REAL ESTATE IN A DOWN ECONOMY

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I. **INTRODUCTION**. The purpose of this paper is to discuss in very general terms how title to economically distressed real estate is transferred in a distressed economic environment along with the related risks. We will take a brief look at the state of the real estate market both locally and nationally. Then spend a few minutes discussing some basics of real estate law for purposes of having a more substantive conversation about the process through which distressed real estate is often transferred and some related risks.[1]

II. **STATE OF ECONOMY**. It is no secret that the collapse of the residential real estate market is evidence of the recent collapse in the general economy and that some feel it may be one of the major reasons for the economic collapse in the first place. In addition to the residential real estate crisis, many fear that commercial real estate may be the next shoe to drop.

III. **METHODS OF ACQUISITION OF DISTRESSED PROPERTY**. With distressed real property in a distressed market, there are three points in time at which property can be bought, before the foreclosure, through the foreclosure or after the foreclosure.

A. **Acquisition Pre-foreclosure**. With distressed property, an acquisition before the foreclosure is like any other purchase and sale transaction in that the purchaser will be buying the property from the original owner of the property, as compared to the lender or foreclosure purchaser. What distinguishes pre-foreclosure acquisition of distressed property from a more traditional real estate purchase is that the seller's lender and other creditors may play a significant role in how and whether the acquisition occurs. This is so because the original owner often times owes more than the property is currently worth. This situation is discussed in more detail below under the heading, short sales.

B. **Acquisition at Foreclosure Sale**. Once a property goes into foreclosure, it may be purchased by anyone at the time of the foreclosure sale. This method of acquisition and its inherent risks will be discussed in more detail below.

C. **Acquisition Post-foreclosure**. Distressed property can be purchased after a foreclosure sale in much the same way as property is purchased before a foreclosure sale. The difference of course is now the owner/seller is the person who was the high bidder at the foreclosure sale. Often times, that person is the lender. Again, this will be discussed in more detail below.

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[1] This paper focuses on certain real estate aspects of buying distressed property. There are other areas of the law that may have a significant impact on the purchase of distressed property such as bankruptcy law and tax law. This paper is not a how to guide. Likewise, this paper is not intended as legal advice on any particular matter or circumstance. An attorney should be consulted before buying distressed property.

IV. **WHAT IS A SHORT SALE**? A short sale is a pre-foreclosure sale in which the seller desires to sale the property for less than the seller owes to the seller's secured lenders. On the other hand, a secured lender is entitled to payment in full upon the sale of its real estate collateral if the lender's deed of trust contains a due on sale clause. Almost all deeds of trust contain due on sale clauses. As a result, if the seller desires to sale for less than the amount owed, then the seller will have to obtain the secured lender's consent to accept a "short payoff."

A short payoff is a bit of a misnomer because the lenders are often times being asked to accept a payment less than the amount owed in exchange for the release of the real estate collateral. If agreed to by the lender, this leaves the seller continuing to owe the lender the difference between the outstanding loan balance and the sale price. Assuming the lender will agree to a short payoff, then the seller will usually want to negotiate with the seller's secured lender for the release of seller from the balance.

That negotiation can derail a short sale if the seller refuses to sale unless the lender releases the seller. In addition, if there are multiple lenders, then the negotiations between the lenders on the split of the sales proceeds can also derail the sale. We will review an example of this below.

V. **NATURE OF A FORECLOSURE**. In North Carolina, there are 2 different types of foreclosures, a judicial foreclosure[2] and a power of sale foreclosure.[3] Almost all foreclosures in North Carolina are power of sale foreclosures. Accordingly, this paper will focus only on power of sale foreclosures.

In theory, all foreclosures start off with a borrower default, which is then followed by a demand for payment. The foreclosure process then follows.

The applicable foreclosure statutes require the lender to provide a 30 day letter in which the borrower (I will assume that the borrower and the land owner are the same person) is given notice that a default has occurred and the amount that is owed to pay off the loan, among other items. N.C.G.S. Section 45-21.16(c)(5a). The trustee will then file a Notice of Hearing which is served on the borrower and others as required by statute and the property is also usually posted with notice of the foreclosure, at least 20 days after service, there is a hearing before the clerk of court in the county in which the property is located. See N.C.G.S. Section 45-21.16(a). The clerk is charged with finding that six (6) things exist: (1) there is a valid debt of which the party seeking to foreclose is the holder, (2) there has been a default, (3) the lender/trustee has a right to foreclosure under the loan documents, (4) notice has been given as required by statute, (5) the underlying mortgage is not a home loan or, if the underlying mortgage is a home loan, that certain consumer protection requirements have been met including disclosure and notice requirements,[4] and (6) the sale is not barred because the debtor is an active military service

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[2] See Webster's Real Estate Law in North Carolina, Fifth Ed., Section 13-20 for a brief discussion of judicial foreclosures.

[3] See Article 2A of Chapter 34 of the North Carolina General Statutes for Sales under Power of Sale.

[4] This paper will focus on commercial real property, not residential real property. While examples in this paper and the related speech may include references to houses, the reader needs to be aware that there are numerous consumer protection issues related to the foreclosure of personal residences which are not being addressed in this paper and the

member. N.C.G.S. Section 21.16(d). After the hearing, the trustee can then file a notice of sale, post the same at the courthouse and mail a copy to the borrower and other persons designated by statute.

The foreclosure sale can then be held 20 days later subject to certain posting and publication requirements. N.C.G.S. Section 21.17. It is a public sale at which anyone can bid. The high bidder must make a deposit. There is then a 10 day upset bid period. N.C.G.S. Section 45-21.17. If an upset bid is made, then the 10 day upset period begins anew. After the 10 day upset period expires, the high bidder is obligated to pay the bid amount and the trustee is obligated to deliver title and disburse the sales proceeds as required by law.

It is important to understand that the lender is entitled to credit bid in an amount up to what the secured lender is owed. As a result, the secured lender is usually the high bidder.

VI. **ACQUISITION FROM LENDER**. If the secured lender is the high bidder, then title is transferred to the secured lender who then is the owner of the property. This is commonly referred to as real estate owned and referred to as REO or some similar acronym. The acquisition from a lender is like a traditional purchase. The major difference at this point is that the person that is selling the property is not an owner/occupier, may know very little about the property, may have very little business experience and may have very little authority to deal with the real estate except as specified in a company manual of general application to properties in multiple states. On the other hand, the person at the secured lender's office may be a local person with knowledge of the area, serious business experience and authority. This is where identifying the lender is very important.

VII. **RISKS OF ACQUISITION OF DISTRESSED PROPERTY**. The acquisition of distressed property carries with it all of the risks inherent in the acquisition of real estate plus many additional risks.

A. **Business Risks**.

1. Physical Inspections. In a traditional real estate transaction, the primary business issue is whether the property will serve its intended or desired purpose profitably. This risk is usually addressed by performing extensive due diligence during a free look period under the contract period. This may not be the case in the purchase of distressed property. While a pre-foreclosure or post-foreclosure purchase may include a due diligence period, a bidder at a foreclosure sale may not have had the opportunity to perform any significant physical due diligence prior to the foreclosure sale.

2. Representations and Warranties. In addition, in a traditional real estate transaction, the seller will usually provide representations and warranties about the property to help the buyer better address risks associated with the acquisition of the property. Again, this is often times not the case in the purchase of

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related speech. In addition, this paper focuses on the impact of the priority of mortgages foreclosed, not the actual foreclosure process.

distressed property. In a pre-foreclosure acquisition, the seller may be willing to give representations and warranties. But if the seller is in financial trouble, the seller may be willing to say anything to sell the property and what is a representation or warranty worth if the seller has no money or other assets to back up the representations and warranties? In a foreclosure, there will be no representations and warranties. In a post-foreclosure acquisition, the secured lender will make only very basic representations about its own authority, and will rarely make any representation as to the property. If any representation is made, then it is usually limited only to the period of actual physical possession of the property by the secured lender.

3. Waste. Often times, the physical custody of the property turns out to be a big issue in acquiring distressed property because the physical condition of the property may deteriorate or be intentionally damaged by the borrower during the foreclosure process.

B. **Legal Risks**. There are many legal risks in the acquisition of distressed property. Before the foreclosure, the buyer must be concerned with the possibility of contracting with someone who may file a petition in bankruptcy or who may have unknown creditors or partnership disputes lurking around in the background. Throughout the entire process, the buyer has the concern of understanding the contractual obligations with which the seller may have burdened the property especially if there may be a planned change in use. There is also the legal risk associated with competing priorities of liens and other parties who may have an interest in the seller's property or may want an interest in the seller's property because it may be one of the biggest assets of the seller, if not the only asset of seller, available for seller's creditors to try to recoup their losses against seller.

C. **Chaos—Jed and His Shotgun**. Someone once told me that all of the legal rights in the world don't do you any good in that single moment in time when you realize that the person with whom you are dealing does not respect the law. In another words, a legal right of access does you no good if a man is blocking your access with his pickup truck and a shot gun.

VIII. **HOW TO MITIGATE THE RISKS--DUE DILIGENCE**. The following is a list of due diligence items that buyers typically make inquiry of in an acquisition. If these items are not properly investigated, then the buyer should at least be aware of the risk.

A. **Classification of Property**. In looking at real estate it is important to categorize the property that you are looking at because the type of the property, the use of the property and who finances that type of property affects the required due diligence and may dictate the method of acquisition of the property.

1. By Property Type. Is the property residential or commercial?

2. By Use. Is the property raw land, single family residential, retail, industrial or multifamily?

3. By User. Is the property owner occupied or income producing?

4. By Lender. Has it been financed by a private financing, a local bank, a large multistate bank, or a nonrecourse lender?

B. **Physical Condition of Property**. This is obvious, but hard to address if the buyer does not have access to the improvements including, without limitation, the major mechanical systems, the roof, structural supports, floor and foundation as well as aesthetics. For example, consider the impact of finding out after the foreclosure that all of the copper wire has been stripped from the electrical system.

C. **Financial/Economic Condition of Property**. Are there any agreements that affect the property such as leases? If the value of the property depends on a rental stream of income, then this is imperative due diligence. These are typically not matters of public record. For example, consider the impact of not knowing rental rates, lease terms, use restrictions, use exclusives, and termination rights in a shopping center or office building.

D. **Legal Use/Zoning**. Are there private restrictions that limit the use of the property? Are there zoning limitations that limit the use of the property? Fortunately, these are typically matters of public information. However, there are always exceptions, such as use restrictions and exclusive uses in unrecorded leases.

E. **Environmental**. In the commercial context, this is a must. But again, this may be difficult to do without access to the improvements. Even without access to the improvements, a buyer may be able to obtain a very limited site assessment that would at least disclose matters of public record that may reveal the environmental condition of the property including whether the site was formerly the location of underground storage tanks or dry cleaners. Also a site assessment may reveal the environmental condition of the property that are not related to the improvements such as whether the site or adjoining sites had previously been used by businesses that might have a higher incidence of environmental contamination.

F. **Title**. In the purchase of distressed property this too is a must. From a title search, a buyer can learn if the seller is the actual owner of the real estate, what lenders have deeds of trust that encumber the property, and who else may have a record lien on the property. By expanding the scope of the public records search, it is also possible to determine with whom the seller may be in litigation and if that litigation is likely to impact title to the property. The good thing is that this is public information for which no authorization for inquiry is needed from the seller.

G. **Survey**. I always recommend a survey to buyers. A survey can reveal defects in title and other problems such as encroachments onto and off of the property as well as the location of encumbrances like easements that may restrict the future use of the property. The problem of course is that absent permission to access the property, a survey may not be performed.

IX. **FUNDAMENTALS OF TITLE**.

A. **The Basics**. To understand the legal complexities of purchasing distressed real estate, one must first understand several basic concepts about North Carolina real estate law.

1. Instruments of Conveyance. First, title is transferred in North Carolina in most situations by deed. There are three basic types of deeds in North Carolina as follows:

a) *General Warranty Deed*. In a general warranty deed, the grantor represents among other things that the grantor is the owner of the land being conveyed and that the grantor will defend title against anyone claiming an adverse interest in the land except for the matters of title expressly excepted in the deed. This deed is frequently used in the residential context and sometimes used in the commercial context, but not usually used in the foreclosure or post-foreclosure context.

b) *Special Warranty Deed*. In a special warranty deed, the grantor represents among other things that grantor has done nothing to impair the title that grantor received and grantor will defend the title against anyone purporting to claim an interest in the title through the grantor, as compared to a predecessor of grantor. This is what is typically used by lender's in the sale of REO property and is generally used in the commercial context.

c) *Nonwarranty Deed*. In a nonwarranty deed, the grantor makes no warranties express or implied. It is a bare conveyance of whatever title the grantor may have, if any, or in other words the property is conveyed AS-IS from a title perspective. As a practical matter, this also means that if the grantor does not have any interest in the property to convey, then the conveyance is a nullity and the grantee has no recourse against the grantor by virtue of the deed alone. This is what is typically used by a trustee in a foreclosure sale.

2. Perfection—Registration. North Carolina is a pure race state. So, in North Carolina, the only way to protect your interest in real property from the interest of others is to record your interest. NCGS Section 47-18(a). There is case law in North Carolina that goes on to say that no notice, no matter how full or formal will replace record notice. Lawing v. Jaynes, 285 N.C. 418, 206 S.E.2d 162 (1974). This means that even if someone has actual knowledge of your interest in the real property, that person can defeat your interest by recording that person's interest first. This is called winning the race to the courthouse. For example, if George owns whiteacre and transfers title to Hillary by deed and Hillary sticks the deed in her desk drawer and then a month later George transfers

whiteacre to Barry, then Barry can defeat Hillary's interest in whiteacre by recording his deed first.

3. Priority--The Race to the Courthouse. Often times the competing interests in real property are not mutually exclusive. For instance, George may own whiteacre, encumber whiteacre by granting an easement to Dick, grant a lien to Alan and convey title to Barry. None of these interests are necessarily mutually exclusive, it all depends on the recording order which in turn establishes priority. Hayes v. Ricard, 245 N.C. 687, 97 S.E.2d 105 (1957) [deed later dated but first registered defeats deed first dated but later registered]; Bourne v. Lay & Co., 264 NC 33, 140 S.E.2d 769 (1965) [grantee who registered deed before tenant's 10 year lease was registered had a superior right to the land even though grantee had actual knowledge of the lease]. Priority determines whose interest in property is superior and then whether items are, or may become, mutually exclusive and who wins when a conflict arises.

B. **Who is in the Race**? There are many different types of people that can have an interest in real property. Some of those are as follows:

1. Fee Owners
2. Easement Holders and other Nonpossessory Interest Holders
3. Secured Parties
4. Tenants. **May or may not have an interest of record**.
5. Contract lien holders. **May or may not have an interest of record**.
6. Judgment Holders.
7. Litigants.
8. Taxing Authorities.
9. Heirs. **May or may not have an interest of record.**

It is imperative to understand who these people are and whether any of them have an interest in the property in which the buyer is interested. It is also important to **RECOGNIZE** that there are **exceptions to our pure race statute** so that **some people have a hidden interest** in the property which may not be a matter of record. This of course is what makes life interesting.

C. **Ownership v. Quality of Title**. Many people like to look at title as an absolute. Does the seller own the real estate? For them the answer of yes or no is the end of the inquiry. However, ownership of title is only the beginning of the inquiry for there are many interests in real property that can affect the quality of title and thus the value of the real property. Some of those are as follows:

1. Easements appurtenant.
2. Easements of burden.
3. Restrictions.
    a) Use Restrictions.
    b) Architectural Restrictions.

c) Assessments and other financial obligations.

4. Liens, Judgments and similar encumbrances.

For example, it is obvious that a tract of land encumbered by a deed of trust is less valuable. However, how is the value of a tract of land affected if it is bisected by an easement that prohibits the construction of improvements within the easement or a restriction that limits use to a single use?

X. CASE STUDY AND OTHER EXAMPLES.

A. Background.

1. George owns a house, a nice white house, that he bought for $200,000 in 2000.

2. In 2000 George borrowed $160,000 from Local Bank to purchase the house.

3. In 2005, George's house had increased in value to $250,000 and like every red blooded American man, he decided that he needed, no in fact, he deserved a place of his own on which he could go for recreation and relaxation. So George obtained an equity line of credit from National Convention Bank for the difference between his house's value and his mortgage with Local Bank, approximately $100,000 at that time. George used the money together with other funds to buy 100 acres of farm land with a quaint farmhouse.

4. By 2008 George only owed $140,000 on his mortgage to Local Bank. But, in 2008, George lost his job. Luckily he had saved lots of money and was able to pay his mortgage for awhile. After many months of job searching George realized that he did not have any marketable skills, so he decided to write a book. Realizing that his book might not be ready for publication very quickly and that his savings would soon be depleted, George decided that he would just have to quit making his payments to Local Bank and National Convention Bank.

5. After many more months Local Bank informed George that he was in default and that foreclosure proceedings would be started immediately unless he paid Local Bank off in full. Several weeks later, National Convention Bank also sent George a notice that George's loan with them was in default and that if not paid in full, National Convention Bank would foreclose.

6. George immediately put his house, a nice white house, up for sale.

B. **The Short Sale**. As stated above, a short sale is a consensual sale by the pre-foreclosure owner for an amount less than the total debt that encumbers the real property being sold.

1. Shortly after George put his house on the market along came a man named Barry.

2. Barry really liked George's big white house.

3. In addition to Barry, there was a woman named Hillary who also liked George's house. She had lived in the neighborhood before and she felt she knew what George's white house was really worth.

4. Hillary made an offer of $150,000 for George's house with the condition that George be able to convey title at closing free of encumbrances including his existing mortgages.

5. Barry was busy trying to make sure he had enough money to buy the big white house and so had not submitted an offer before George accepted Hillary's offer.

6. Hillary's attorney Bill immediately contacted Local Bank and National Convention Bank for payoffs. The payoff for Local Bank was $138,000. The payoff for National Convention Bank was $100,000 as George had paid interest only since he obtained his equity line.

7. A recap of the numbers:

Value at time of first loan	$200,000
Value at time of second loan	$250,000
Value at time of default	?
Outstanding Debt at time of default	
Local Bank	$138,000
National Convention Bank	$100,000
Hillary's Offer	$150,000

8. Try as they might neither Bill, Hillary, nor George could get Local Bank and National Convention Bank to accept Hillary's $150,000 in any combination on which the banks would agree. The deal fell through.

9. Possible reasons for failure of offer:

a) Unable to find anyone at one or both lenders who would work with Hillary and George in a timely fashion; or

b) One or all of the banks, seller and buyer did not agree on the value of the white house.

c) Local Bank refused to accept anything less than a full payoff of $138,000 because Local Bank believed the white house was worth at least $138,000 and Local Bank believed it would have priority in a foreclosure. This would leave only $2,000 to pay the National Convention Bank.

d) National Convention Bank thought the white house was worth more than Hillary offered so they refused to accept a short payoff because National Convention Bank thought the house would bring more in foreclosure.

C. **The Foreclosure**. As stated above, a foreclosure is a remedy exercised by a secured lender after a borrower default in which the secured lender seeks to sell the real property and use the proceeds to satisfy the secured debt.

1. Basic rules.

a) A foreclosure cuts off the interest in the real property of all people with lower priority. N.C.G.S. 45-21.29A; Merchants' Bank & Trust Co. of Winston-Salem v. Watson, 187 N.C. 107, 121 S.E. 181 (1924) [City not entitled to receipt of foreclosure sales proceeds, but City's assessment which had a super priority lien remained lien on property after sale and disbursement of proceeds by trustee]; Cooper v. Smith, 24 Bankr. 19 (W.D.N.C. 1982) A lower priority means anyone whose interest in the real property was recorded later in time (with a few exceptions and assuming no subordination agreements have been entered into) to the interest of the person foreclosing.

b) Money flows down, not up, with money being paid to the foreclosing party first, with the excess funds paid to parties of lower priority in order of priority with the balance being paid to the borrower if anything is left. Merchants, 187 N.C. 107, 121 S.E. 181. This is because the person whose interest is wiped out by the foreclosure should be paid to the extent there are funds available after paying off those with senior priority when working your way down from the person who holds the lien that is being foreclosed. People with liens superior in priority to the foreclosed lien do not receive any of the proceeds because their liens remain intact after the foreclosure sale.

c) Nothing is simple because there are always exceptions.

2. Example--Foreclosure of deed of trust where there is only one deed of trust. Assume the Borrower owns a house worth $200,000 and owes $150,000 to First Bank who recorded its deed of trust and there are no other encumbrances of

title . The Borrower defaults and First Bank forecloses. The property is sold for $175,000 at foreclosure. The proceeds are paid first to First Bank in the amount of $150,000 with the balance of $25,000 being paid to the Borrower.

3. Example—Foreclosure of second lien deed of trust where there are 2 deeds of trust. Assume that the Borrower owns a house worth $200,000 and owes $150,000 to First Bank who recorded its deed of trust first, the Borrower owes $25,000 to Second Bank who recorded its deed of trust second and there are no other encumbrances of title. The property is sold for $35,000. The proceeds are paid first to Second Bank in the amount of $25,000 with the balance of $10,000 being paid to the Borrower. The high bidder at the foreclosure sale takes title subject to the $150,000 First Bank deed of trust.

4. Example—Foreclosure with deed of trust and judgment.

a) *Basic Rule*.

(1) A judgment is a lien on real estate owned by the judgment debtor at the time of the entry of the judgment or acquired by the judgment debtor thereafter. N.C.G.S. Section 1-233 and 234.

(2) A judgment has priority from the date of entry except with respect to after acquired property which has a priority from the date of acquisition of the after acquired property. Moore v. Jordan, 117 N.C. 86, 23 S.E. 259 (1895).

(3) Again, nothing is simple because there are exceptions to these rules such as the doctrine of instantaneous seisin which will be discussed below.

b) *Deed of trust with subsequent judgment*. Assume that the Borrower owns a house worth $200,000 and owes $150,000 to First Bank secured by a recorded deed of trust. After recordation of the First Bank deed of trust, Judgment Lienholder sues and wins a verdict against the Borrower in the amount of $25,000. The Borrower defaults on the loan to First Bank who then forecloses. At foreclosure the property is sold for $185,000. The foreclosure wipes out the lien of Judgment Lienholder in the real property. The proceeds are paid first to First Bank in the amount of $150,000, second to Judgment Lienholder in the amount of $25,000 with the balance of $10,000 paid to the Borrower.

c) *Deed of trust with prior judgment*. Now let's assume the same facts in (b) above except that the judgment is entered before the deed of trust to First Bank is recorded. First Bank forecloses. The property is sold for $185,000. The proceeds are paid first to First Bank in the amount of $150,000, with the balance of $35,000 being paid to the Borrower. The

high bidder at the sale takes title from the trustee subject to the $25,000 judgment lien of Judgment Lienholder.

5. Case Study Example Continued - George, Hillary, Barry and the White House. Let's go back to our friends George, Hillary, and Barry and their pursuit of George's white house.

a) Ultimately Local Bank foreclosed with the help of its attorney Hank.

b) Barry had finally gotten his funds together, $5 here and $10 there. Hillary had fallen on hard times and could not complete her bid for the white house.

c) Confident of the value of the white house, Barry paid $139,000 at the foreclosure sale. He was the high bidder and Local Bank transferred title to Barry 10 days later.

d) National Convention Bank was wiped out.

e) Barry was the happiest man alive, his own white house. He quickly moved in and started fixing things just the way he liked them.

f) One day a man named Ben sent Barry a letter letting him know that George owed Ben's predecessor Alan over $300,000 for some business ventures that went bad and that debt was evidenced by a judgment that had been entered of record in 1999 and which had been renewed last year for another 10 years.

g) Barry had spent all that he had to buy the white house and to fix it up. Ben executed on his judgment and took the white house from Barry.

6. Case Study Example Continued - Raw Land. As discussed above, the classification of the property can have an impact on the issues in buying distressed property and how those issues play out.

a) *Background*.

(1) George owned 100 acres of undeveloped farm land that he used for recreation. The farm land had substantial road frontage and easy access to the highway which it abuts, it also had access on the rear side of the farm along a private road to another state road that crossed several creeks and otherwise difficult terrain. That rear access put you in the country far from anywhere. George had purchased the farm land in 2005 by using $100,000 from his equity line as a down payment plus another $100,000 from his personal

savings and borrowed the balance of $800,000 from Local Land Bank.

(2) After closing, George was approached by Donald who wanted to buy the front 20 acres of George's farm to build a life style center which would include shopping, offices and residential uses. Donald had already engaged an architectural and engineering firm who had run preliminary plans for the site.

(3) George agreed to sell to Donald with the understanding that he would have a right to use the center's driveways to access the highway which his farm now abuts. Donald agreed to include an access easement in the declaration of covenants, conditions and restrictions at closing, but George would have to provide a survey with the division of the 20 acres from the farm. George agreed.

(4) George knew he wanted to use a portion of the sales proceeds to remodel his house, so George hired Brownie, a good friend, to act as general contractor so George could have a turnkey job. Part of George's agreement with Brownie was that Brownie would handle the survey lumped in with the rest of the work. Brownie agreed.

(5) At closing, Donald paid George $400,000 for the 20 acres. Local Land Bank agreed to release its lien in exchange for a principal payment of $200,000 leaving a balance owing to Local Land Bank of $600,000.

(6) George used the remaining $200,000 to trick out his tractor, buy a new pickup truck and to remodel his farm house. The contract for the remodel job, including the survey, was to cost $150,000.

(7) At closing, Donald obtained a $20,000,000 development and construction loan from Development Bank to build the life style center and immediately after closing, entered into a contract on the day of closing with a general contractor who started work that day. Donald continued forward with his architect for finalizing the plans and specifications for the life style center as well as supervision of the development and construction of the life style center.

(8) Everything went along fine, Brownie got the survey done and started on the remodel job, Donald closed on the 20 acres and his $20,000,000 loan and started on the development and construction of the life style center.

(9) The transaction documents were recorded at closing including the Local Land Bank release deed, the deed from George to Donald and the Development Bank deed of trust. The Declaration including the access easement was recorded several days after closing.

(10) But then the economy crashed, George defaulted on his loan from Local Land Bank and Donald defaulted on his loan from Development Bank. Brownie had not yet finished the remodel and was still owed more than $90,000 by George when the economy collapsed and George stopped paying. Donald defaulted on his agreement with his general contractor to whom he owes $2,500,000 and the architect to whom he owes $125,000.

b) *Contractor and Materialmen Liens*. As mentioned above, there are many people who may obtain an interest in real estate such as the contractors and suppliers and in some instances those liens may not be readily apparent.

(1) *The Basic Rule*.

(a) A contractor or supplier has a statutory lien right that arises at the time of contract for the provision of material or labor for the improvement of real property. N.C.G.S. Section 44A-8; N.C.G.S. Section 44A-11; N.C.G.S. Section 44A-12.[5]

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[5] A contractor has "a right to file a claim of lien on real property on the real property to secure payment of all debts owing for labor done or professional design or surveying services or material furnished or equipment rented pursuant to the contract." NCGS Section 44A-8. There must be a contract, either express or implied. And the lien arises only for work done or material furnished. As a result, the lien is for sums owing for work done, not lost profits. W.H. Dail Plumbing, Inc. v. Roger Baker & Associates, 78 N.C. App. 664, 338 S.E. 2d 135, cert. denied, 316 N.C. 731, 345 S.E.2d 398 (1986). A distinction must be drawn between one who contracts directly with the owner of the real property (i.e. a contractor) and one who does not (i.e. a subcontractor): (1) Contractor. The lien rights on the real property of an owner arises for a contractor upon the first furnishing of labor or materials and is perfected by the filing of a claim of lien on real property. NCGS Section 44A-8; NCGS Section 44A-11; NCGS Section 44A-12. It is an inchoate right until perfected. Frank H. Conner Co. v. Spanish Inns Charlotte, Ltd., 294 NC 661, 242 S.E.2d 785 (1978). (2) Subcontractors. The lien rights of subcontractors in real property are dependent upon the subcontractors first having a lien on funds. NCGS Section 44A-20(b) and (d); NCGS Section 44A-23. Unlike the contractor's lien right under NCGS Section 44A-8 which is an inchoate lien right arising upon first furnishing of labor or material, the lien rights of subcontractors in real property requires the prior filing of the statutory notice to protect

(b) This lien runs in favor of some people like architects and engineers that may do not be discernible from a physical inspection of the property. See N.C.G.S. Section 44A-7(1).

(c) To perfect the lien, a notice of lien must be filed within 120 days of the date of last performance and an enforcement action must be filed within 180 days of the date of last performance. N.C.G.S. Section 44A-12(b); N.C.G.S. Section 13(c).

(d) The **lien** has a priority that **relates back in time** to the **date of first performance**. N.C.G.S. Section 44A-10.

(2) *Example—Foreclosure of Deed of Trust with contractor's lien*. Assume the Borrower owns a piece of land worth $100,000, entered into a contract for $45,000 with architect and engineer to design plans for construction of a building and to supervise construction throughout the construction of the building, the borrower then obtained a loan from First Bank, who after performing a title search to make sure there were no recorded liens, loaned $250,000 to the Borrower to build a building and First Bank recorded its deeds of trust. The Borrower then enters into a contract with a general contractor to build the building. When the project is complete, the Borrower defaults on the contract with the architect, the loan from First Bank, and the contract with the general contractor. First Bank immediately forecloses. During the foreclosure process, the architect files a claim of lien and starts an enforcement action for $25,000 for its unpaid fee for work performed and the general contractor files a claim of lien and starts an enforcement action for $75,000 for its unpaid fee for work performed. At the foreclosure, the high bidder pays $275,000 for the property. The proceeds are paid first to First Bank in the amount of $250,000 with the balance of $25,000 being paid to the general contractor. The lien of the general contractor is wiped out. The high bidder takes title subject to the lien rights of the architect including the $25,000 lien.

(3) Consider how the result would have been different if the architect had not yet filed its lien claim? Would a purchaser at the foreclosure know about the lien when the purchaser calculated its bid amount?

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the subcontractors from having funds received avoided in bankruptcy. Precision Walls, Inc. v. Crampton, 196 Bankr. 299 (E.D.N.C. 1996).

(4) *Example—Foreclosure of Purchase Money Deed of Trust with Contractor's Lien, because every rule needs an exception*.

(a) Doctrine of Instantaneous Seisin. The doctrine of instantaneous seisin rests on the principle that a lender who funds the acquisition price of land should have a deed of trust with a priority superior to other liens in exchange for advancing the funds that enabled the purchaser to acquire the land. Smith Builders Supply Inc. v. Rivenbark, 231 N.C. 213, 56 S.E.2d 431 (1949); See also Carolina Builders Corp. v. Howard Veasey Homes, Inc., 72 N.C. App. 224, 232, .E.2d 626, 631, denied, 313 N.C. 597, 330 S.E.2d 606 (1985). If the purchase money lender secures its purchase money loan as well as additional funds with the same deed of trust, then, in establishing the priority of the deed of trust, the deed of trust should be able to take advantage of the doctrine of instantaneous seisin only to the extent of the funds advanced for the purchase price. Dalton Moran Shook Inc. V. Pitt Development Company, 113 N.C. App. 707, 440 S.E.2d 585 (1994) [Contractor's prior lien was subordinate to the lien of the lender's deed of trust under the doctrine of instantaneous seisin only to the extent of the purchase money, but not to the extent of any funds secured by the deed of trust which were used for any purpose other than purchase money].[6]

(b) Let's assume the facts are the same as above in X.C.6.b)(4)(b) except that the borrower was purchasing the land for $100,000 at closing and the loan from First Bank was for $350,000 which includes $100,000 for land acquisition and $250,000 for construction. With that change of facts, the Doctrine of Instantaneous Seisin comes into play to rearrange the priorities such that the architect will now be in a second position behind First Bank to the extent of the $100,000 of the purchase money loan by First Bank. First Bank will find the priority of its loan bifurcated so that the portion of the loan attributable to anything other than purchase money will have a priority after the architect.

[6] In Dalton, the developer/borrower contracted with contractor to perform engineering and architectural services on property prior to developer purchasing such property. Developer purchased property and executed a promissory note to bank in the amount of $7,718,000 secured by a deed of trust on the property. Bank disbursed $4,323,251.83 to developer for the purchase of the property. The deed of trust also secured additional obligatory advancements to the developer. The deed and the deed of trust securing the note were recorded simultaneously. Developer ultimately defaulted on its loan obligation and the bank began foreclosure proceedings. Contractor then filed a claim of lien on the property pursuant to N.C.G.S. Section 44A, Article 2, Part 1. Bank then foreclosed on the property and following the foreclosure the contractor filed an action to enforce its claim of lien.

c) *Raw Land example continued*. Returning to our Raw Land example from X.C.6(a) above, what happened when the economy crashed? It all goes back to the priority rules that we discussed.

(1) Local Land Bank has a first priority on the 80 acres left of the original farm.

(2) Assume Brownie timely filed his claim of lien, thus perfecting Brownie's lien for his $90,000 that relates back in time before the recording of the Development Bank deed of trust. The architect likewise timely filed the architect's claim of lien for $125,000 that relates back in time before the recording of the Development Bank deed of trust. The general contractor timely filed his lien for $2,500,000 that relates back in time to a period after closing and the recording of the Development Bank deed of trust. The Doctrine of Instantaneous Seisin comes into play here. Since Brownie was engaged by George before the sale, the Doctrine has no application to Brownie because George was the seller, not the purchaser. However, the Doctrine of Instantaneous Seisin does affect Donald's architect because Donald's architect was engaged by the purchaser, Donald. So, even though Donald's architect's lien relates back in time to a date before the purchase, the lien of Development Bank is superior to that of Donald's architect because of the application of the Doctrine of Instantaneous Seisin. The lien of Donald's general contractor is also junior to the lien of Development Bank because Donald's general contractor's lien relates back in time to a time subsequent to the recording of the Development Bank Deed of Trust.

(3) Above, I indicated that Local Land Bank had priority as to the 80 acres of the original farm. Perhaps the biggest loser in this scenario however could be Local Land Bank based on when the access easement was recorded relative to the deed of trust of Development Bank. The access rights of Local Land Bank will be subject to the lien rights of Development Bank, Donald's architect, Donald's general contractor and Brownie. The cost to Local Land Bank to pay off one or more of Development Bank, Donald's architect, Donald's general contractor and Brownie for the purpose of repairing title to protect access may far exceed the value of the land to Local Land Bank. On the other hand, while Development Bank is subject to the lien of Brownie, Development Bank is not subject to the lien of Donald's general contractor or architect and is prior to the access agreement, which puts Development Bank and Local Land Bank in much different positions.

7. Buyer Beware. A purchaser at a foreclosure sale must understand all of the above and more to avoid getting caught short after becoming the high bidder at the foreclosure sale **because the rights of the high bidder are established by the priority of the deed of trust foreclosed and through which the high bidder takes priority.**

D. **The Post-foreclosure Acquisition of Real Property**. As stated above, these types of acquisitions are similar to traditional real property acquisitions. The major difference is that they follow the economic downfall of the borrower. To properly value a property post-foreclosure, one must understand what liabilities have attached to the property throughout the economic downfall of the borrower as well as how the foreclosure can cure title defects or complicate the realization of value from real property. The important point to remember here is that questions of title really are more than who owns the property. It is more of a question of quality of title which affects value.

XI. **CONCLUSION**. The acquisition of distressed real property requires the same due diligence as in the traditional acquisition of real property plus added sensitivity to matters of title as well as a heightened awareness of the risks associated with limited due diligence. The buyer who recognizes and addresses these issues is more likely to avoid the pitfalls of ownership than their predecessor in title.