with unusual, even unique, business risks. These risks alone entitle banking to have the last word on the "care and feeding" of interim financing but there is another reason. Banking, after all, fathered the child.