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Pitfalls Involving Owner Financing of Residential Property in Texas

BY MARTIN CAMP

Owner financing can benefit both parties. Sellers can realize a higher rate of return and buyers gain access to financing not available conventionally. Because of the home mortgage crisis and housing collapse, access to conventional mortgage financing has become more restricted and more highly regulated. Unaware sellers may find themselves subject to unintended liability for failure to correctly navigate these more dangerous waters.

Federal and state legislation designed to protect borrowers from predatory lending has made the seller financing more complicated and difficult. Three laws in particular affect owner financing: (i) Chapter 5 of the Texas Property Code governing installment sales; (ii) the S.A.F.E. federal act and the T.S.A.F.E. Texas version, requiring sellers to have a mortgage loan origination license if they are selling non-homestead property to other than family members; and (iii) the Dodd-Frank Act which overlaps the S.A.F.E. Act imposing obligations on seller/lenders to ascertain that the buyer/borrower has the ability to repay the loan prior to lending.

Traditional seller financing, like third party financing, involves a note and deed of trust. Sellers transfer title to the buyer secured by this lien. Sellers also have an implied vendor's lien which can become an express lien, if it is included in the deed. Vendor's liens must be judicially foreclosed. Prudent sellers will insist on both a deed and trust and reserved express vendor's lien.

In installment sales contracts (contracts for deed), the seller retains title until the buyer has completed payment of the sales price, sometimes after many years. Rather than foreclosing on a lien, traditionally the seller was able to terminate the contract for buyer default and terminate the buyer's right to possession. Chapter 5 of the Texas Property Code imposes significant burdens upon sellers desiring to use installment sales contracts. Sellers have multiple disclosure obligations. After payment by the buyer of a certain percentage of the sales price, or making the requisite number of payments, the contract is essentially treated like a mortgage. It must be foreclosed upon in the event of a default. This preserves the buyer's right to his equity. Failure to strictly comply with this section can result in significant penalties for the seller. A close review of this complicated Chapter together with properly drafted contract forms and compliance regimens is mandatory to avoid costly violations.

Leasing with an option to purchase, including partial credit for lease payments, is another seller financing method. Sellers need to understand that courts will look at the substance over form. When treated as a financing, these might be subject to aggregation with other financings to meet the annual transactions figures requiring mortgage broker licensing discussed below. Use of wraparound mortgages and land trusts are other financings that could trigger compliance issues.

A seller involved in more than five qualifying financings in a year may be subject to the licensing requirements of S.A.F.E and T.S.A.F.E. Persons involved in more than five transactions can engage an intermediary (RMLO) to act as their agent to satisfy this requirement. There are many companies now offering these services for a reasonable fee.

Regulations promulgated by the Consumer Finance Protection Board (CFPB) under Dodd/Frank require creditors not to make covered loans unless the creditor has made a good faith determination that the consumer can pay in accordance with its terms. The list of factors that must be considered includes income, credit history, other debt, etc. There is a de minimus exception for persons who are not in the building business and engage in three or less transactions in a year. Non-conventional loan terms can create problems under Dodd/Frank when applying these factors. Balloon payments, for example, must be scrutinized closely. The bottom line is that to comply, the lender must be able, based upon verified documented information, to determine that the borrower has the ability to repay (ATR). Once again, use of a RMLO can assist with this determination.

Sellers intending to use owner financing on a regular basis should carefully review the various regulatory schemes to avoid inadvertent violations that can result in severe consequences. **HN**

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