Pitfalls Involving Owner Financing of Residential Property in Texas

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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 significant burdens upon sellers desiring to use installment sales contracts. Sellers have multiple disclosure obligations. After payment disclosure 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.

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 disclosure 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.

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.

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